THE LAW SOCIETY OF HONG KONG 香港律師會

COMMENTS ON THE DRAFT SECURITIES AND FUTURES (KEEPING OF RECORDS) RULES

Introduction

The draft Rules are to be made by the SFC under Section 147(1) of the Securities and Futures Ordinance, which will give the SFC wide-ranging powers to make rules as to records to be maintained by intermediaries.

It is clearly important that intermediaries should retain records sufficient to demonstrate their financial position and to enable true and fair accounts to be produced. It is also important that intermediaries should maintain records of client transactions and of cash and assets held for clients, and that the records should be readily accessible by auditors and the SFC.
The detailed requirements set out in the Rules, and whether they go further than is necessary to meet the regulatory objectives underpinning the Rules, are matters on which intermediaries themselves are best placed to comment. However, the Law Society is also concerned by the width of some of the Rules, in view of:

- the obligation to report any non-compliance with the Rules to the SFC and
- the criminal penalties attaching to breach of the record-keeping and reporting requirements in the Rules.

The fact that a breach of the Rules, without reasonable excuse, is a criminal offence, makes it important that the scope of the Rules is clear and not unduly broad. As a general matter, we question whether it is necessary to attach criminal sanctions to breaches of these Rules (although we agree that a breach of the record keeping requirements committed with intent to defraud should be criminal). If criminal sanctions are to remain, we suggest that some of the provisions of the draft Rules would more appropriately be dealt with in SFC Codes and Guidelines rather than in these Rules.

The Law Society's comments on the draft Rules are as follows:

Rule 3 - General record-keeping requirements for intermediaries

Rule 3(a) requires an intermediary to keep the records specified in Schedule 1, and Rule 3(b) also requires records to be kept which are sufficient to meet various requirements.

There appears to be significant overlap between the records referred to in Schedule 1, and the records that will be needed to comply with Rule 3(b). In many cases, it may be unclear whether the records set out in Schedule 1 are sufficient to satisfy Rule 3(b) as well, or whether Rule 3(b) is intended to impose additional requirements. It may be preferable to consider re-drafting Rule 3 so as to incorporate the provisions currently in Schedule 1 within the text of Rule 3(b).

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Rule 3(b)(ix) requires that an intermediary maintains records sufficient to "demonstrate compliance with its systems of control and all applicable provisions in the Ordinance and any Rules made under the Ordinance".

We agree that, consistent with the SFC's Management, Supervision and Internal Control Guidelines, an intermediary's operating procedures and control mechanisms should be appropriately documented, and that (for example) computerised systems should generate exception reports to indicate where procedures have not been correctly followed. However, Rule 3(b)(ix) as drafted gives rise to the following compliance difficulties:

(i) in view of the width of the definition of "systems of control" in the Rules, it seems unrealistic to expect that a firm's records could demonstrate compliance with its systems of control. Some procedures within the control system are inevitably undocumented, and, because of this, a firm's records would not be able to demonstrate compliance.

(ii) Furthermore, we do not think it is realistic to expect that an intermediary will have records to demonstrate compliance with "all applicable provisions in the Ordinance and any Rules made under the Ordinance". The "applicable provisions" are not defined, and we assume that this is intended to encompass all provisions of the Ordinance that are relevant to the business of an intermediary. For example, an intermediary may have compliance procedures, training programmes etc. to guard against the risk of "market misconduct" being carried out. However, it will never be possible to produce records to demonstrate that each transaction conducted by the intermediary did **not** involve insider dealing or some other form of market misconduct.

We suggest that Rule 3(b)(ix) be re-drafted. One possibility might be to require the intermediary to ensure that its "systems and controls" are in documentary form (along the lines of the requirements in the SFC's Management, Supervision and Internal Control Guidelines) and to require the intermediary to keep a record of any material breaches in complying with its systems of control, and any material breaches of the Ordinances and Rules made thereunder.

Furthermore, in view of the criminal sanctions attaching to a breach of the Rules, it may be preferable to address these matters in SFC Codes or Guidelines rather than in the Rules.

Rule 4 - General record-keeping requirements for associated entities

Our comments on Rule 3 also apply in respect of Rule 4.

Rule 7 - Additional requirements for advising on securities or futures contracts

This obligation appears extremely wide in scope. It requires records to be kept to explain the basis for any views disseminated to another person (directly or indirectly) regarding any specific securities or futures contracts. This would appear to apply, for example, to the situation

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where an analyst is interviewed on a television programme and expresses a view on the prospects of a particular company.

We note that Rule 7 only applies to an intermediary licensed or exempt for advising on securities or futures contracts. Licensing under this category is not required in respect of corporate finance advice, or for asset management. Nor does a securities dealer or futures dealer need to be licensed to advise on securities or futures contracts in order to give advice which is wholly incidental to the carrying on of its dealing business. While this may restrict the potential scope of Rule 7, the fact that the application of Rule 7 turns on the category or categories of licence held by the relevant person, appears somewhat arbitrary.

We suggest that Rule 7 be limited in scope to a person who is licensed or exempt for advising on securities or futures contracts and who makes a recommendation for remuneration, or who gives advice to a customer to whom he has assumed an advisory responsibility. This would be more consistent with the current SFC Management, Supervision and Internal Control Guidelines (see Section A3 of the Appendix to those Guidelines).

Alternatively, in view of the criminal sanctions attached to the Rules, it may be more appropriate to limit the scope of the Rules to records relating to the financial position of the intermediary, and to its custody of cash and assets for its clients. Matters such as keeping records of the basis for recommendations may more appropriately be dealt with in Codes and Guidelines, where a breach would reflect on "fitness and properness" but would not constitute a criminal offence.

Rule 8 - Additional requirements for advising on corporate finance

The obligation to keep such records as are sufficient to show separately and explain any work performed in providing corporate finance advice to a client, appears very broad. It appears to overlap substantially with the requirement in the Corporate Finance Adviser Code of Conduct to "be able to provide a proper trail of work done upon request by the SFC".

Again, in view of the criminal sanctions attaching to a breach of the Rules, we consider that matters referred to in Rule 8 would more appropriately be addressed in a Code of Conduct instead. Otherwise, we believe that Rule 8 needs to be re-drafted, because its scope is unclear and potentially too wide.

Rule 13 - Reporting of non-compliance with these Rules

Rule 13 requires any non-compliance with the Rules of which an intermediary or associated entity becomes aware to be notified in writing to the SFC within one business day thereafter. At the very least, we consider that this reporting obligation should be restricted to "material" breaches of the Rules.

In view of the fact that a breach of the Rules, without reasonable excuse, is a criminal offence, it is troubling that intermediaries have a responsibility to report non-compliance. We question

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whether it is really necessary or appropriate for breaches of the Rules (unless committed with intent to defraud) to give rise to criminal sanctions.

Rule 14 - Penalties

As already noted, some of our concerns about the rather broad and open-ended nature of the Rules stems from the fact that any breach of the Rules, without reasonable excuse, is a criminal offence.

We have no objection to imposing criminal sanctions on a person who fails to comply with the record-keeping requirements with intend to defraud. This is set out in Rule 14(b), but we do not believe that this sub-Rule is necessary, because an offence for record-keeping violations with intend to defraud is already set out in Clause 147(4) of the Bill. Although Clause 147(6) also enables the SFC to provide for a breach of the Rules, committed with intent to defraud, to be a criminal offence, we consider that Clause 147(4) is sufficiently wide, and that it is unnecessary to create an additional criminal offence pursuant to the Rules.

The Securities Law Committee
The Law Society of Hong Kong
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