

TOPIC 2 - OVERVIEW

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1. SECURITIES AND FUTURES (FINANCIAL RESOURCES) RULES

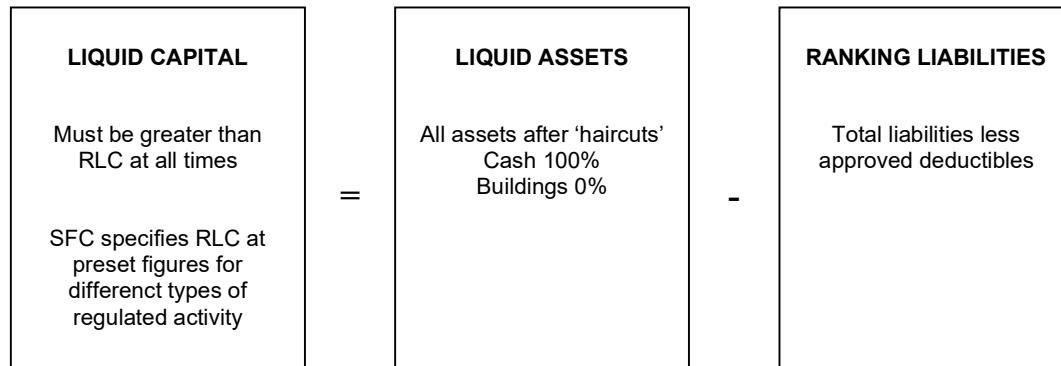
- When looking at the **fitness and propriety** of a licensed corporation, the first criterion is **financial status**. The regulator must be satisfied that a licensed corporation has enough capital to:
 - Support the level of business activities
 - Be able to pay debts as they fall due
 - Provide a financial buffer in times of sudden market volatility
- Minimum capital levels required by **registered institutions** are set by the **HKMA**, not the SFC, and are therefore not examinable
- Minimum capital levels required by **licensed corporations** are set by the **SFC** through the **Securities and Futures (Financial Resources) Rules (FRR)**
- The FRR are designed to enable the SFC to make timely assessment of the solvency of licensed corporation and accurate assessment of the risks involved in any licensed corporation's regulated activities.

1.1 Financial Resources Requirements

- A licensed corporation must meet the requirements before obtaining a license and continue to maintain sufficient capital at all times.
- The required level of paid-up share capital for a licensed corporation is:

Dealing in securities:	
➤ where it provides securities margin financing	HK\$10 million
➤ others	HK\$5 million
Advising on securities (except if client assets not held)	HK\$5 million
Securities margin financing	HK\$10 million

- If a corporation is licensed for more than one activity, the capital requirement will be the highest amount for all such activities.
- Approved introducing agents and securities advisers not holding client assets do not have paid-up share capital requirements



- A licensed corporation must maintain at all times minimum LC as follows:

Dealing in securities (there are additional requirements for SEHK participants)	HK\$3 million
Advising on securities:	
➤ where it does not hold client assets	HK\$100,000
➤ where it holds client assets	HK\$3 million
Securities margin financing	HK\$3 million

- A licensed corporation must have an **adequate amount of liquid assets to meet its liabilities**. To extract the relevant liquidity information, the regulator requires **balance sheets to be prepared or adjusted on specified bases**:
 - In accordance with generally accepted accounting principles
 - Substance of transactions to be reported
 - Items to be calculated on trade dates, not settlement dates
 - Liabilities not on the balance sheet to be included

1.2 Liquid Assets

- These are assets that can be quickly converted into cash.
- Certain assets cannot be included as liquid assets of a licensed corporation. For example:
 - Assets it owns, but which it has provided to others as security for its liabilities or obligations
 - Assets held in foreign currency that are not freely remittable to Hong Kong
- The following are examples of assets that can be included:
 - Cash in and at bank
 - Amounts receivable from clients for the purchase of securities on a cash against delivery basis
 - Amounts receivable from providing SMF
 - Shares the corporation owns (after relevant “haircut”)
 - Amounts receivable from clearing houses
 - Fees, commissions, rebates and interest that will be billed in the next three months
 - Cash provided as security for short selling if the securities have not been delivered to the counterparty for settlement
 - Deposits maintained with HKEx as security for stamp duty or contract notes liabilities
 - Prepaid operating expenses
 - Tax reserve certificates issued by the Commissioner of Inland Revenue
 - Dividends receivable on shares it beneficially owns

