THE LAW SOCIETY OF HONG KONG 香港律師會

Securities Law Committee of the Law Society of Hong Kong – Comments on the Draft Securities and Futures (Contract Notes, Statements of Account and Receipts) Rules

The Committee welcomes the opportunity to comment on the draft Rules, which would be made by the SFC under Clause 148 of the Securities and Futures Bill.

SECTION 2 - INTERPRETATION

"**Contract notes**" - it is helpful that any document complying with the requirements of the Rules can constitute a "contract note", without having to be described on the face of the document as a "contract note". It is also helpful that the time for providing a contract note to the client has been extended from 1 to 2 business days.

In practice, it is common for an intermediary to send an informal confirmation of the transaction to the client, and then to produce a "contract note" complying with legal and regulatory requirements. Indeed, para 8.2 of the SFC Code of Conduct specifically requires an intermediary to provide prompt confirmation of transactions to its client. We assume that it is **not** the intention of Section 6(3) of the Rules that the informal confirmation, if sent in the form of a document, must include all the contents required for a "contract note"?

"**Relevant contract**" - appears to be extremely widely defined. Arguably, the definition should not apply to transactions which would not constitute, because of the exceptions in Schedule 6 to the Bill, "dealing in futures contracts" or "dealing in securities". However, it is not clear whether this is the intention. We assume that the SFC intends the Rules to extend to all transactions in securities or futures contracts by regulated intermediaries (for example, where the regulated intermediary deals as principal with a "professional investor", even though this is exempted from the definition of "dealing in securities")?

We question whether the Rules should extend to situations such as the following:

- an underwriter entering into an underwriting agreement with the issuer of securities;
- an underwriter entering into arrangements with sub-underwriters;
- the placing of securities by an underwriter or placing agent;
- lending and borrowing under stock lending and borrowing agreements.

In all these cases, the arrangements will be appropriately documented under current market practice, and it may create a significant additional burden to require contract notes to be issued.

An exemption from the Rules in respect of transactions with "professional investors" would be one way of addressing these situations.

SECTION 3 - APPLICATION

"**Arrangers**"

Section 3 excludes an intermediary from the scope of the Rules where it has merely introduced an investor to an executing broker, or passed on an offer from that broker to an investor.

Since the requirement under Section 6 to prepare a contract note only applies, in any event, in respect of every relevant contract **entered into** in Hong Kong by an intermediary with or on behalf of a client of the intermediary, Section 3 as drafted appears unnecessary. In the circumstances described in Section 3(a) and (b), the relevant "intermediary" will not be entering into a contract, whether as principal or agent, but is merely acting as an "arranger".

SECTION 5 - AVOIDANCE OF DUPLICATION

While this is helpful, it would be useful if it extended to the situation where a Hong Kong intermediary refers the client's order to an executing broker outside Hong Kong, and the executing broker provides a contract note to the client in accordance with its local rules. As discussed above, arguably the Hong Kong intermediary should not fall within the scope of the Rules in any event. If the Hong Kong intermediary is subject to the Rules, but is satisfied that the executing broker will supply a contract note to the client in accordance with local regulatory requirements, arguably the Hong Kong intermediary should fall within the scope of the Section 5 exemption.

SECTION 6 - PREPARATION AND PROVISION OF CONTRACT NOTES

It is helpful that Section 6(2) permits an intermediary to provide a single contract note to a client in respect of relevant contracts entered into on the same business day. We also note that the intermediary may, in respect of a purchase or sale of the same description of securities (or futures contracts), provide the average price at which the securities or futures contracts were purchased or sold, but only **at the request of the client.**

Even if, as a policy matter, the SFC wishes to permit average pricing only where the client has agreed to this, the wording "at the request of the client" appears unduly restrictive. As long as the client has agreed (for example, by signing a letter to this effect), we suggest that this should be sufficient even if the intermediary had initiated the request for the client's consent. It should be noted that Section 6(7) affords additional protection to the client, by requiring the intermediary to provide a breakdown of the average price on request.

Where an average price has been provided, Section 6(7) enables the client to request a breakdown of the pricing. We suggest that a time limit should be imposed on the obligation in Section 6(7) and, for consistency with Section 14(5), this should be a period of two years from the time at which the contract note was issued.

Section 6(6)(a) requires, in the case of a leveraged foreign exchange contract, a statement, where applicable, that the intermediary is acting as agent, and the name of the person for whom it is acting. We assume that this is only intended to apply where the intermediary is acting as agent for the counterparty to the trade, and not where it is acting as agent for the client.

SECTION 8 - DAILY STATEMENTS OF ACCOUNT, INTERMEDIARIES PROVIDING FINANCIAL ACCOMMODATION

Section 8 contains provisions relating both to

- daily statements of account which are required in the case of deposits, withdrawals and other adjustments, and
- summary of the terms on which financial accommodation is provided.

As a drafting matter, it would be clearer if these two matters were dealt with in separate Sections. As a further drafting point, Section 8(2)(b) appears to require that, when there is a subsequent change in terms, a summary of the terms **and** details of the change are sent to the client. It would be clearer if Section 8(2)(b) referred to delivery of such summary of terms **or, as the case may be,** details of any subsequent change in such terms.

SECTION 11 - PREPARATION AND PROVISION OF MONTHLY STATEMENTS OF ACCOUNT

Section 11(6), as drafted, only refers to a client agreeing in writing not to receive a statement of account **as referred to in sub-section (4)**. Since Section 11(4) relates only to asset managers, it appears that only clients of asset managers who are professional investors can waive the requirement for monthly statements. However, we assume that this is a drafting error, as the consultation paper from the SFC contains a general statement that monthly statements of account need not be sent to professional investors who agree to this arrangement in writing.

SECTION 14 - DELIVERY AND LANGUAGE OF DOCUMENTS AND RETENTION OF COPIES

Under Section 14(2), adequate procedures must be adopted by the intermediary to identify any non-delivery and to **ensure** successful delivery by alternative means. It would be helpful if the SFC could provide guidance on what is meant by “adequate procedures”. In any event, we suggest that procedures will never be able to **ensure** delivery of statements, etc. to all clients. For example, there may be a client who has a small outstanding balance on his account but had moved address without notifying the intermediary. In these circumstances, it will not be possible to ensure that the monthly statements of account reach the client.

SECTION 15 - REPORTING OF NON-COMPLIANCE WITH CERTAIN RULES

The current requirement under the SFC Code of Conduct is that intermediaries report to the SFC any **material** breach of or non-compliance with (amongst other things) Rules made by the SFC. However, as Section 15 is drafted, it would be necessary to inform the SFC of any non-compliance with the Rules, however minor (for example, an error in a daily statement of account which was later corrected). This could potentially lead to a large volume of insignificant matters being notified to the SFC.

SECTION 16 - PENALTY

Failure, without reasonable excuse, to comply with any provision of the Rules will be a criminal offence punishable by a fine of up to HK$25,000. While it is important that clients receive prompt and accurate information from intermediaries, the Rules are administrative and technical in nature, and we expect that most breaches will occur through human error, computer failure, etc. rather than deliberate or reckless misconduct. The SFC will, under the Securities and Futures Bill, have extensive disciplinary powers that can be exercised against intermediaries, including the power to fine. It seems unnecessary to provide

for non-compliance with the Rules to be a criminal offence. While the only penalty is a fine, nevertheless, having a criminal record may have very serious consequences for an organisation or for an individual.

The Committee would be happy to discuss any of the above comments with the SFC.

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Securities Law Committee

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