

Consultation Document
The Draft Securities and Futures (Contract Notes, Statements of Account and Receipts) Rules (the “draft Rules”)

Introduction

1. Unlike the Securities Ordinance and the Commodities Trading Ordinance, the Securities and Futures Bill does not contain detailed requirements in relation to the issuance of contract notes, statements of account or receipts; it merely gives the Commission the necessary rule-making power under clause 148 to prescribe requirements in the subsidiary legislation. The basis for this approach is that, consistent with modern securities legislation such as the UK Financial Services and Markets Act, effective regulation depends upon the regulator having the flexibility to quickly address changing market practices and global conditions, by amending the rules rather than the primary legislation.
2. While there are controls already built into the legislative system whereby any rules made by the Commission must be subject to negative vetting by the Legislative Council, the Commission now releases the draft Rules for public consultation.
3. The SFC has used the FinNet communication network to send copies of this consultation document to registered dealers that have lodged their Financial Resources Rules returns electronically with the SFC via FinNet. Copies of the consultation document are available free of charge at the SFC’s office and may also be found on the SFC’s Internet website at <http://www.hksfc.org.hk>.
4. The public is invited to submit comments before close of business on 9 November 2001 by sending them by fax to 2523-4598 or by mail or e-mail to the following address:

SFC Contract Notes Rules
12/F, Edinburgh Tower
The Landmark
15 Queen’s Road, Central
Hong Kong

or:

contract_notes_rules@hksfc.org.hk

5. It should be stressed that the draft Rules must be read in conjunction with the Securities and Futures Bill itself. For example, exempt persons

will only need to issue contract notes etc. in the course of their regulated activities.

6. To ensure that our regulatory thinking is generally in the right direction, the SFC has formulated the draft Rules after consulting selected representatives from the brokerage, fund management and banking industry. We wish to acknowledge and thank them for their invaluable input.

Background

7. A copy of the draft Rules is attached. In short, the draft Rules prescribe how intermediaries licensed or exempt for different types of regulated activities (and where appropriate their associated entities) must issue contract notes, statements of account and receipts to their clients.
8. The draft Rules have drawn on sections 75 and 121Z of the Securities Ordinance, section 45A of the Commodities Trading Ordinance and section 4 of the Leveraged Foreign Exchange Trading (Books, Contract Notes and Conduct of Business) Rules, the Code of Conduct for Persons Registered with the Securities and Futures Commission (“Code”) and the Fund Manager Code of Conduct (“FMCC”).
9. We have prepared the draft Rules with the aim to
 - (a) rationalise our requirements, which are currently disposed in four different Ordinances;
 - (b) rectify known anomalies and deficiencies; and
 - (c) where appropriate, streamline the requirements where intermediaries conduct more than one regulated activity.

The Rules must be drafted to ensure that clients get timely and meaningful information about transactions conducted on their behalf, so that they can properly understand their circumstances and protect their own interests.

New Policy Initiatives

10. Several policy changes have been incorporated into the draft Rules:
 - (a) to apply to all intermediaries (or, where applicable, their associated entities);

- (b) to allow introducing brokers, asset managers and some others not to issue contract notes to the clients where another intermediary, typically the execution broker, already provides the clients with the necessary information;
- (c) to bring together all related requirements currently incorporated in the Code and the FMCC;
- (d) to make specific allowance for consolidated contract notes and statements of account in view of the single licence regime;
- (e) to relax existing requirements in relation to securities margin financing;
- (f) to allow for average pricing for reporting in contract notes dealing in securities and futures contracts; and
- (g) to extend the time for providing a contract note to a client from one to two business days.

Application of Rules – Intermediary Types

11. Currently, under the various Ordinances, the relevant requirements only apply to specific types of registered, exempt or licensed persons (namely securities dealers, futures dealers, securities margin financiers and leveraged foreign exchange traders). This will be too restrictive under the Bill as there will be new types of regulated activities which an intermediary may conduct. Under the draft Rules, all intermediaries will be required to issue contract notes or statements of account whenever they enter into a contract¹ or provide financial accommodation in the course of any regulated activity.

Where a Transaction Involves Two Intermediaries

12. Section 75, Securities Ordinance currently requires all securities dealers to issue contract notes. However, many of the asset managers that are registered as securities dealers do not issue contract notes because these tend to be issued directly by the execution brokers to the custodians or trustees or directly to the clients. Moreover, there are some introducing brokers that do not issue contract notes at all. As the execution brokers already issue the contract notes to the clients, there are no investors' protection issues. Under the draft Rules, in these circumstances, only one set of contract note needs be issued to avoid duplication (section 5).

¹ Defined to cover dealing in securities, futures and leveraged foreign exchange trading.

Application of Rules - Transaction Types

13. Currently, a securities or futures dealer is clearly required to issue contract notes when they purchase, sell or exchange securities or futures contracts. There is uncertainty however as to other types of transactions. It is unclear, for example, whether a contract note will need to be issued for options trading or for securities borrowing or lending. The draft Rules now make it clear that contract notes are required to be issued wherever there is dealing in securities or futures contracts of any kind, including specifically securities borrowing or lending (section 6(3)(a)(ii) and 6(4)(b)(iii)(B)).

