

LEGISLATIVE COUNCIL BRIEF

Securities and Futures Ordinance (Cap. 571)

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

INTRODUCTION

Pursuant to section 152 of the Securities and Futures Ordinance (Cap. 571) (the SFO), the Securities and Futures Commission (the SFC) has made the Securities and Futures (Contract Notes, Statements of Account and Receipts) Rules (the Rules) at the **Annex**.

BACKGROUND

The SFO

2. The SFO was enacted in March 2002. It consolidates and modernizes ten existing ordinances governing the securities and futures markets into a composite piece of legislation to keep the regulatory regime on a par with international standards and practices. For effective regulation, the SFO has already provided flexibility in addressing changing market practices and global conditions by empowering the Chief Executive in Council, the Financial Secretary, the Chief Justice and the SFC to prescribe detailed and technical requirements as necessary by way of subsidiary legislation, to supplement the regulatory framework laid down under the primary legislation.

3. On 22 February 2002, the House Committee of the Legislative Council has established the Subcommittee on Draft Subsidiary Legislation to be made under the Securities and Futures Ordinance (the Subcommittee) to study the subsidiary legislation necessary for commencing the SFO. From March 2002 to October 2002, the Subcommittee held 12 meetings and considered a total of 37 sets of draft subsidiary legislation, including the vires to make them.

THE PROPOSALS

Major policy considerations

4. The Rules supplement Part VI of the SFO which mainly concerns ongoing operational requirements, including the requirements to provide clients with contract notes, statements of account and receipts, applicable to an intermediary and its associated entity¹. The Rules prescribe when certain documents have to be provided to clients and the contents of such documents; they apply to an intermediary (and where applicable, an associated entity of an intermediary) that enters into contracts for dealing in securities, futures, or leveraged foreign exchange trading with or on behalf of clients, or receives and holds client assets, in the conduct of regulated activities for which the intermediary is licensed or registered.

5. The Rules have drawn on sections 75, 75A and 121Z of the Securities Ordinance (Cap.333), section 45A of the Commodities Trading Ordinance (Cap.250) and section 4 of the Leveraged Foreign Exchange Trading (Books, Contract Notes and Conduct of Business) Rules (Cap.451 Sub.Leg. D), the Code of Conduct for Persons Registered with the Securities and Futures Commission (Code) and the Fund Manager Code of Conduct (FMCC). They seek to ensure that an intermediary's clients receive timely and meaningful information about transactions conducted with them or on their behalf consisting of confirmation of transactions, daily statement of financial accommodation provided and margined transactions entered into, and monthly summaries of all activity and holdings in their accounts.

Major new elements

6. The Rules rationalize and consolidate the requirements under the aforesaid three existing ordinances and two codes of business conduct relating to the preparation and provision of contract notes, statements of account and receipts. Major policy changes that have been incorporated into the Rules include:

¹ An associated entity is a corporation that receives or holds in Hong Kong client assets of an intermediary and has a controlling-entity relationship with the intermediary.

- (a) applying the Rules to -
 - (i) all intermediaries; and
 - (ii) in relation to the provision of receipts, also to their associated entities introduced as part of the package to impose direct regulation of associated entities in order to close an existing regulatory gap²,
while providing certain exemptions for:
 - (iii) dealings with clients who are professional investors;
 - (iv) intermediaries licensed or registered for asset management; and
 - (v) avoidance of duplicative documents being sent to clients; so as to reduce compliance burden without compromising investor protection;
- (b) making specific allowance for consolidated contract notes and statements of account in view of the single licence regime;
- (c) allowing the use of average price in contract notes issued in respect of dealing in securities and futures contracts; and
- (d) extending the time for providing a contract note to a client from one to two business days.

THE RULES

7. Section 2 of the Rules contains interpretation provisions that apply throughout the Rules.

² There is an apparent regulatory gap under the existing legislation in that a securities dealer can discharge his obligation to his client in respect of that client's securities held in the dealer's safe custody in Hong Kong by registering those securities in the name of his nominee. To bring the nominee into the regulatory net for better investor protection, section 164 of the SFO prescribes the types of persons that are allowed to receive or hold in Hong Kong client assets, i.e. the intermediary, its associated entity and a person falling within the definition of "excluded person" which includes an authorized financial institution. The SFO then imposes direct regulation over an associated entity.