1.3 Ranking Liabilities

- In principle, most liabilities of the licensed corporation must be included for the calculation of ranking liabilities. For example:
 - Amounts payable to clients, counterparties and clearing houses
 - Net amounts payable to other corporations providing SMF
 - Aggregate value of cash and securities pledged as collateral for stock lending
 - Market value of securities which it holds on its own account in short position
 - Overdrafts and loans
 - Provisions for contingent liabilities
- The SFC has the power to grant modifications or waivers for compliance with specific provisions in the FRR.

1.4 Reporting Requirements

Monthly Returns

- A licensed corporation must submit monthly returns within 3 weeks of the month-end. Examples of items to be included are:
 - a liquid capital computation
 - a RLC computation
 - analysis of margin clients
 - analysis of collateral from margin clients
 - a summary of bank loans and other credit facilities
 - an analysis of client assets

Quarterly Returns

- A licensed corporation must submit within 3 weeks of each quarter-end:
 - an analysis of its clients; and
 - an analysis of its proprietary derivative positions.

Six-monthly Returns

- Advisers (Type 4 activity) that do not hold client assets are only required to submit financial returns semi-annually (June and December). These must be submitted within 3 weeks of the end of each period and include:
 - a liquid capital computation
 - a required liquid capital computation;
 - a profit and loss account; and
 - an analysis of clientele
- **A licensed corporation must notify the SFC in writing if:**
 - its LC falls below 120% of the RLC;
 - its LC falls below the RLC (see below);
 - its LC falls below 50% of the last LC reported;
 - its LC would fall below the RLC if it did not rely on a subordinated loan approved by the SFC;
 - its paid up share capital falls below that required,
 - the information submitted in any earlier return is, or has become, materially misleading;
 - there are breaches of concentration rules for a securities margin financier; or
 - a material change to accounting policy occurs

1.5 Failure to Meet Financial Resources Requirements

- A licensed corporation that cannot meet the LC requirements must notify the SFC promptly and must cease trading unless permitted by SFC to continue.
- The SFC has the power to require a licensed corporation to report its financial position at any time.
- Failure to comply with the requirements, without reasonable excuse, is a criminal offence. A breach with intent to defraud carries a maximum sentence of HK\$1 million and seven years' imprisonment.

2. SECURITIES AND FUTURES (CLIENT SECURITIES) RULES

- The Securities and Futures (Client Securities) Rules apply to all intermediaries and associated entities.
- The Client Securities Rules apply to client securities or securities collateral of an intermediary that are:
 - listed on a recognized stock market (ie SEHK);
 - interests in an SFC authorized CIS; and
 - received or held in Hong Kong by an intermediary (or its associated entity) in the course of conducting a regulated activity
- The Client Securities Rules **do not apply** to securities of an intermediary **in an account in a client's name**, set up by that client with persons other than the intermediary or its associated entity:
[Rules only apply to Hong Kong stocks held in Hong Kong received by an intermediary or associated entity in the course of conducting regulated activities]
- Securities held for professional investors are covered by the Rules.

2.1 Requirements for Registration or Deposit of Securities

- The intermediary shall, **as soon as reasonably practicable** after receiving the assets, deal with them as follows:
 - If a deposit is to be made it must be with one of the following:
 - an authorized financial institution;
 - an approved custodian; or
 - another intermediary licensed for dealing in securities

NB: Trust companies are excluded from this list

- The assets should be kept in safe custody in **separate segregated accounts** for each category (client securities and securities collateral), designated as trust accounts or client accounts or in the case of securities collateral only, it may be held in the name of the intermediary
- If registered it must be done in the name of:
 - the client;
 - an associated entity of the intermediary; or
 - the intermediary itself (only permitted in the case of securities collateral)