To Rectify Inconsistency of Approach

14. The requirements for securities margin financiers, securities dealers providing securities margin financing and leveraged foreign exchange traders to prepare and send regular statements of account are in the relevant legislation. However such requirements for futures dealers and securities dealers (i.e. those not providing securities margin financing) are only in the Code or FMCC. Furthermore, the Code currently contains some extra requirements such as the indication of a short selling order on the contract note by an exchange participant of the SEHK. These requirements are now rationalised and incorporated into the draft Rules².

Contract Notes – New Definition

15. Some market practitioners are currently issuing confirmations and memoranda instead of contract notes as required under the Ordinances. There has been uncertainty as to whether confirmations and memoranda are acceptable alternatives. The draft Rules now define contract note (section 2) as a document which records a contract so that the actual title itself becomes irrelevant.

Average Pricing

16. Also, some of the larger firms have noted a need to quote average price upon client's request. According to a strict interpretation of the law, contract notes must be issued for each transaction³ and hence average price cannot be used in the contract notes. We see no good reason why this should be disallowed if clients actually prefer to get their

² With the exception that managers of authorised collective investment schemes need not comply with our statement of account requirements – as this is covered under the Code on Unit Trusts and Mutual Funds.

³ This means that if a client places a large order, requiring the intermediary to enter into different transactions in order to fill that order, the client may be receiving many contract notes in relation to that same order.

information on this basis, and therefore propose to allow average price (section 6(4)(b)(ii) and 6(5)(a)(ii)).

Consolidated Reporting to Clients

17. Given that an intermediary is permitted to conduct different kinds of regulated activities under the Bill, under the draft Rules, an intermediary may consolidate contracts for all regulated activities entered into on the same business day into one single contract note (section 6(2)). The same applies to statements of account (section 7). This requirement for daily reporting was introduced by legislative amendment last year. Although it is repeated in the draft Rules, we are particularly interested in observations from the industry about how the requirement has worked in practice and the compliance burden.

Requirements to Provide Daily Statements of Account for Margined Transactions

18. Currently, many intermediaries collect margins from their clients for dealing in futures and options contracts, leveraged foreign exchange trading, short selling and securities borrowing and lending transactions. Instead of repeating the requirements under each heading, we have introduced a new section under “margined transaction” to cover these types of transactions (section 9).

Requirements to Provide Details of Margin Policies, etc.

19. The requirements to issue statements of account under the Securities (Margin Financing) (Amendment) Ordinance have been criticised for being excessive (it requires a statement of account to be issued each time certain terms, such as list of acceptable collateral and margin ratios, change; whether these affect the client or not). The draft Rules now require an intermediary to provide details of margin policies etc. to a client at the outset and to promptly notify the client of any subsequent changes (section 8(2) and (3)). This will be extended to apply to all margined transactions⁴, see section 9(2) and (3). We believe it is important for a client to know the terms under which margining is done and be advised when these terms are changed.

Receipts

20. Section 75, Securities Ordinance does not mention the issuance of a receipt to a client but section 83, Securities Ordinance requires the

⁴ Under the Leveraged Foreign Exchange Trading (Books, Contract Notes and Conduct of Business) Rules and the Code, there is already a requirement for the client agreement to include details of margin requirements, circumstances under which collateral is to be liquidated and position closed etc.

maintenance of a copy of the acknowledgement of receipt where a dealer is in receipt of securities from a client. The draft Rules now make it clear that an intermediary must issue receipts in order that a client can obtain proof of his deposit of securities or money with the intermediary (section 12) for safe custody or margin collateral purposes. At the same time, the draft Rules also prescribe circumstances under which the issuance of a receipt will not be necessary: such as when scrip is directly deposited into CCASS.

Delivery by Electronic Means

21. A number of enquiries had been received as to whether communications, documents transmitted via electronic means would be acceptable. It is proposed to clarify that such will be permitted subject to requirements under the ETO. Also since the Code had recently stipulated that client agreements etc be written in Chinese or English (as selected by the client), it is proposed to allow the client to select Chinese or English for contract notes, statement of accounts and receipts (section 14(4)).

Monthly Statements of Account

22. A relaxation is made in the draft Rules so that monthly statements of accounts need not be sent to professional investors who agree to this arrangement in writing.
23. The draft Rules require monthly statements of account to be issued by intermediaries (with the exception of fund managers managing collective investment schemes authorised by the Commission under clause 103 of the Bill) within 7 days of each month-end (section 11(4)).

Delivery of Contract Notes to Clients

24. While we have relaxed an isolated requirement (issuance of monthly statements of account) where the client involved is a professional investor, we may be criticised for not having gone far enough to differentiate sophisticated or professional investors from others. We shall specifically invite comment on this.