

SECURITIES AND FUTURES ORDINANCE

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The Securities and Futures Ordinance <"SFO"> was effective on 1st April, 2003. It consolidates and modernizes 10 different ordinances regulating the securities and futures markets which were written over nearly for the last 30 years.

In this context, we focus on the major changes on the rules relating to the capital requirement, the conduct of regulated activities and the responsibilities of auditors which are most relevant to the audit of securities and brokerage companies <"licensed corporations">.

CAPITAL REQUIREMENT

Section 145(1) of the SFO specifically empowers the Securities and Futures Commission <"SFC"> to make rules requiring licensed corporations to maintain financial resources according to specific requirements. The rules in regulating the financial resources of licensed corporations are Financial Resources Rules <"FRR">.

Licensed corporations which handle clients' assets are required to comply with capital requirements which are made up of a paid-up capital requirement and a liquid working capital requirement. The minimum amount of paid-up capital of a licensed corporation must maintain varies with the different types of regulated activities. The minimum amount of liquid capital that a licensed corporation is required to maintain is known as its required liquid capital.

The major changes of the new FRR are as follows:

- There is only one standard set of capital rules for general application to all types of licensed corporations.
- The new FRR shall accommodate the conduct of a business consisting of multiple regulated activities by licensed corporations.
- There is a provision to provide for a licensed corporation to allow its cash clients to settle on a roll-over balance basis.
- There is an application of new haircut rates to constituent stocks of the Hang Seng Hong Kong LargeCap Index and the Hang Seng Hong Kong MidCap Index.
- In the calculation of concentration discounting factor, the grouping of related securities under former rules is no longer applicable.
- The overseas futures/options exchanges and clearing houses in certain regions are recognized.
- For the calculation of adjusted liabilities, client money held overseas is excluded under certain conditions.

CONDUCT OF REGULATED ACTIVITIES

For regulating the conduct of regulated activities of licensed corporations, several subsidiary legislations under the SFC are enacted. In this context, we focus on the Securities and Futures (Client Money) Rules, Securities and Futures (Client Securities) Rules, Securities and Futures (Keeping of Records) Rules and Contract Notes, Statement of Accounts and Receipt Rules. The following are the details of the rules:

Securities and Futures (Client Money) Rules <"Client Money Rules">

The purpose of the Client Money Rules is to prescribe the manner in which licensed corporations and their associated entities must treat and deal with client money that they receive or hold in Hong Kong. The rules are only applicable to licensed corporations and their associated entities. Authorized financial institutions, i.e. licensed banks are excluded. The rules apply to client money of a licensed corporation that is received or held on behalf of the licensed corporation or an associated entity in the course of the conduct of a regulated activity. They do not apply to client money of a licensed corporation that is received or held outside Hong Kong. There is a provision for the payment of client money into segregated accounts designated as trust accounts or client accounts within one business day after receipt. In the previous rule, the time limit for segregation of client money received was four days after receipt. The rule also provide for payment out and the treatment of interest bearing out of such accounts.

The following are the other major features of the Client Money Rules:

- Segregated account for client money must be maintained with either a licensed bank or a person approved by the SFC for such purposes.
- Payment out of segregated accounts must be paid to the client either with a written direction or with a standing authority for certain specified purposes.
- A licensed corporation or its associated entity is required to report to the SFC regarding any non-compliance with rules on payment in or payment out of such accounts within one business day after it has become aware of the fact.
- A standing authority is a written notice given by a client to a licensed corporation or an associated entity authorizing the handling of client money as specified but the duration of the notice must not longer than 12 months, except in the case of a professional investor.
- A licensed corporation or an associated entity shall remind a client at least 14 days prior to the expiry of a standing authority and inform him that unless he objects, the authority will be renewed upon expiry. In such event, the licensed corporation or associated entity shall give a written confirmation to the client of the renewal of the standing authority within one week after expiry.