2.2 Client Authority

- An intermediary must obtain one of the following from the client before it can withdraw or deal with the securities in the segregated account:
 - A specific client direction – special instruction for the intermediary to act in a certain manner in relation to a specific amount of client securities
 - A standing authority:
 - This is a written notice authorizing the intermediary to deal with client assets as specified
 - The effective period specified in the authority cannot exceed 12 months but it may be renewed on the written request of the client (or deemed to be renewed after giving 14 days notice to the client) at any time prior to expiry for further periods each not exceeding 12 months
 - A deemed renewal must be confirmed by the intermediary within a week after expiry
 - No time limit for renewal applies to Professional Investors

2.3 Handling of Client Securities and Securities Collateral

- The intermediary or its AE is not allowed to use the standing authority to:
 - transfer client assets to the intermediary, its AE or any entity which has a controlling relationship with the intermediary or its AE;
 - make any such transfer to any officer or employee of these entities; or
 - deal with the client assets in any unconscionable manner (contrary to a sense of justice, decency and reasonableness)
- The rules do allow, with the specific direction of the client, for:
 - the withdrawal of client securities to sell or settle a sale order on his behalf; or
 - the disposal of client securities or securities collateral, in settlement of a liability of the client to the intermediary, associated entity or a third person
- A Type 1 intermediary or its AE, with a standing authority to do so, may:
 - use client securities or securities collateral for a stock borrowing and lending transaction
 - deposit the same with a recognized clearing house or another Type 1 intermediary as collateral for settlement obligations
 - re-pledge the securities collateral (but not client securities) with an AFI to borrow money
- If the aggregate market value of the re-pledged securities collateral exceeds 140% of the margin loan value, the intermediary must reduce the value to below 140% by the next business day

2.4 Penalties

- Failure to comply with the Client Securities Rules with an intent to defraud carries a maximum sentence of a HK\$1m fine and 7 years imprisonment

3. SECURITIES AND FUTURES (CLIENT MONEY) RULES

- The Client Money Rules prescribe how **licensed corporations and their associated entities** should deal with client money received or held in **Hong Kong**

3.1 The Rules

- The Rules do **not** apply to client money that:
 - Is received or held **outside** Hong Kong
 - Is moved outside Hong Kong
 - Is held in a bank account by the client in his own name
- Client money to be safeguarded includes all amounts received by the licensed corporation or its associated entity, from or on behalf of clients, less amounts due from the clients and any proper charges due

3.2 Segregation of Client Money Received or Held in Hong Kong

- The licensed corporation/associated entity holding client money should have **one or more segregated accounts** (designated as a trust or a client account) **maintained with an AFI** or another SFC-approved person (ie open a separate bank account)
- **Within one business day** of receiving client money, the licensed corporation/associated entity should **pay the money**:
 - Into a segregated account;
 - To the client directly;
 - In accordance with a written direction; or
 - In accordance with a standing authority
- If any money held in a segregated account is found to be not client money, the licensed corporation or AE must move it out within one day of being aware of the fact.
- Client money to be safeguarded includes:
 - amounts received from securities dealing on behalf of a client:
 - less brokerage commission
 - except settlement amounts due to be paid within two business days
 - except amounts owed by a client to a licensed corporation

3.3 Payment of Money out of a Segregated Account

- **Money should be held in the segregated account** until payment has to be made
 - To the client
 - In accordance with a written direction
 - In accordance with a standing authority
 - To meet settlement or margin requirements
 - To meet amounts due from the client to the licensed corporation/associated entity
- Interest received on client money is due to the client unless otherwise agreed in writing

3.4 Penalties

- As per other Rules

4. SECURITIES AND FUTURES (CONTRACT NOTES, STATEMENTS OF ACCOUNT AND RECEIPTS) RULES

4.1 Requirements

- All intermediaries conducting the business of:
 - dealing in securities
 - securities borrowing and lending
 - margin financing
 - advising on securities
 - conducting margined transactions (any transactions for which the intermediaries collect margins from their clients, e.g. dealing in options and short selling)

must provide to their clients (in either English or Chinese):

- contract notes
 - receipts for client assets received
 - monthly statements summarizing all activities in the client accounts
 - daily statements of financing arrangements and margined transactions
- The Contract Notes Rules relating to the provision of contract notes, statements of account and receipts to clients **do not apply to PIs**:
 - If PIs are **defined in the SFO** (see Topic 3), the intermediary has informed them in writing and the clients do not object
 - If PIs are **defined in the Professional Investor Rules** (see Topic 3), and the clients have agreed in writing not to receive these documents

