

Updating Your Study Manual

Instructions for Inserting Version 1.3, 2003

The followings serve as the instructions for updating **Topic 4: Licensing and Subsidiary Legislation** of Study Manual 1 for the Licensing Examination for Securities and Futures Intermediaries. Please be reminded that only the updated sections are provided for downloading. You may replace the relevant sections with this updated version for the study manual you possess.

Instructions:

1. Download and print out the following pages.
 2. **Remove** pages 4-11 to 4-12 and **Insert** new pages 4-11 to 4-12.
 3. **Remove** pages 4-15 to 4-16 and **Insert** new pages 4-15 to 4-16.
 4. **Remove** pages 4-25 to 4-30 and **Insert** new pages 4-25 to 4-30.
 5. **Remove** pages 4-35 to 4-38 and **Insert** new pages 4-35 to 4-38.
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An individual applicant whose application is successful should continue to meet the requirements in paragraphs 1.19 to 1.22 on an ongoing basis.

Continuous Professional Training ('CPT')

- 1.23 The Guidelines on Continuous Professional Training ('GCPT') set out the SFC's expectations regarding CPT. These will also be applied as appropriate by the HKMA.
- 1.24 The SFC expects every individual licensee to clock up a minimum of 5 CPT hours every calendar year per regulated activity with proportional hours for incomplete years. CPT may be obtained through attendance at courses, workshops, lectures and seminars, distance learning, self study with submission of assignments by recognized institutions, research, publications, speeches and so on. As with other similar programmes, normal work and the reading of financial journals and newspapers and other technical publications which do not involve interaction with other individuals will not count towards CPT.

HKMA requirements for staff engaged in regulated activities

- 1.25 It is reiterated that the HKMA expects staff of registered institutions responsible for or conducting regulated activities to comply with the SFC's Fit and Proper Guidelines, the GC and GCPT requirements. This compliance will be monitored by the HKMA.
- 1.26 The equivalents of responsible officers for registered institutions are called **executive officers**. There **must** be at least 2 executive officers for each of regulated activity **conducted by the registered institution**. At all times there must be at least one executive officer available to supervise the regulated activity concerned. In addition, other staff of a registered institution conducting regulated activities must be on a register maintained by the HKMA of such persons, **but they need not be individually licensed by the HKMA or the SFC. These staff** are the equivalents of licensed representatives of licensed corporations.

The Securities and Futures (Licensing and Registration) (Information) Rules

(Referred to as 'the Rules' in this section)

- 1.27 The Rules prescribe the information to be included in:

- applications;
- notifications of changes;
- annual returns by licensed persons (which must be made within 4 months after the financial year-end); and
- particulars for entry in the Public Register maintained by the SFC.

Transitional arrangements

1.28 During the transitional period of 2 years from the date of implementation of the SFO (i.e. 1 April 2003) an arrangement has been made whereby the old categories of licensed persons will be deemed to be licensed to carry out certain regulated activities under the new regime. Details are as follows:

Old registration	New Activity Type	Activity permitted
Securities dealer	Type 1 Type 4 Type 6 Type 9	Dealing in securities Advising in securities Advising in corporate finance Asset management (securities only)
Commodity dealer	Type 2 Type 5 Type 9	Dealing in futures contracts Advising in futures contracts Asset management(futures contracts only)
Leveraged foreign exchange trader	Type 3	Trading in leveraged foreign exchange contracts
Investment adviser	Type 4 Type 6 Type 9	Advising on securities Advising in corporate finance Asset management (securities only)
Commodity trading adviser	Type 5 Type 9	Advising in futures contracts Asset management(futures contracts only)
Securities margin financier	Type 8	Securities margin financing

- 2.10 At the other end of the scale, the licensee may have fixed assets such as real estate and intangible assets such as goodwill and patents. These cannot be converted into cash quickly; they will normally take the longest time to convert. So they are given a deduction or 'haircut' of 100% i.e. they are marked down to nil value.
- 2.11 The many classes of assets between these two extremes are given various 'haircut' percentages, as they are called, based on the experience of the regulators. This is part of the reason for the FRR being over 150 pages long.

Ranking liabilities

- 2.12 Generally the liabilities included in the calculation, called ranking liabilities, are the total liabilities of the licensee. On the other hand, there may be items which are allowed by the SFC as deductible from the total liabilities, for example, loans which the lenders have agreed to subordinate to the rights of other creditors and lenders. These are few.

Liquid capital

- 2.13 After all these adjustments have been made we end up with 2 items:
- the total of adjusted liquid assets; and
 - the total of ranking liabilities.

