

TOPIC 2 - OVERVIEW

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1. SFC NOTIFICATION REQUIREMENTS

1.1 Notification under S135 SFO

- Under Section 135 of the SFO, a person licensed by or registered with the SFC must report to the SFC:
 - **Notice of intention to cease conducting the regulated activity** as soon as possible or not later than seven business days prior to intended cessation date
 - **Notice of intended change of business address** at least seven business days' in advance
 - **Any changes to information supplied to the SFC** within seven business days of change (covering representatives, responsible officers or substantial shareholders)
 - **Notice of any change of directors** within seven business days of change

1.2 Information in annual returns to SFC

- Securities and Futures (Licensing and Registration)(Information) Rules sets out required information in annual return, including:
 - Reporting periods
 - Any changes in information previously supplied to SFC
- Annual return must be submitted within one month of anniversary date of licensing
- Annual audited financial statements must be sent to SFC within four months of financial year-end

1.3 Annual Fees

- Annual fees are payable at same time as submitting the annual return
- If fees late, penalty is 10% of unpaid amount for first month, and 20% for each subsequent month

1.4 Breaches of laws and regulations

- Intermediaries are required under the Code of Conduct to report to SFC immediately any material or suspected breach, infringement or non-compliance by itself, an employee or an appointed agent with the relevant laws, rules, regulation and codes
- This is an ongoing requirement

2. CAPITAL REQUIREMENTS

2.1 Basic Provisions

- **Financial Resources Rules (FFR)** contain general capital requirements for licensed corporations, covering paid-up share capital and required liquid capital (RLC) – they do not apply to registered institutions
- Licensed corporations must keep records in sufficient detail to establish if requirements have been complied with and make information available to SFC within five business days
- Licensed corporations must report as soon as practicable to SFC, if they cannot meet capital requirements and should cease to carry on activity. See further details in 2.4 below
- SFC may suspend license or allow corporation to continue to trade subject to certain conditions

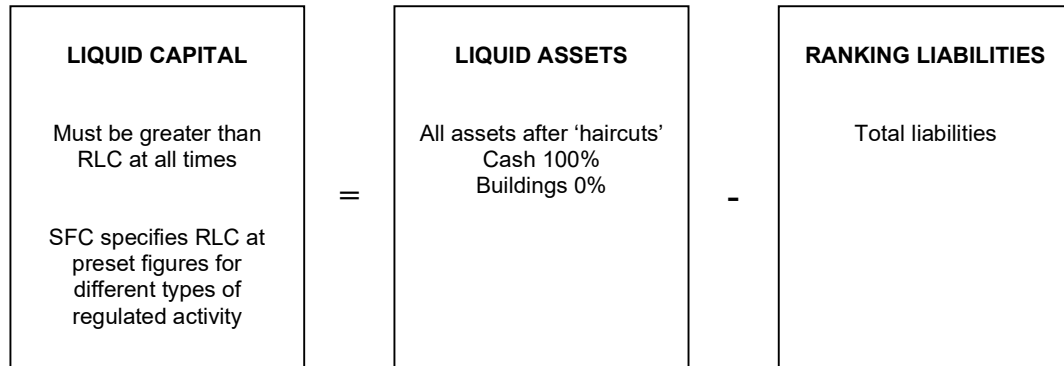
2.2 Paid-up Share Capital

- Licensed corporations must maintain not less than the amount of paid-up share capital shown below. If engaged in more than one activity, a licensed corporation must keep the highest paid-up capital specified

Regulated Activity	Required Paid-up Share Capital (s.5 and Sch. 1 Table 1 FRR)
Dealing in securities (i) where it provides securities margin financing (ii) others	HK\$10 million HK\$5 million
Dealing in futures contracts	HK\$5 million
Advising on securities	HK\$5 million
Advising on futures contracts	HK\$5 million
Asset management	HK\$5 million
Providing credit rating services	HK\$5 million

- A licensed corporation which carries on regulated activities solely as one of the following is exempt from requirement:
 - Holds a Type 4, 5, 9 or 10 license (advising on securities, futures contracts, asset management or providing credit rating services) and may not hold client monies
 - Holds a Type 6 license (advising on corporate finance) and is not allowed to act as sponsor or hold client monies
 - Is an approved introduction agent not licensed for leveraged foreign exchange trading
 - Is a licensed corporation which is trader or futures non-clearing dealer