Securities and Futures (Client Securities) Rules <"Client Securities Rules">

The purpose of the Client Securities Rules is to prescribe the manner in which intermediaries and their associated entities must treat and deal with client securities and securities collateral that they receive or hold in Hong Kong. The rules apply to client securities and securities collateral of an intermediary, which are either listed/traded on a recognized stock market or in an authorized collective investment scheme and received or held in Hong Kong by or on behalf of the intermediary or its associated entity in the course of the conduct of a regulated activity. The rules do not apply to overseas securities.

The following are major features of the Client Securities Rules:

- An intermediary or its associated entity is required to ensure that client securities or securities collateral received are deposited in segregated trust accounts or registered in the name of the clients or associated entity. The segregated trust account must be with a licensed bank, an approved custodian, or another licensed intermediary in Hong Kong.
- The rules apply to local securities as well as to collective investment schemes.

- The right of disposal of client securities can be provided for in client' s agreement.
- The dealing of client securities and collateral shall be in accordance with specific directions or standing authority which the duration shall not over 12 months except in the case of a professional investor, but must not be unconscionable. A client must be given a written confirmation of the renewal of a standing authority within one week after its expiry.

Securities and Futures (Keeping of Records) Rules <"Keeping of Records Rules">

The purpose of the Keeping of Records Rules is to provide for the keeping of specified records by intermediaries and their associated entities in relation to the businesses which constitute the regulated activities for which they are licensed or registered. The rules are divided into 2 divisions. One is general record keeping requirements which apply to intermediaries in general and the other which separately apply to individual types of regulated activities.

The following are the major features of Keeping of Records Rules:

- Intermediaries must keep sufficient accounting trading and other records to reflect their true financial positions and all records and movements of client assets, to reconcile balances or positions with exchange companies, clearing houses, custodians and banks.
- The records shall demonstrate compliance with the Client Money Rules, Client Securities Rules and FRR.
- Associated entities of intermediaries shall be required to keep specified records in respect of client assets that they receive or hold.
- Intermediaries shall keep records to enable particulars of orders or instructions to be traced through their trading accounting settlement and stock holding systems and retain them for 2 years.
- All other records referred to in the rules shall be retained for 7 years.
- Different regulated activities such as foreign exchange trading, securities margin financing and asset management shall keep specified records.
- If an intermediary or an associated entity becomes aware that it does not comply with any provisions of the rules it is required to report to the SFC regarding the non-compliance within one business day.

Contract Notes, Statement of Accounts and Receipt Rules

The Contract Notes, Statement of Accounts and Receipt Rules apply to intermediaries and their associated entities conducting regulated activities except where it is licensed or registered for asset management apart from certain requirements on issue of receipts. However, the rules may be avoided by intermediaries or associated entities in respect of a client who is a professional investor as defined in Part 1 of Schedule 1 to the SFO, where he is so informed in writing and does not object to the arrangement of non-provision.

The following are the major features of Contract Notes, Statement of Accounts and Receipt Rules

- An intermediary who enters into a contract with or on behalf of a client shall provide a contract note not later than the end of the second business day.
- Subject to no contrary instructions from client, an intermediary may prepare a single contract note with average pricing for multiple contracts entered into on the same day in

accordance with specific rules on consolidated contract notes.

- An intermediary providing financial accommodation to a client shall prepare and provide to him a statement of account on the same day when a transaction or event takes place.
- An intermediary who enters into margin transactions with or on behalf of a client shall prepare and provide to him a statement of account not later than the end of the second business day.
- An intermediary shall prepare and provide to its client a monthly statement not later than 7 days from the end of the month.
- Upon a request from a client for a statement of account to date, an intermediary shall prepare and provide that statement of account as soon as practicable giving information.
- An intermediary or its associated or its associated entity shall provide to its client a receipt for the assets or securities that it has received from the client not later than the end of the second business day.
- If an intermediary or an associated entity becomes aware that it does not comply with provisions of the rules it is required to give written notice to the SFC regarding the non-compliance within one business day.

RESPONSIBILITIES OF AUDITORS

Appointment/ change of Auditors

It is mandatory that a licensed corporation must appoint auditors within one month after it becomes licensed. An associated entity of a licensed corporation has the same obligation in this respect as if it is a licensed corporation. After the appointment of auditors, a licensed corporation or an associated entity must notify the SFC of the details of the auditors within 7 days.