Liquid Capital ('LC') = Approved Liquid Assets – Ranking Liabilities

Required liquid capital

- 2.14 The regulator is not fully satisfied if there is a positive LC and wants more. The collective experience of regulators has been that it is safer if the LC was always greater than a buffer figure or Required Liquid Capital ('RLC'). The SFC specifies RLC at preset figures for different types of regulated activities.
- 2.15 So the LC must be greater than the RLC. A first point to note therefore is that *the RLC or minimum capital level must be maintained at all times.*

Paid up share capital requirements

- 2.16 In addition to the RLC, licensed corporations are also required to have and maintain at all times paid up share capital ranging from HK\$5 million to HK\$30 million depending on the regulated activity they conduct. (Refer to the figures given in Table 1, Schedule 1 to the FRR). If a licensed

corporation conducts more than one regulated activity, it must maintain the highest single requirement applicable to the individual activities. Some classes of licensed corporations, generally those which do not incur liabilities to clients, do not have paid up capital requirements.

Miscellaneous requirements

Notifications to the SFC

- 2.17 We have seen in paragraph 7.3 of topic 3 that a licensed corporation must notify the SFC if it fails to maintain the specified required amounts of capital or is unable to comply with other capital requirements. A licensed corporation that cannot comply with the specified LC requirements will have to cease trading unless it is permitted to carry on by the SFC. Section 54 of the FRR requires the notification to state the reasons and the steps being taken to rectify the breach.
- 2.18 A licensed corporation must also notify the SFC in writing in a number of circumstances, **such as**:
- if its LC falls below 120% of the RLC, or falls below the RLC, or falls below 50% of the last LC reported;
 - **if** its paid-up share capital falls below that required; and
 - **if** the information submitted in any earlier return is, or has become, materially misleading.

Returns to the SFC

- 2.19 Corporations licensed for any one or more of the regulated activities, {other than pure advising activities (Types 4, 5, 6 and 9) not involving the holding of client assets} are required to make monthly returns of LC and RLC with supporting information. The 4 classes excluded above have only to make a return on the calendar half years containing financial statements with less detail as specified than for the others.
- 2.20 The returns must contain declarations specified by the SFC.

Request and approvals by the SFC

- 2.21 The SFC may request information from the licensed corporation to assist it in reviewing the FRR position.

manner specified is an offence and the offender is liable to pay penalties on conviction.

Revision question:

Question 10: What event will trigger off a duty for a licensed corporation to make a report to the SFC under the Client Money Rules? What are the likely consequences?

5 Securities and Futures (Keeping of Records) Rules **(Referred to as ‘the Rules’ in this section)**

5.1 The SFC has made the Securities and Futures (Keeping of Records) Rules, under s.151, SFO for intermediaries and their associated entities. The SFC has stated that the records which are required to be kept apply to regulated activities only. However it should be noted that as the records should be sufficient to produce financial statements they must show all liabilities. Other relevant requirements and recommendations will be studied under business operations in Topic 5.

General requirements for intermediaries

- 5.2 These provide for the keeping of accounting, trading and other records by intermediaries:
- to reflect the financial position and operations of the regulated businesses;
 - to enable financial statements to be prepared from time to time;
 - to show all client assets handled and movements in these assets;
 - to be able to make monthly reconciliations with external parties;
 - to demonstrate compliance with the Securities and Futures (Financial Resources) Rules, the Securities and Futures (Client Money) Rules and the Securities and Futures (Client Securities) Rules;
 - to demonstrate that the intermediary has systems of control to ensure compliance with the Client Money and Client Securities Rules;

- which will enable audits to be conveniently and properly carried out; and
- which are kept in accordance with generally accepted accounting principles.

The records should include all the items specified in the Rules and the Schedule attached to the Rules to which interested readers may refer. Students will not be expected to have a detailed knowledge of the items in the Schedule.

Record keeping requirements for associated entities

- 5.3 The requirements are similar to those for intermediaries above in particular providing for the keeping of records by associated entities of client assets, movements in them and in financial items relating to them.

Miscellaneous

Form of records

- 5.4 The records should be kept, in Chinese or English, in writing or in any other form that may be readily accessed and convertible into writing. The Rules require all reasonable procedures to be adopted to guard against, and to enable discovery of, any falsifications.

Retention time

- 5.5 The general rule is that all records should be kept for **at least** 7 years unless other periods are specified by legislation for any particular records. For example, the Rules require records documenting orders and instructions received to be kept for **at least** 2 years and the Contract Notes rules require that copies of contract notes should be retained for a period of **at least** 2 years (see paragraph 6.11 below). Also the definition of a record in section 2 excludes telephone recordings which are covered in the Code of Conduct for Persons Licensed by or Registered with the SFC. (The Code says that tape records should be kept for a minimum period of 3 months.)

Offences

- 5.6 A breach of the requirements in the Rules will be an offence which will attract penalties, of a fine for a breach without reasonable excuse, and a

fine and imprisonment if the breach was committed with an intent to defraud.