2.3 Liquid Capital (LC) and Required Liquid Capital (RLC)



- If engaged in more than one activity, LC must be more than the highest RLC, as specified below:

Regulated Activity	Required Liquid Capital (s.6 and Sch. 1 Table 2 FRR)
Dealing in securities	
(i) where it is an approved introducing agent or trader	HK\$500,000
(iii) others	HK\$3 million
Dealing in futures contracts	
(i) where it is an approved introducing agent, futures non-clearing dealer or trader	HK\$500,000
(ii) others	HK\$3 million
Advising on securities	
(i) and may not hold client assets	HK\$100,000
(ii) others	HK\$3 million
Advising on futures contracts	
(i) and may not hold client assets	HK\$100,000
(ii) others	HK\$3 million
Asset management	
(i) and may not hold client assets	HK\$100,000
(ii) others	HK\$3 million
Providing credit rating services	
(i) and may not hold client assets	HK\$100,000
(ii) others	HK\$3 million

- LC is calculated on balance sheet amounts prepared or adjusted on specific 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

2.4 Notifications to SFC

- A licensed corporation, unable to comply with capital requirements (RLC and paid-up capital) must:
 - Notify the SFC in writing asap
 - Cease conducting the regulated activity immediately, unless permitted by SFC to continue
- A licensed corporation must also notify the SFC in writing within one business day if:
 - LC falls below 120% of RLC
 - LC falls below 50% of last LC reported
 - Exceeds any borrowing limits
 - Is unable to meet any repayment demands
 - Any lenders liquidate or intend to liquidate any collateral security
 - Aggregate of commitments or claims against it exceed HK\$5 million or, if deducted from its LC, would reduce that below 120% of RLC
 - A commitment, including a guarantee, has been provided on its behalf by a group company to an exchange or clearing house
 - Information which has been supplied previously has become materially misleading

2.5 Returns to SFC

- Licensed corporations, including asset managers, must submit additional **FRR returns** to the SFC
 - Permitted to hold client assets**
 - Monthly declaration statement with supplementary financial information within 3 weeks of period end
 - Financial information should include liquid capital calculation, RLC calculation, summary of bank loans and other credit facilities, and an analysis of client assets
 - Three monthly declaration to end of March, June, September and December with details of number of active clients, proprietary derivative positions and (if an asset manager) assets under management
 - Not permitted to hold client assets**
 - Six monthly declaration statement for periods to June and December to be submitted within three weeks
 - Financial information should include liquid capital calculation, RLC calculation, a profit and loss account, report on number of active clients and (if an asset manager) an analysis of assets under management

2.6 Approvals by SFC

- The SFC may approve the following for specified periods:
 - Certain licensed corporations as **approved introducing agents**, who only introduce business, do not hold client assets and incur no legal liabilities (different RLC levels as noted above)
 - Modification or waiver of liquid capital calculation (including exclusion of certain redeemable shares and subordinated loans from ranking liabilities)
 - Adoption of a non-GAAP accounting principle

2.7 Offences

- Breaches of FRR are an offence punishable by fine and/or imprisonment.

3. CLIENT SECURITIES

- The Client Securities Rules (CSR) apply to intermediaries and their associated entities
- The CSR do not apply to trust companies providing custody services to authorized CISs
- The CSR do not apply where the client maintains his securities in an account in his name with a person other than the intermediary or its associated entity
- CSR only apply to Hong Kong stocks (not overseas stocks) received or held in Hong Kong by an intermediary or associated entity in the course of conducting a regulated activity
- An asset manager may sell client securities or settle a sales order on behalf of a client with the written agreement of the client

4. CLIENT MONEY

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

4.1 Application

- The Rules do **not** apply to client money that is:
 - received or held **outside** Hong Kong
 - moved outside Hong Kong
 - held in a bank account by the client in his own name

4.2 Sources of Client Money

- 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

4.3 Treatment of Client Money on Receipt

- 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
 - In accordance with a standing authority
- **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
- Money held in a segregated account, which is discovered not to be client money, must be moved out of the account within one business day of discovery