4.2 Contract Notes

- A contract note must be issued whenever an intermediary buys or sell shares, including a transaction under a securities borrowing and lending agreement, for a client
- The intermediary must issue a contract note detailing a single transaction (or all transactions on the same day – unless the client instructs otherwise) to the client by the end of the second business day after the transaction (T+2).
- A contract note **must contain**:
 - Client's name and account number
 - Intermediary's trade name
 - Dates of contract and settlement
 - Full particulars of the contract
 - Commission payable
 - Charges and stamp duty
 - Notification if intermediary is acting as principal
 - Whether the account is a margin account

4.3 Daily Statements of Account

- A daily statement must be prepared:
 - By intermediaries providing securities margin finance and their associated entities when client assets are deposited or withdrawn
 - By intermediaries conducting margined transactions, both when the margined transaction is entered into, and when it is closed
- A daily statement must be issued to the client no later than the end of the second business day after the specified event

4.4 Monthly Statements of Account

- A monthly statement must be prepared by an intermediary for **all** clients
- Monthly statements will contain information broadly similar to that of the daily statement of account
- Information should also include:
 - All contracts entered into for the client during the month
 - Outstanding balances at the beginning and end of the month
 - All open positions held at the end of the month
- Monthly statements must be issued within **7 business days** of the end of each monthly accounting period
- No statement needed when no activity during the month and no balances at the end of the month

4.5 Receipts

- Receipts must be issued by an intermediary or an associated entity on receiving client assets/security **by the end of the next business day** after the day of receipt

4.6 Record Retention

- Contract notes, daily statements and receipts must be kept for a minimum of 2 years
- Monthly statements must be kept for a minimum of 7 years

4.7 Other Matters

- Only the client, or persons independent of the intermediary and designated by the client in writing, can receive documents for the client
- Employees or officers of a licensed corporation are not allowed to receive documents for their clients (no “hold mail” accounts)

5. SECURITIES AND FUTURES (KEEPING OF RECORDS) RULES

- The Keeping of Records Rules apply to intermediaries and their associated entities and are contained in the Securities and Futures (Keeping of Records) Rules

5.1 Application

- The Keeping of Records Rules:
 - Apply to intermediaries and their associated entities;
 - Apply to records required for regulated activities only; and
 - State that the records must be sufficient to produce financial statements

5.2 Records to be Kept by Intermediaries

- An intermediary must keep accounting, trading and other records in accordance with GAAP in sufficient detail to:
 - explain and reflect the financial position and operation of its business;
 - enable financial statements to be prepared from time to time;
 - enable it to readily establish whether the FRR have been complied with;
 - account for all client assets that it receives or holds*;
 - enable all movements of client assets to be traced through its systems*;
 - enable monthly reconciliations with external parties*;
 - demonstrate compliance with the client money and securities Rules*;
 - demonstrate that it has systems of control in place to ensure compliance with the Rules*; and
 - enable an audit to be conveniently and properly carried out*.
- * also required by associated entities – see below

5.3 Records to be Kept by Associated Entities

- An AE of an intermediary must, in respect of client assets of the intermediary, keep copies of all contracts, order forms, confirmations, statements and receipts.
- An AE must also keep sufficient records in accordance with GAAP to:
 - achieve items shown above*;
 - show separately and account for all receipts, payments, deliveries and other uses of client assets made by it; and
 - demonstrate that it has kept contracts with clients, agreements with PIs, and authority or specific directions from clients.

5.4 Records to be Kept by Securities Margin Financiers

- Securities margin financiers are intermediaries providing services related to short selling, securities borrowing and lending, financing and margined transactions.
- In addition to the requirements above, they must also keep records of:
 - margin policy/lending policy/margin call policy
 - all securities and client collateral deposited
 - quantity and market value of securities deposited for safe custody/collateral
 - for each client, market value of securities collateral and margin calls made

5.5 Other Issues

- The general rule is that all records should be kept for at least **7 years**, except for:
 - Daily statements of account – 2 years
 - Records documenting orders – 2 years
 - Copies of contract notes – 2 years
 - Documentary assurances for short sales – 1 year
- Records are to be kept in Chinese **or** English
- Non-compliance with Rules must notified to SFC in writing within one business day
- A breach of the Rules with an intention to defraud can carry a maximum penalty of HK\$1m and imprisonment of 7 years

6. SECURITIES AND FUTURES (ACCOUNTS AND AUDIT) RULES

- The Securities and Futures (Accounts and Audit) Rules are to allow an independent confirmation of a licensed corporation's financial statements, FRR compliance, and compliance with the rules governing client assets.
- The Rules do not apply to registered institutions or associated entities that are AFIs.