6 Securities and Futures (Contract Notes, Statements of Account and Receipts) Rules

(Referred to as ‘the Rules’ in this section)

6.1 The provisions in the SFO regarding the keeping of records are supplemented in s.152 by the recognition that various documents should be given to clients to provide evidence and keep them informed of the transactions carried out by the intermediaries and associated entities on their behalf. The SFC has made the Securities and Futures (Contract Notes, Statements of Account and Receipts) Rules under s.152, SFO regarding such documents. The Rules will not apply to professional investors:

- if they are professional investors as **specified** in Schedule 1, SFO and the investor does not object; or
- if they are professional investors as specified in the Securities and Futures (Professional Investor) Rules and the client agrees in writing not to receive these documents.

Contract notes

6.2 A contract note includes details of contracts for:

- dealings in securities, including securities borrowing and lending transactions;
- dealings in futures contracts; and
- dealings in leveraged foreign exchange contracts.

It is usually prepared in respect of a single transaction but several contracts on the same day for the same client may be included in a single contract note or consolidated into the daily statement. It must be issued by the intermediary to the client or any designated person by no later than the second business day after entering into the contract.

6.3 The contract must contain full particulars of the client, the intermediary, the contract, whether the intermediary is acting as principal (this need not be stated in a leveraged foreign exchange contract), whether the

account is a margin account, and additional details as specified in the Rules for:

- securities contracts;
- futures contracts; and
- leveraged foreign exchange contracts.

Application of Electronic Transactions Ordinance ('ETO') to contract notes

6.4 A Guidance Note was issued by the SFC prior to the making of the SFO which basically stated that contract notes may be issued in electronic form provided the requirements of the Electronic Transactions Ordinance ('ETO') and the Stamp Duty Ordinance where applicable were complied with.

6.5 The Guidance Note stated that to meet the requirements of the ETO:

- the client must consent to the contract note being in electronic form and to receiving it in that form;
- the issuer of the contract note should ensure that the original information is accurate, and is retained, transmitted and reproducible accurately; and
- the records contain accurate information as to the origin, destination, and time and date of transmission of the contract note.

Daily statements of account

6.6 A statement of account may be a daily statement or a monthly statement. A daily statement must be prepared:

- by intermediaries providing margin finance (Type 8 activity) and their associated entities showing opening and closing positions and movements in client assets and money; and
- by intermediaries conducting margined transactions (see note below) other than margin financing i.e. where they enter into contracts on behalf of clients against the receipt of margins or security from clients (a client of an asset manager may choose not to receive daily statements in writing); and issued to the client or his designated person not later than the second business day after any change in the account.

Note: A margined transaction refers to a contract which requires a client entering into the contract to pay a margin to the intermediary or provide security other than under a financial accommodation agreement.

Monthly statement of account

- 6.7 A monthly statement must be prepared by an intermediary for all clients with full details of opening and closing holdings, balances, open positions, margins held etc. and issued within 7 business days of the end of each monthly accounting period (which can be 4 weekly cycles and not necessarily calendar months; also portfolio asset managers are allowed 10 business days for issuing statements) to the client or his designated person. The only case when no monthly statement needs to be issued is if there is absolutely no action whatsoever on the account during the month and no balances at the end of it.
- 6.8 An asset manager need not prepare monthly statements of account for authorized collective investment schemes that it manages.

(For more details regarding the above please refer to the Rules.)

Receipts

- 6.9 Receipts should be issued by an intermediary or an associated entity on receiving client assets by the end of the next business day after the day of receipt. No receipts are required to be given in some cases where the client has received satisfactory confirmation in other ways.

Other matters

- 6.10 The general rule is that a client is entitled as soon as practicable:
- to receive copies of contract notes, statements of account and receipts upon his request; and
 - upon applying to the SFC, and subject to the SFC giving directions, to inspect copies of contract notes, statements of account and receipts kept by the intermediary.
- 6.11 The intermediary or associated entity must retain:
- contract notes, daily statements of account and receipts issued for a period of **at least 2 years**; and
 - monthly statements of account for a period of **at least 7 years**.

- 6.12 An intermediary or associated entity that becomes aware of a failure to comply with the provisions of these Rules must notify the SFC within one day. If it fails to comply with the Rules without reasonable excuse it will have committed an offence and may be fined.

Revision questions:

Question 11: Do the Contract, Statements of Account and Receipts Rules apply to professional investors?

Question 12: What is the difference between contract notes and statements of account?

7 Audit

- 7.1 Provisions relating to audit and accounting matters are contained in ss.153 to 163, SFO and were discussed in paragraphs 7.16 to 7.27 of Topic 3.