- Fund subscription money must be deposited in a segregated account if held for more than 2 business days

Standing Authority

- A written notice authorizing the intermediary/associated entity to deal with client assets in specified ways
- Effective for a period not more than 12 months
- May be renewed on the written request of the client for a period not more than 12 months
- May be **deemed to be renewed** by the intermediary/associated entity giving written notice at least 14 days prior to expiry reminding client of impending expiry. Deemed to be renewed on date of expiry, unless client objects
- Intermediary/associated entity must provide written confirmation of deemed renewal to client within a week of expiry date
- The **standing authority** cannot be used by the intermediary/associated entity to make payments:
 - In an unconscionable manner
(*Unconscionable = contrary to a sense of justice, decency or reasonableness*)
 - To an account of the intermediary, its associated entity or any entity which has a controlling entity relationship with the intermediary other than to meet the client's normal obligations arising from regulated activities
- Failure to comply with the requirement to pay client money into segregated accounts is an offence
- The SFC must be notified within one business day of failure to comply with the CMR on opening of segregated accounts or paying and holding money in segregated accounts

5. RECORD KEEPING

- The Keeping of Records Rules apply to intermediaries and their associated entities

5.1 General Requirements

- Sufficient accounting, trading and other records should be kept:
 - To explain and reflect the financial position and operations of regulated businesses
 - To enable financial statements to be prepared
 - To show all client assets handled and their movements
 - To make monthly reconciliations with external parties
 - To demonstrate compliance with the FRR, Client Securities Rules and Client Money Rules
 - To enable audits to be conveniently and properly carried out
 - In accordance with GAAP

- Specifically, an asset manager which holds client assets should keep records for each client to show assets and liabilities, including any financial commitments and contingent liabilities

5.2 Form of Records

- Records should be kept in Chinese **or** English, in writing or in any other form that may be convertible into writing

5.3 Retention Time

- The general rule is that all records should be kept for at least **7 years**, except for:
 - Daily statements of account – 2 years
 - Copies of contract notes – 2 years

5.4 Offences

- A breach of the Rules without a reasonable excuse will attract penalties, including a fine
- If a breach is committed with **intent to defraud**, imprisonment can result
- Breaches must be notified to the SFC in writing within one business day

6. CONTRACT NOTES, STATEMENTS OF ACCOUNT AND RECEIPTS

6.1 Introduction

- The Contract Notes Rules relate to the provision of contract notes, statements of account and receipts to clients
- In general, Contract Notes Rules do not apply to asset managers (or their associated entities) other than for
 - Receipts, and
 - Monthly statements of account
- Contract Notes Rules apply to other intermediaries involved in the asset management industry, such as distributors

6.2 Provisions applicable to asset managers

Receipts

- Receipts must be issued by an asset manager, whenever it receives assets/security, by the end of second business day after receipt
- Receipt must include:
 - Full name of intermediary and client
 - Relevant dates
 - Description of assets/security
 - Accounts into which receipt deposited

Monthly Statements of Account

- Monthly statements must be issued within 10 business days of the month-end
- No statement needed when no activity during the month and no balances at the end of the month
- An asset manager does not need to prepare monthly statements for authorized CISs that it manages
- Monthly statements must include:
 - Asset manager's trade name
 - Asset manager's business address
 - Client's name, address and account number
 - Date of preparation of the statement
 - Month-end valuation of assets with
 - Quantity, market price, cost and value of each security
 - Details of all open positions
 - Money balance held
 - Amounts payable and receivable
 - Income credited and charges levied during month
 - List of all contracts entered into during month

6.3 Provisions applicable to intermediaries other than asset managers

Contract Notes

- Usually prepared for a single transaction, but several contracts on the same day for the same client may be included in a single contract note or consolidated into the daily statement of account
- Need not be issued if another intermediary will issue contract note for the same transaction
- Must be issued no later than **second business day** after contract entered into
- Can be sent by email
- A contract note **must contain**:
 - Client's name and account number
 - Intermediary's trade name
 - Full particulars of the contract including:
 - Quantity, name, description of instrument
 - Nature of transaction (purchase, sale etc)
 - Name of market or exchange
 - Opening or closing a position
 - Whether intermediary is acting as principal