6.1 Accounts and Audit Requirements

- A licensed corporation and any associated entity are required to supply the SFC with the following information:
 - Within 1 month of becoming licensed, it must decide on its fiscal year-end (for an associated entity the deadline is within 1 month of becoming an associated entity)
 - Annual audited accounts prepared in accordance with GAAP (profit and loss account, balance sheet, notes to the accounts and audit report) must be submitted within 4 months of its financial year-end
 - Notification of employment of an auditor within 7 days after the appointment
 - Notification of the resignation/replacement of auditor within 1 business day
- A licensed intermediary (not an AFI) must also prepare and submit to the SFC for each financial year:
 - annual returns, including, for example
 - liquid capital calculations;
 - various analyses of borrowings and client accounts; and
 - an SFC business and risk management questionnaire.
- An associated entity (not an AFI) must prepare and submit to the SFC for each financial year, in addition to accounts:
 - an analysis of client assets as at the financial year-end; and
 - an SFC business and risk management questionnaire.

6.2 Auditor's Report

- The normal 'true and fair' opinion is required of the auditor regarding the profit & loss account and balance sheet
- In addition, the auditor is required to report on:
 - Accuracy of returns made under the FRR
 - Compliance with the FRR, Keeping of Records Rules, Client Securities Rules and Client Money Rules
- The audit report can be submitted in 2 parts: one containing the normal 'true and fair' opinion and another referring to other compliance matters

6.3 Auditor's Immunity

- An auditor communicating with the SFC with regard to a reportable matter, in good faith, will not be held to have breached any duty as an auditor
- A reportable matter for a licensed corporation is one which:
 - Is a failure to comply with any prescribed requirement
 - Adversely affects the financial position of the licensed corporation
 - Involves a breach of the FRR

7. COMPENSATION AND INSURANCE RULES

7.1 Compensation Scheme for Investors

- The SFO allows for investor compensation arrangements to compensate investors for losses arising from defaults of market intermediaries on account of insolvency and dishonesty. Relevant Rules are:
 - Securities and Futures (Investor Compensation – Levy) Rules
 - Securities and Futures (Investor Compensation – Claims) Rules
 - Securities and Futures (Investor Compensation – Compensation limits) Rules

7.1.1 Investor Compensation Fund Company (ICC)

- The body responsible for management and administration of the fund.
- An independent company recognized and regulated by the SFC.
- Both the seller and buyer of securities (some exemptions) traded on the SEHK have to pay a levy of 0.002% to the compensation fund (now suspended)
- Levy is collected by the SEHK on behalf of ICC
- The levy is waived when the net asset value of the Fund exceeds HK\$1.4 billion and reinstated when the Fund falls below HK\$1 billion

7.1.2 Permitted Claimants

- A claim may be made on the fund by a client of a covered intermediary who sustains a loss due to a default of the intermediary, with default defined as:
 - bankruptcy or winding up of the intermediary; or
 - any breach of trust, defalcation, fraud or misfeasance committed by the intermediary or its employees.
- The Scheme does not cover losses on A shares bought through the Shanghai-Hong Kong Stock Connect as a result of intermediary default
- Institutional investors are not entitled to claim compensation, only retail investors

7.1.3 Limits and Timing of Claim

- A maximum of HK\$150,000 may be awarded to one claimant for loss in securities trading.
- The same maximum exists for futures. An investor who suffers loss for both securities and futures trading with the same intermediary may be awarded a maximum of HK\$300,000.
- An aggrieved investor must lodge a claim before the deadline given in the claims notice published by the ICC.