8. Section 3 disapples the Rules to an intermediary licensed or registered for asset management and its associated entity in relation to their conduct of asset management, except for the preparation and provision to clients of monthly statements and receipts. This section also prescribes the circumstances under which certain provisions of the Rules do not apply to an intermediary or its associated entity in respect of clients who are professional investors.

9. Section 4 prescribes the circumstances under which an intermediary or its associated entity is exempt from compliance with certain provisions for avoiding duplicate documents being sent to a client.

10. Section 5 requires an intermediary which enters into a relevant contract with or on behalf of a client to prepare and provide a contract note in respect of such contract to the client. This section also prescribes the information that is required to be included in the contract note generally and in relation to particular regulated activities.

11. Section 6 provides that an intermediary may consolidate one or more contract notes required under section 5 with any statement of account required under section 8 or 9 in respect of the same day.

12. Section 7 prescribes the information that has to be included generally in a statement of account which is required to be prepared under sections 8, 9, 11 or 12.

13. Section 8 requires an intermediary which provides financial accommodation to a client to prepare and provide to the client a statement relating to the account of the client on the day certain events take place. This section also prescribes the additional information that has to be included in such statement.

14. Section 9 requires an intermediary which enters into a margined transaction³ with a client to prepare and provide to the client a statement

³ A “margined transaction” is a relevant contract entered into by an intermediary with or on behalf of a client under which the client must pay margin or provide security for its obligations to the intermediary. It excludes arrangements where an intermediary provides financial accommodation to a client (section 2).

relating to the account of the client on the day the transaction is entered into or closed. This section also prescribes the additional information that has to be included in such statement.

15. Section 10 provides that an intermediary may consolidate a statement of account required under section 8 with the one required under section 9 in respect of the same day.

16. Section 11 requires an intermediary to prepare and provide to a client a monthly statement in respect of the client's account and the additional information to be included in such statement.

17. Section 12 requires an intermediary to prepare and provide to a client, upon request, a statement in respect of the client's account as of the date of the request and the additional information that has to be included in such statement.

18. Section 13 prescribes the circumstances under which an intermediary or an associated entity of an intermediary is required to prepare and provide a receipt to a client, and the information to be included.

19. Section 14 requires an intermediary or an associated entity of an intermediary to, upon request of a client, provide to the client a copy of any particular contract note, statement of account or receipt that it is required to provide under Part 2 of the Rules.

20. Section 15 prescribes that the required documents shall be in Chinese or English.

21. Section 16 requires an intermediary or an associated entity of an intermediary to retain a copy of the prescribed documents for the period prescribed.

22. Section 17 prescribes that any document that is required to be provided under the Rules shall be regarded as duly provided to the client if it is served on the client or on any other person (except an officer or an

employee of the intermediary or associated entity) designated by the client in writing.

23. Section 18 requires an intermediary or an associated entity of an intermediary to report to the SFC non-compliance with prescribed provisions of the Rules.

24. Section 19 prescribes the penalties for contravening the Rules.

PUBLIC CONSULTATION

25. The SFC released a consultation document and an exposure draft of the Rules on 28 September 2001 for comment by the public. A total of 21 submissions were received. The SFC has considered all the comments received and revised the Rules as appropriate.

26. A draft of the Rules was considered by the Subcommittee at its meetings held on 6 June 2002 and 24 October 2002. No major concerns were expressed by members of the Subcommittee at the meetings.

FINANCIAL AND STAFFING IMPLICATIONS

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

COMMENCEMENT DATE

28. The Rules will come into operation on the day appointed for the commencement of the SFO, together with other subsidiary legislation necessary for the commencement. We expect this to take place shortly, after completion of the negative vetting procedure through the Legislative Council and allowing the industry a reasonable period of time for making necessary adjustments with reference to the subsidiary legislation. We aim to announce the target commencement date by the end of 2002.

PUBLICITY

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

ENQUIRIES

30. For any enquiries on this brief, please contact Mr Raymond Wong of the Intermediaries Supervision Department of the SFC at 2842 7693 or Ms Vania Cheng of the Legal Services Division of the SFC at 2283 6166.

The Securities and Futures Commission
13 December 2002