- Transaction and settlement dates
- Date of preparation of contract note
- Charges payable (rate of commission, stamp duty or levy or other charges)

Daily Statements of Account

- A daily statement must be issued to the client no later than the end of the second business day after the specified event
- Contents of a daily statement of account are the same as contract notes (see above) and should also include:
 - Each transaction entered into and closed during the day
 - Outstanding balance at the beginning and end of the day
 - All income and charges during the day

Monthly Statements of Account

- Monthly statements must be issued within 7 business days of the month-end
- Contents are similar to monthly statements for asset managers (see above)

6.4 Other matters

- Clients may request copies from the intermediaries of contract notes, daily and monthly statements, and receipts
- Clients may request a statement of account on any particular day with up-to-date details
- Retention of documents:
 - Contract Notes, Daily Statements and Receipt – 2 years
 - Monthly Statements – 7 years
- A breach of the Rules without a reasonable excuse will attract penalties, including a fine
- If breach is committed with **intent to defraud**, imprisonment can result
- Breaches must be notified to the SFC in writing within one business day

7. ACCOUNTS AND AUDIT

Requirements are covered in Accounts and Audit Rules

7.1 Notification of end of financial year

- A licensed corporation must notify the SFC of the financial year-end, within one month of being licensed
- Financial year must not exceed 12 months
- SFC permission is required to change the financial year-end
- It is an offence to fail to comply with these requirements

7.2 Annual financial statements and other documents

- Licensed corporations and associated entities of intermediaries are required to prepare accounts for each financial year consisting of:
 - Profit & loss account
 - Balance sheet
 - Notes to the accounts
- Supplementary financial information should also be supplied covering:
 - Returns required by FRR
 - Liquid capital calculations
 - Business and risk management questionnaire
 - Analyses of borrowings and client accounts
- Financial statements, auditor's report and other documents must be submitted to SFC within 4 months of financial year-end or cessation of business
- SFC may grant time extension
- It is an offence to fail to submit accounts. If there is an intent to defraud the penalty will be higher

7.3 Auditors

7.3.1 Appointment of auditors

- Licensed corporations must appoint an independent auditor within one month of being licensed or whenever there is a vacancy
- SFC must be notified of:
 - Name and address of auditor within 7 business days of appointment
 - Motion to remove or replace an auditor within 1 business day
 - Auditor ceases to hold office before expiration of term within 1 business day
- It is an offence not to appoint an auditor or to fail to give the SFC the above notifications
- The auditor of a mutual fund scheme must be independent of the management company, trustees/custodian and directors

7.3.2 Auditor's Report

- The normal 'true and fair' opinion is required of the auditor
- 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
- If client assets or client money is not held then the additional opinions will not be necessary

7.3.3 Matters reportable by auditors

- The auditor of a licensed corporation must report to the SFC:
 - Any failure to comply with the relevant requirements (including KRR, CMR and CSR)
 - Any matter which adversely affects its financial position to a material extent
 - Any matter which involved a breach of the FRR
- The auditor must report in writing to the SFC, as soon as practicable, if:
 - He becomes aware of a reportable matter, or
 - He proposes to include a qualification or adverse statement in his report
 - He resigns or does not seek reappointment or otherwise ceases to be the auditor (within 1 business day)

7.3.4 Auditors' Immunity

- An auditor making communications, in good faith, on reportable matters or ceasing to be an auditor will not have breached his duty as an auditor
- This also applies to former auditors

7.3.5 Appointment of auditors by SFC

- The SFC may appoint an auditor if:
 - FRR have not been complied with
 - Prescribed conditions have not been met
 - Annual accounts and reports have not been submitted
 - Auditor's report is qualified
 - SFC has received a written application that the licensed corporation has failed to account for assets or profits or has not compensated client for losses as instructed

- Auditor appointed by SFC may:
 - Examine, on oath, officers, agents and auditors of target entity
 - Require all persons holding client assets to produce relevant records and explain contents
 - Exercise powers with respect to any business carried out, if relevant to the audit
- It is an offence to fail to comply with any requirements of the auditor appointed by the SFC