7.2 Insurance for Intermediaries

- Under the SFO, the maintenance of insurance cover is a necessary condition for the granting of a license by the SFC
- The objective of the **Securities and Futures (Insurance) Rules** is to provide protective coverage for all intermediaries that control client assets and investors against infidelity events, errors or omissions on the part of the licensed corporation.
- Applies to licensed corporations (Type 1, 2 and 8) other than those with a licensing condition that they may not hold client assets and are not exchange participants
- **Master Policies:** the Rules provide that the SFC may approve master policies for insurance for specific regulated activities.
- The insurance should cover loss due to:
 - Fraudulent or dishonest acts of staff
 - Robbery or theft while assets are in custody of licensed corporations or AEs
 - Fraudulent use of an information system
 - Forged or fraudulent instructions relating to client assets
 - Forgery or fraudulent alteration of cheques or negotiable instruments

8. SECURITIES AND FUTURES (CONTRACTS LIMITS AND REPORTABLE POSITIONS) RULES

8.1 Background

- The CLRP Rules seek to **prevent/discourage the large build-up of derivative positions** that could adversely affect the orderly functioning and stability of HK's financial markets
- The CLRP Rules **apply to futures contracts/stock option contracts** listed in the CLRP Rules schedules and traded through the HKFE and the SEHK
- The CLRP Rules primarily operate by specifying:
 - reportable positions, being the **aggregate number of open positions in futures or stock options contracts** that have reached a certain level; and
 - **prescribed limits**, being limits on the aggregate number of futures or stock options contracts that are permitted to be held or controlled.
- The CLRP Rules **apply to any person who holds a relevant position in futures or stock options contracts**, whether or not such person is licensed by or registered with the SFC
- SFC has issued the **Guidance Note on Position Limits and Large Open Position Reporting Requirements** ("CLRP Guidelines").
- The CLRP Rules **have the force of law** and breaching them is a criminal offence that can result in the imposition of a fine of up to HK\$100,000 and/or imprisonment for up to 2 years
- On the other hand, the CLRP **Guidelines do not have the force of law** and primarily operate to inform market participants of the SFC's policy intent in relation to the CLRP Rules.

8.2 Where Position Held or Controlled for Another

- Where control arises only as a result of a corporate structure, such as a parent-subsidary relationship, in the absence of day-to-day directions being given, **the parent company would not be regarded as controlling any futures or stock options contracts** owned by its subsidiaries or affiliates.

8.3 Reportable Positions

- The person holding or controlling a reportable position **must report the position to the HKFE or SEHK**, according to the exchange on which the futures or stock options contract is traded
- The report must be **made in writing within one business day** of there being a reportable position, and each day thereafter for so long as the person continues to hold a reportable position, even if the position remains unchanged
- The reporting obligation will only cease once the position is **reduced to below the reporting level**
- The person holding or controlling a reportable position may also **appoint an agent** to make a report on its behalf, however, as the obligation to make the report is non-delegable such person bears the ultimate responsibility to satisfy the reporting obligation

- The report must contain **details of the futures or stock options contracts held and the identity of any person** that holds or controls the futures or stock options contracts.

8.4 Prescribed Limits

- **All futures or stock options contracts subject to the reporting requirement are also subject to position limits** that are higher than the respective reportable positions. To give **three examples**:
 - a person holding or controlling **a stock futures contract on shares listed on the SEHK** will be subject to a reporting obligation once they come to hold **1,000 open contracts** for any one contract month, and will be subject to a **prescribed position limit of 5,000 open contracts** for any one contract month
 - a person holding or controlling **HSI volatility index futures contracts** will be subject to a reporting obligation once they come to hold **1,000 open contracts** for any one contract month, and will be subject to a **prescribed position limit of 10,000 open contracts** for any one contract month;
 - a person holding or controlling **gold futures contracts** will be subject to a reporting obligation once they come to hold **500 open contracts**, however, **there is no prescribed position limit**
- Any person who **holds positions in excess of the position limits** prescribed in the CLRP Rules **commits an offence**, unless they have been given authorization to exceed the relevant limit
- Such **authorization may be given by the HKFE, the SEHK, or the SFC**, of which discussions follow.

