

## **LEGISLATIVE COUNCIL BRIEF**

### **Securities and Futures Ordinance (Cap. 571)**

#### **SECURITIES AND FUTURES (KEEPING OF RECORDS) RULES**

##### **INTRODUCTION**

Pursuant to section 151 of the Securities and Futures Ordinance (Cap. 571) (the SFO), the Securities and Futures Commission (the SFC) has made the Securities and Futures (Keeping of Records) 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 established the Subcommittee on Draft Subsidiary Legislation to be made under the Securities and Futures Ordinance (the Subcommittee) to consider 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 the ongoing and operational requirements, including the requirement to keep proper records, applicable to an intermediary and its associated entity<sup>1</sup>. The Rules prescribe the records that are to be kept by an intermediary and its associated entity, to ensure that they maintain comprehensive records in sufficient detail relating to their businesses and client transactions for proper accounting of their business operations and clients' assets. In designing the requirements, the SFC was conscious of the need to strike an appropriate balance between providing investor protection and reducing the compliance burden of its regulatees. While the requirements are mainly prepared with reference to the existing section 83 and Division 5 of Part XA of the Securities Ordinance (Cap.333), section 45 of the Commodities Trading Ordinance (Cap.250) and section 3 of the Leveraged Foreign Exchange Trading (Books, Contract Notes and Conduct of Business) Rules, the SFC has, in consultation with the Hong Kong Monetary Authority, made the Rules with certain new elements designed to enable it to better achieve the aforesaid objectives.

### **Major new elements**

5. While the SFC has tried to minimize changes, it has rationalized the existing requirements in the aforesaid three different ordinances and prescribed requirements for application to intermediaries and their associated entities with respect to all types of regulated activities<sup>2</sup> and for selected types. Major policy changes that have been incorporated into the Rules include :-

- (a) to apply the Rules to a registered institution and an associated entity of an intermediary, introduced as part of the packages to remove the exempt status currently enjoyed by banks for their

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<sup>1</sup> 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.

<sup>2</sup> There are nine types of regulated activities. They are set out in Schedule 5 to the SFO.

securities operations and impose direct regulation of associated entities in order to close an existing regulatory gap<sup>3</sup>;

- (b) to expressly require an intermediary and an associated entity of an intermediary to keep, where applicable, records as are sufficient to reconcile balances and positions at least monthly, with the statements provided by external parties such as exchanges and clearing houses, and show how the reconciling differences (if any) were resolved; and
- (c) to expressly require an intermediary and an associated entity of an intermediary to keep records to demonstrate compliance with specified provisions in the SFO and rules made thereunder, and where applicable, their systems of control for ensuring compliance thereof.

## **THE RULES**

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

7. Section 3 of the Rules prescribe the accounting, trading and other record requirements that apply to the businesses which constitute any type of regulated activity carried on by an intermediary. The records required include those specified in the Schedule and in sections 5, 6, 7 and 8 (depending on the particular regulated activities being carried on).

8. Section 4 of the Rules prescribes the accounting and other record requirements that apply to an associated entity of an intermediary with respect to the client assets of the intermediary that it receives or holds.

9. Sections 5, 6, 7 and 8 of the Rules prescribe particular record keeping requirements applicable to an intermediary or a licensed corporation (as the case may be) respectively regarding their activities in dealing in

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<sup>3</sup> 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.

securities, leveraged foreign exchange trading, providing securities margin financing and other financial accommodation as well as entering into margined transactions, and providing asset management.

10. Sections 9 and 10 of the Rules respectively prescribe the form in which records must be kept and the period for which they must be retained.

11. Section 11 of the Rules requires an intermediary and an associated entity of an intermediary to report to the SFC non-compliance with prescribed provisions of the Rules.

12. Section 12 of the Rules prescribes penalties for contravention of prescribed provisions of the Rules.

## **PUBLIC CONSULTATION**

13. The SFC released a consultation document and an exposure draft of the Rules on 15 February 2002 for comment by the public. A total of 15 submissions were received by the end of the consultation period. The SFC has considered all the comments received and revised the Rules as appropriate.

14. A draft of the Rules was considered by the Subcommittee at its meetings held on 9 July 2002 and 24 October 2002. No major concerns were expressed by members of the Subcommittee at the meetings.

## **FINANCIAL AND STAFFING IMPLICATIONS**

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

## **COMMENCEMENT DATE**

16. 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**

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

## **ENQUIRIES**

18. For any enquiries on this brief, please contact Ms Linda Chiang of the Intermediaries Supervision Department of the SFC at 2842 7766 or Ms Vania Cheng of the Legal Services Division of the SFC at 2283 6166.

The Securities and Futures Commission  
13 December 2002