TOPIC 5 - OVERVIEW

1. RECORDS TO BE KEPT BY INTERMEDIARIES

1.1 Introduction

- **Keeping of Record Rules (KRR)** require intermediaries to maintain comprehensive records relating to their business and client transactions
- Records must be in sufficient detail to ensure proper accounting for business operations and financial position, including a true and fair view of profit and loss and balance sheet, and client assets
- Generally, records should be kept for 7 years, although there are some specific requirements under SFO and other legislation
- Records must be written in Chinese or English or in any electronic form, readily convertible into writing

1.2 Records to be Kept

- An intermediary must keep sufficient accounting, trading and other records in accordance with generally accepted accounting practices in sufficient detail to:
  - ➢ Explain financial position and operations of business
  - ➢ Prepare financial statements
  - ➢ Show all client assets and movement in assets
  - ➢ Reconcile positions each month with external parties
  - ➢ Demonstrate system of controls to ensure compliance with SFC Rules
  - ➢ Enable audits to be performed

1.3 Particulars to be Recorded

- Records must show particulars of:
  - ➢ All money received and disbursed
  - ➢ All income received
  - ➢ All expenses, commissions and interest incurred or paid
  - ➢ All orders or instructions received or initiated (with detail of transactions, the account and ability to trace transaction through systems)
  - ➢ All disposals of client securities or collateral
  - ➢ Assets and liabilities, including commitments and contingencies
  - ➢ All securities held belonging to intermediary
  - ➢ All securities held not belonging to intermediary
  - ➢ All bank accounts, including segregated accounts
  - ➢ All off-balance sheet transactions or positions
- Records of all contracts, standing authorities, written directions and evidence of PI status must be kept

1.4 Margined Transactions

- Records must also show particulars of:
  - Market value and margin value of each type of securities collateral deposited
  - Total (aggregate) market value and total margin value of such securities collateral
  - Details of margin calls made

1.5 Associated Entities (AEs)

- 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:
  - 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
  - enable an audit to be conveniently and properly carried out
  - 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.

1.6 Requirements under Codes and Guidelines

1.6.1 Books and Accounts

Code of Conduct requires intermediaries who are participants of HKFE to maintain proper books and records which correctly and clearly record:

- Financial position of each client's trading account
- Time, date and complete particulars of instructions received and trades executed
- Particulars of all intermediary and client open positions
- Amount of margin deposited with clearing houses and individual agents
- Amount of variation adjustment and interest rate cash adjustment paid to clearing house and each executing agent
- Amount of margin deposited or required to be deposited for each client
- Amount of variation adjustment collected or required to be collected from each client
- All payments and assets received or held to satisfy margin requirements
- Particulars of all margin calls and demands for variation adjustments
- Any other particulars as required from time to time by HKFE

1.6.2 Client Ledgers

Code of Conduct requires intermediaries who are participants of HKFE to:

- Maintain separate ledger accounts for every client for HKFE, non-HKFE and all other trades
- Record details of all collateral received from clients and send statements to clients with details
- Segregate clients' ledger accounts for HKFE, non-HKFE and other accounts so there is no offset between accounts

1.6.3 Telephone Recording

Code of Conduct requires orders/confirmations received/given by telephone to be recorded and kept for at least 6 months (records, per KRR, does not cover telephone recordings)

1.6.4 Advisers

Management, Supervision and Internal Control Guidelines requires advisers to:

- Record advice given
- Explain reasons and basis for advice

Records should show compliance with Code of Conduct general principles, including suitability of advice and acting with due care and diligence

1.7 Record Retention Time

- KRR requires that all records should be kept for not less than 7 years, unless otherwise specified
- Client orders and instructions, contract notes, daily statement of accounts and receipts should be kept for not less than 2 years

1.8 Miscellaneous

- Records are to be kept in Chinese **or** English
- Documentary assurances for short sales only need to be kept for one year

1.9 Reporting of Non-Compliance

- Written notice of non-compliance must be given to the SFC within one business day

1.10 Penalties

- Failure to comply with KRR without a reasonable excuse (such as an administrative error) is an offence
- Breach of rules with an intent to defraud carries a fine of up to HK$1 million and 7 years' imprisonment if convicted on indictment or HK$500k and 1 year imprisonment on summary conviction

2. CONTRACT NOTES, STATEMENTS AND RECEIPTS

2.1 Introduction

- The SFC made the Contract Notes Rules to require intermediaries and associated entities to provide clients with timely documents containing valid information
- All intermediaries conducting the business of:
  - dealing in securities/futures
  - 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 **as defined in the SFO** (see Topic 4), the intermediary has informed them in writing and the clients do not object
  - If PIs are **as defined in the PI Rules** (see Topic 4), and the clients have agreed in writing not to receive these documents

2.2 Contract Notes

- A contract note must be issued whenever an intermediary buys or sells futures contracts, 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:
    - Quantity, name and description of the futures contract
    - Price per futures contract or average price per contract
    - Name of any agent involved in either dealing or clearing
    - Name of market/exchange on which it was executed
    - Whether the contract is for opening/closing a position

- Commission payable, charges and stamp duty
- Notification if intermediary is acting as principal

2.3 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, such as futures contracts, 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 and should include:
  - Intermediary company name and name of any associated entity that holds client assets
  - Client name, address and account number
  - Date when statement prepared
  - Information for that day, including:
    - Opening and closing balances with details of day's movements
    - Quantity, market price and market value of each type of collateral provided by client that day
    - Details of all contracts closed during the day
    - Details of all income and all charges that day
    - All floating profits and losses at the end of the day
    - Net equity at the end of the day
    - A list of all open positions at the end of the day
    - Minimum margin requirement for all open positions
    - Amount of margin excess/shortfall at the end of day
    - Client's position limit and trading limit
    - Expiry date of the margined transactions arrangement

2.4 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

2.5 Receipts

- Receipts must be issued by an intermediary or an associated entity on receiving client assets/security **by the end of the second business day** after the day of receipt
- No receipts are required where:
  - Client money is deposited directly by the client into the licensed corporation's or associated entity's bank account, or where the intermediary is a registered institution or the associated entity is an AFI (banks issue receipts)
  - Securities are deposited with the intermediary's custodian (custodians issue receipts)
  - Contract note includes the required information and is stated to serve as a receipt

2.6 Other Related Requirements

- 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)

2.7 Reporting of Non-Compliance

- Written notice of non-compliance must be given to the SFC within one business day

2.8 Penalties

- Failure to comply with the Contract Note Rules without a reasonable excuse is a criminal offence
- Breach of rules with an intent to defraud carries a fine of up to HK$1 million and 7 years' imprisonment if convicted on indictment or HK$500k and 1 year imprisonment on summary conviction

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

3.1 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.

3.2 Where Position Held or Controlled for Another

- Where control arises only as a result of a corporate structure, such as a parent-subsidiary 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.

3.3 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.

3.4 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.

3.5 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

3.6 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**