8.5 Authorization by HKFE/SEHK to Exceed Prescribed Limits

- The HKFE or SEHK may authorize the following persons to exceed the position limits prescribed by the CLRP Rules:
 - market makers or liquidity providers; and
 - certain issuers of structured products listed on the SEHK who hold or control futures or stock options contracts for hedging risks

8.6 Authorization by SFC to exceed prescribed position limits

- The SFC is empowered to authorize a person to exceed the position limits in **four circumstances**:

1. Allowing an exchange participant (or its affiliate) to provide services to clients **where it has a relevant business need** (such as hedging risk) and the participant has **adequate financial capability to cover the potential risks**
2. To enable an exchange participant (or its affiliate) to engage in **index arbitrage activities**

For these two cases, the person seeking authorization must have adequate internal control procedures and risk management systems, have adequate financial capability to cover the potential risks, and only use the excess for the stated purpose

3. For a person licensed or registered for **Type 9 regulated activity** (asset management) managing assets with a **total value of not less than HK\$80 billion**

The asset manager must have adequate internal control procedures and risk management systems.

4. In special circumstance

- In each case, the SFC must be satisfied that authorising such excess **would not be prejudicial to the interest of the investing public**, having regard to the prescribed limit and the liquidity of the futures or stock options contract
- The SFC will also consider whether granting any authorization would be **inconsistent with its statutory regulatory objectives** as set out in the SFO
- Any authorization given must **specify the maximum amount by which the prescribed limit may be exceeded** (it is expressed as a **percentage** and the period for which the authorization is valid, and must be in writing)
- The SFC also has the **power to vary or withdraw the terms of the authorization** at any time subject to **at least 5 business days written notice**. A person who has received an authorization may apply for renewal
- The SFC may not authorize an amount **in excess of 300% of the position limits** prescribed in the CLRP Rules
- SFC decisions in relation to authorizations may be appealed to the **Securities and Futures Appeals Tribunal**

9. SECURITIES AND FUTURES (OTC DERIVATIVE TRANSACTIONS – REPORTING AND RECORD KEEPING OBLIGATIONS) RULES

9.1 Background

- There has been an international effort to reduce systemic risks in the **OTC derivatives market** as a result of the global financial crisis of 2008
- There are now requirements for OTC derivative transactions to be **reported to trade repositories** and cleared through a central counterparty (CCP)
- Since 10 July 2015, there has been a Hong Kong requirement for mandatory reporting and record keeping prescribed by the Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping Obligations) Rules (“OTCD Reporting Rules”)
- This topic considers the requirements for **Licensed Corporations**

9.2 Scope of Application

- Reporting and record-keeping obligations arise in respect of OTC derivative transactions that the HKMA has specified as being subject to transaction information reporting requirements

9.3 Reporting Obligations

- Unless exempted, all licensed corporations are subject to OTCD Reporting Rules. **The obligations arise for an intermediary as a result of:**
 - Entering into a specified OTC derivative transaction as a counterparty
 - Conducting a transaction in a specified OTC derivative transaction “in Hong Kong” on behalf of an affiliate; or
 - Losing its exempt status

9.3.1 Means and Timing of Reporting

- All transaction information must be reported to the HKMA via the **Hong Kong Trade Repository (HKTR)** electronic reporting system operated by the HKMA
- HKTR membership is required to make a report
- Reports must be made **within two business days** of a transaction (T+2)
- Reporting details and timing are subject to a “concession period” and possibly a “grace period”

9.3.2 Information to Report

- Information to be reported includes:
 - Product class and type
 - Dates: transaction; effective and maturity
 - Particulars of counterparties
 - Clearing information
 - References assigned to the transaction
 - Transaction particulars (notional amount, currency rate, interest rate etc)
 - Subsequent events

9.3.3 Exemptions

- A licensed corporation is exempt from the reporting requirement if the **notional amount of all outstanding OTC Derivative transactions** in aggregate **does not exceed US\$30 million**
- The exemption is lost permanently once the notional value exceeds US\$30 million

9.4 Record Keeping Obligations

- Transaction records must be kept for at least **five years** after the maturity date
- Records must be sufficient to demonstrate compliance with reporting requirements
- Where a licensed corporation is exempt from reporting, records should still be kept to justify the exemption

9.5 Legal Entity Identifiers

- From 1 April 2019, entities subject to the reporting obligation are required to use their Legal Entity Identifiers (LEI) when reporting
- An LEI is an identifier issued under the Global LEI System, enabling clear and unique identification of legal entities participating in financial transactions