Any change of the existing auditors by a licensed corporation or its associated entity must be notified to the SFC within one business day as from:

- (1) giving a notice to members at general meeting to pass a resolution to either remove auditors before the expiration of their term of office or to replace them at the expiration of their term of office, and
- (2) auditors ceasing to be such before the expiry of their term of office under any other circumstances.

Reporting to the SFC

In the course of auditing, once auditors become aware of a “reportable matter” or proposes to include any qualification or adverse statement in any report on the financial statements of their client, they shall lodge a written report with the Commission as soon as reasonably practicable. Where an associated entity of an intermediary is a registered institution, the auditors shall lodge a report on a reportable matter both to the Commission and the Monetary Authority and if it is in respect of a qualification and adverse statement, the report shall be lodged with the Commission alone.

Under S.157(1) of the SFO, a reportable matter can be briefly summarized as follows:

- With reference to a licensed corporation, it is a matter which
 - (1) Constitutes a failure to comply with any prescribed requirement;

- (2) Adversely affects its financial position to a material extent; or
 - (3) Constitutes a failure to comply with the provisions of financial resources under section 146 or any requirement under the FRR.
- With reference to an associated entity of an intermediary, it is a matter which is described either under (1) or (2) above, where in the case of (2), the associated entity is not a licensed bank.

When auditors resign or do not seek reappointment or cease to become auditors of a licensed corporation, they must notify the SFC within one business day by notice in writing separately as distinguished from the duty of the licensed corporation to do the same. They shall also give particulars of any connected circumstances which they consider ought to be drawn to the attention of the SFC. Where no such circumstances exist, the auditors shall give the SFC a statement to that effect.

Securities and Futures (Account and Audit) Rules <" Account and Audit Rules">

The Account and Audit Rules can be broadly categorized under three main topics, they are:

1. The preparation by licensed corporations and associated entities of intermediaries of such financial statements and other documents for periods as described.
2. The preparation of such documents when licensed corporations and associated entities cease to carry on regulated activities, or cease to be an associated entity.
3. The matters upon which auditors must give a statement of opinion in their report on the accounts of the licensed corporation or associated entity they are auditing.

The following are the major features of Account and Audit Rules:

- A licensed corporation shall prepare for each financial year.
 - A set of financial accounts.
 - Prescribed returns under the FRR.
 - A business and risk management questionnaire.
- On ceasing to carry on a regulated activity, a licensed corporation shall prepare for the financial year a set of accounts and a liquid capital computation as referred to in the FRR.
- An associated entity of an intermediary shall prepare for each financial year.
 - A set of accounts.
 - An analysis of client assets.
 - A business and risk management questionnaire
- On ceasing to be an associated entity of an intermediary, a corporation shall prepare for the financial year a set of accounts and an analysis of client assets.
- Auditors' report made under section 152(either(1)(b) or (2)(b)) shall contain a statement as to whether in the auditors' opinion:
 - (a) The financial statements are correctly compiled
 - (i) to give a true and fair view of the state of affairs;
 - (ii) from records kept according to Keeping of Records Rules;
 - (b) The FRR returns are compiled correctly from the records;
 - (c) There has been in place systems of control to ensure compliance with the relevant provisions of the Client Money Rules and Client Securities Rules;
 - (d) That certain provisions of the Keeping of Records, Client Money and Client Securities Rules and the FRR are complied with.
- A licensed corporation or an associated entity may submit two separate auditors' report in

the same financial year, one containing a statement by the auditors concerning matters of the financial statements and the other statement by the auditors concerning the other matters.

- Certain specific requirements under Client Money Rules, Client Securities Rules, Keeping of Records Rules are defined as “prescribed requirements” and as such an auditor of a licensed corporation or an associated entity of an intermediary is required to report to the SFC as soon as reasonably practicable, regarding their non-compliance.

If you have any queries in the compliance of these new rules and regulations, please seek professional advice from your auditors.

REFERENCE

For the full contents of the SFO and its subsidiary legislations, you may visit the website at <http://www.hksfc.org.hk/eng/bills/html/index/index0.html>.