Securities and Futures (Accounts and Audit) Rules (Referred to as ‘the Rules’ in this section)

- 7.2 The SFC has made the Securities and Futures (Accounts and Audit) Rules specifying the form and contents of financial statements and other documents that licensed corporations and associated entities of intermediaries should prepare and the content of auditors’ reports.

Financial statements

- 7.3 The Rules require the preparation of accounts for each financial year consisting of a profit and loss account, a balance sheet and notes to the accounts for licensed corporations, associated entities of an intermediary and cessation accounts for each of these if they cease to carry on regulated activities or cease to remain as associated entities respectively.
- 7.4 In the case of active licensed corporations, supplementary information as at the end of the financial year, as specified in the Rules will have to be prepared including liquid capital calculations, a business and risk

- The Client Money Rules apply to money received or held by or on behalf of a licensed corporation or its associated entity in Hong Kong; it does not apply to money received or held outside Hong Kong.
- All money received as defined above less any legitimate deductibles such as charges due to the licensed corporation should, within one business day, be paid into a segregated account, to the client direct, or in accordance with his written direction or his standing authority. (In the last case the money may not be transferred to the licensed corporation, an associated entity or to any of their officers.)
- Interest on client money is due to the client unless otherwise agreed.
- A licensed corporation or associated entity should pay any money held in segregated account that is not client money out of the account within one business day of being aware of the fact.
- An intermediary should keep records that will enable it to
 - prepare financial statements from time to time;
 - demonstrate compliance with the specified provisions of the Financial Resources Rules, the Client Money Rules and the Client Securities Rules; and
 - demonstrate that it has systems of control to ensure compliance with the specified provisions of the Client Money Rules and the Client Securities Rules.
- The records kept by an intermediary should be readily accessible and convertible into written form.
- The records should be kept for **at least** 7 years unless otherwise specified by law.
- The Rules relating to Contract Notes, Statements of Account and Receipts do not apply to professional investors.
- Transactions for the same client on the same business day may be recorded in one contract note or in a daily statement of account.
- The Contract Notes Rules apply to dealings in securities, futures contracts and leveraged foreign exchange contracts.
- Monthly statements of account have to be produced except where there are no movements in money or assets and there are no balances in money or assets at the end of the month.

- The auditors' report on the financial statements of a licensed corporation and its associated entities should contain specific confirmations of opinion that:
 - the profit and loss account and balance sheet present a true and fair view of the financial position and trading;
 - records have been kept in accordance with the Record Keeping Rules;
 - specified provisions of the Client Money and Client Securities Rules have been complied with; and
 - control systems were in place to ensure this compliance.

Answers to revision questions

- Answer 1: An executive director must be a licensed representative and be approved by the SFC as a responsible officer.
- Answer 2: It will be applied to directors, managers, substantial shareholders, responsible officers and supervisors who should be of good character.
- Answer 3: Examples are that he should not be an undischarged or recently discharged bankrupt; and should not have been a substantial shareholder or involved in the management of an insolvent corporation, or a licensed corporation which failed to meet all obligations to clients.
- Answer 4: In the Guidance Note on Competence.
- Answer 5: As a licensed corporation is required to maintain the required liquid capital at all times it should be aware of its financial position at all times. This means in practical terms that it should review the liquidity position whenever there is a material adverse movement in its approved assets and ranking liabilities.
- Answer 6: Some points are that:
- transactions should be calculated on trade dates and not settlement dates;
 - the balance sheet must be prepared using generally accepted accounting principles; and
 - the substance of the transaction must be reflected in the balance sheet.
- Answer 7: The Required Liquid Capital ('RLC') of a licensed corporation is the minimum excess of approved assets over ranking liabilities which it is required to maintain. It is usually the greater of a specified floor requirement for that class of licensed corporation as stated in the FRR and a percentage (5%) of the ranking liabilities.
- Answer 8: Approved redeemable shares, approved subordinated loans and any standby approved subordinated loans which have been used.
- Answer 9: The intermediary should, as soon as reasonably practicable, deposit the securities collateral with an AFI, approved custodian, or other intermediary licensed to conduct dealing in securities, in a

segregated account or **to be held with any of these entities** in the name of the intermediary or register them in the name of the client, an associated entity or the intermediary.

Answer 10: If the licensed corporation or associated entity becomes aware of a failure to open a segregated account, pay money into the account or retain the money in the segregated account as specified, it must report the matter to the SFC within one business day thereafter. It is an offence to have failed to comply with the requirements as described above and the failure to do so will attract penalties.

Answer 11: No.

Answer 12: A contract note contains details of one or more specific transactions. A statement of account will normally contain details of the state of an account between the intermediary and the client including opening and closing balances of assets and money and the movement in these balances during the period covered by the account. A statement may, if desired or arranged, also include the full details of transactions contained in the respective contract notes.

Answer 13: He can issue two reports one containing the normal true and fair report and the other containing all the other confirmations.