- It is also an offence for any person with intent to prevent, delay or obstruct the audit by
 - Deleting, concealing, falsifying, altering any records
 - Disposing of property relevant to the records
 - Leaving or attempting to leave Hong Kong

8. SECURITIES AND FUTURES (OPEN-ENDED FUND COMPANIES) RULES

8.1 Background

- An open-ended fund company is a **type of CIS** established in Hong Kong in the form of a **limited company with variable capital** providing flexibility in meeting investor applications and redemptions
- **SFC regulates OFCs**, hence the OFC Rules

8.2 Open-ended Fund Company (OFC) Registration, Formation and Power

- Prior to incorporating an OFC, an **application must be made to the SFC** with details of:
 - OFC name
 - Address of registered office
 - Details of directors, investment manager and custodian
- Once an OFC is registered with the SFC, it is incorporated with the Registrar of Companies

8.3 Share Capital of an OFC

- An OFC may issue **more than one class of share capital with varied rights**, including the right to participate in profits from management of scheme property and voting at general meetings
- Shares are **transferrable** with conditions
- An OFC needs to keep a **register of shareholders** which must be available for inspection by any OFC shareholder, the investment manager or custodian

8.4 Shareholder Meetings and Resolutions

- **Directors have the power** to call general meetings
- **Shareholders holding at least 10%** of the voting rights can require the directors to call a general meeting and to propose a resolution at the general meeting
- **14 days' notice** must be given for an ordinary general meeting and **28 days** for a general meeting to remove or appoint a director/auditor
- Either the directors of the OFC or not less than 5% of the shareholders may **propose a written resolution**

8.5 Operators of the OFC

- **Directors**
 - **Initial directors** will be identified at the time of incorporation
 - If the OFC is required to hold AGMs, **directors should be appointed** at such meetings, otherwise the power to appoint directors resides with the directors
 - **Directors can be removed** at any time by ordinary resolution
 - A **register of directors** should be available for inspection by shareholders
 - Where a director has **an interest in a transaction** with the OFC, it should be declared to other directors
- **Custodian**
 - Directors may appoint a **new custodian**, subject to receiving prior SFC approval
 - When a custodian is **terminated and replaced** by a new custodian, it must make a statement regarding any circumstances that should be brought to the attention of the OFC's shareholders or creditors
- **Investment Manager**
 - Directors may appoint a **new investment manager**, subject to receiving prior SFC approval
- **Auditor**
 - Every OFC must have an auditor appointed by the directors
 - The auditor can be removed by ordinary resolution at a general meeting

8.6 Financial Statements and Financial Reports

- The directors of an OFC must prepare and publish an annual report for each financial year
- The annual report must include the financial statements and the auditor's report

9. REPORTING AND RECORD KEEPING OBLIGATIONS FOR OVER-THE-COUNTER DERIVATIVE TRANSACTIONS

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

- An OTC derivative transaction means a transaction in an OTC derivative product, which is broadly defined in the SFO
- HKMA has specified OTC derivative transactions that require reporting

9.3 Reporting Obligations

- Unless exempted, all licensed corporations are subject to OTCD Reporting Rules. **The obligations arise when:**
 - A new OTC product becomes a specified product type and the licensed corporation is a counterparty
 - On or after a product becomes a specified product type and the licensed corporation:
 - enters into a transaction in a specified product type as counterparty
 - has conducted a transaction in a specified product type “in Hong Kong” on behalf of a Group company
 - loses its exempt status
 - On or after a product becomes a specified product type, the corporation holding the position becomes a licensed corporation
- After a reporting obligation arises, **open and subsequent** positions must be reported

9.4 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”

9.5 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
- The primary reporting obligations rests with the licensed corporation, however if the transaction is conducted on behalf of a Group company, the Group company may make the report. In such a case, the licensed corporation needs written confirmation from the Group company to demonstrate compliance with the reporting requirement

9.6 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

9.7 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

9.8 Legal Entity Identifiers

- **Entities subject to the reporting obligation** are required to use their Legal Entity Identifiers (LEI) in transaction reports submitted to the HKTR (see above)
- **Licensed corporations** are subject to the reporting obligation
- An LEI is an identifier issued under the Global LEI System enabling the **clear and unique identification of legal entities** participating in financial transactions