9.6 Consequences of Breaches

- SFC can bring licensed corporations that breach the OTCD Reporting Rules before the Court of First Instance
- Maximum penalty is HK\$5 million and possible disciplinary sanctions

10. SECURITIES AND FUTURES (OTC DERIVATIVE TRANSACTIONS – CLEARING AND RECORD KEEPING OBLIGATIONS AND DESIGNATION OF CENTRAL COUNTERPARTIES) RULES

10.1 Background

- Following on from the Rules introduced in Section 8 above, the SFC introduced mandatory clearing through subsidiary legislation (above)
- Mandatory clearing of OTC derivative products is being introduced in phases – the first phase was introduced on 1 September 2016

10.2 Mandatory Clearing Obligation

- Where an OTC derivative clearing obligation exists, the transaction must be cleared through a designated central counterparty (CCP) within one business day of the transaction
- Eligible CCPs are:
 - Recognised clearing houses under the SFO
 - Persons authorized by the SFC to provide automated trading services
- Transactions that cannot be cleared in time will be terminated

10.3 Product Subject to the Clearing Obligation

- In the first phase, the only class of product subject to mandatory clearing is Interest Rate Swaps (IRS), including:
 - Fixed to floating
 - Floating vs. floating
 - Overnight index swaps
- As the regulatory objective is to catch systemic risks posed by larger and more significant participants in the OTC derivatives market, the OTCD Clearing Rules only apply to positions of US\$20 billion or more (the clearing threshold)
- Transactions below the clearing threshold are not subject to the clearing obligation

10.4 When Clearing Obligation will not Apply

- When a transaction has been cleared under the laws of a designated jurisdiction, through a designated CCP, it will not be necessary to clear the transaction in Hong Kong

- There are three further situations where the clearing obligation does not apply:
 - Transaction with a group company member that is an exempt affiliate
 - Transaction is recorded in another jurisdiction that is an exempt jurisdiction
 - Transaction is entered into on a multilateral basis to reduce operational or counterparty credit risk

10.5 Record Keeping Obligations

- Records sufficient to demonstrate compliance with the clearing obligations should be kept for at least **5 years** from the termination or maturity date of the transaction

10.6 Consequence of Breaches

- SFC can bring licensed corporations that breach the OTCD Clearing Rules before the Court of First Instance
- Maximum penalty is HK\$5 million and possible disciplinary sanctions

11. ENFORCEMENT ACTIONS IN RELATION TO BREACHES OF RULES

Case 1: Reprimanded and fined for breaching the FRR

- A corporation, licensed to carry on Type 1 (Dealing in Securities) regulated activity was found to have a liquid capital deficiency on a total of 5 business days
- The deficiency arose when the licenced corporation drew down two bank loans at the same time for margin financing granted to its two substantial shareholders for subscription in 2 initial public offerings
- The licenced corporation became aware of the deficiency and reported it to the SFC
- The SFC reprimanded and fined the licensed corporation

Case 2: Reprimanded and fined for breaching the FRR

- A responsible officer, licensed to carry on Type 1 (Dealing in Securities) and Type 2 (Dealing in Futures Contracts) regulated activities, along with the financial controller of a licensed corporation, failed to maintain the required liquid capital on various dates during a period of over 17 months
- The SFC reprimanded and fined the responsible officer and the financial controller, who was not a licensed person, but was a part of the licensed corporation's senior management

Case 3: Licence suspended and fined for breaching the Client Securities Rules

- A corporation licensed to carry on Type 1 (Dealing in Securities), Type 4 (Advising on Securities) and Type 9 (Asset Management) regulated activities was found to have:
 - re-pledged securities belonging to its cash clients to its banks on two occasions without obtaining prior client authorisations; and
 - misallocated client securities to a designated Central Clearing and Settlement System sub-account
- The licensed corporation was fined and one of its responsible officers was suspended for one month

Case 4: Reprimanded for breaching the Client Money Rules

- A licensed corporation, licensed to carry on Type 1 (Dealing in Securities) and Type 4 (Advising on Securities) regulated activities was found to have deposited client money with overseas banks which were not authorised financial institutions under the Banking Ordinance
- The SFC issued a reprimand to the licensed corporation

