Fax no. 2523 4598

Our Ref.: C/EPS, M10584

28 March 2002

Ms. Alexa Lam
SFC FRR,
12/F., Edinburgh Tower,
The Landmark,
15 Queen's Road,
Central,
Hong Kong.

Dear Ms. Lam,

Securities and Futures Bill
Public Consultation on Draft Keeping of Records Rules

This refers to your letter of 15 February 2002 to our President requesting comments on the captioned Consultation Paper. We would like to set out below our responses.

General comments

As stated in the Consultation Document, unlike the Securities Ordinance and the Commodities Trading Ordinance, the Securities and Futures Bill does not contain detailed record keeping requirements; it merely gives the Securities and Futures Commission the necessary rule-making power under clause 147 to prescribe requirements in the subsidiary legislation. We had anticipated therefore that the Keeping of Records Rules made under the Securities and Futures Bill would prescribe reasonably specifically the records required to be kept.

In our review of the Consultation Document, however, we noted that while certain types of records are specified in the draft Rules, some of the requirements are worded more in the form of principles that intermediaries should bear in mind when deciding the types of records to be kept in order to satisfy the requirements of the Rules. We consider that this may cause ambiguity as to what detailed records are to be kept by intermediaries and their associated entities. The problem of interpretation is compounded by the fact that the overall objective of the draft Rules is not entirely clear. The background materials contain only a brief statement that "the draft Rules require intermediaries and their associated entities to keep records containing sufficient details to explain their business activities and operations and account for their client assets". However, the very broad scope of the types of materials that must be retained, for up to 7 years, arguably goes beyond this general statement of purpose. As a corollary to this, auditors would have difficulty in ascertaining whether there are sufficient internal controls in place in respect of

record-keeping unless the draft Rules specify in more detail the record-keeping requirements.

A further general point that we wish to make that is that the term "records" is not defined and appears to be used in different senses in different contexts, sometimes generically and sometimes more specifically. This may cause some confusion. In Rule 3(a), for example, the reference to "records" would appear to be intended to cover all the materials in Schedule 1, whereas Schedule 1 itself, prima facie, distinguishes "records" in paragraph 1(a) from "copies" in paragraph 1(b), which, in the latter case, also includes "records" amongst other materials, such as contracts, order forms, etc.

Comments on specific provisions

1. Section 3(iv)

   Section 3(iv) of the draft Rules stipulates that an intermediary must keep records as are sufficient to "(where applicable) show separately particulars of each transaction entered into by it .... including particulars identifying with whom and on whose behalf it has entered into such transaction ....". This provision appears to go beyond the existing Client Identity Rule Policy issued by the Securities of Futures Commission (SFC) in July 2000 which:

   - applies usually in relation to transactions in securities listed or futures contracts traded on the Hong Kong exchanges, instead of "each transaction" entered into by an intermediary: and

   - states that "if .... client identity information is provided within two business days, disciplinary action will not be taken", and that "[t]he SFC will not specify any particular way to comply with the Rule as long as a registered person has systems in place to ensure that the information can be provided within 2 business days of the request ....".

   Some clarification on the difference in approach, if any, between the Policy and the draft Rules would be helpful.

2. Sections 3(b)(ix) and 4(b)(v)

   Sections 3(ix) and 4(b)(v) of the draft Rules require that an intermediary and its associated entity must keep records as are 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, where practicable and feasible, it is a good practice to maintain proper and sufficient records about the firm's internal control procedures. However, "system of control" is not well defined and can be interpreted broadly. It is also difficult for intermediaries to maintain records to demonstrate compliance with "all applicable provisions in the Ordinance and any Rules made under the Ordinance". Given the fact that any non-compliance with

the Rules may give rise to criminal sanctions, it is important that the SFC provides further guidance on their expectation as to the records and documents that should be kept. Alternatively, the SFC may specify what they consider to be key and important "system of control" and provisions in the Securities and Futures Ordinance, and narrow down the application of this section to those areas.

3. Section 7

Section 7 of the draft Rules requires an intermediary to "keep such records as are sufficient to explain the basis for any views disseminated, or recommendations made by it to another person (directly or indirectly) regarding any specific securities or specific futures contracts". We agree that any specific trade recommendations or investment advice given by an intermediary to its clients should be suitable, balanced and well supported. However, the requirement for intermediaries to keep records as are sufficient to explain the basis for "any views" disseminated directly or indirectly is much broader. This may even technically cover oral and casual communications with clients or other persons that are not intended to solicit or to advise such persons to trade. It seems more appropriate to require an intermediary to keep sufficient records to explain the basis for their views or recommendations, if and only if the intermediary knows or has reason to believe that those other persons will rely on their views or recommendations to deal.

As regards the types of records to be kept, we again consider that more guidance needs to be given. An intermediary's investment advice is likely to be based upon a variety of sources such as overall strategies, analysis reports, research findings etc. Whether documentation of these will be regarded as "sufficient" to explain the basis of particular views or recommendations could be quite subjective. It would therefore be difficult for both the intermediary and its auditors to ascertain whether certain records are required or are not required to be retained under section 7.

We also note that in a number of sections that the proposed requirements are very broad and extensive without regard to issues such the materiality and importance of particular information. We have concerns about the practicality of the proposed requirements and whether a reasonable balance has been struck between the cost and benefits of compliance. Some examples are indicated below.

4. Section 13

Section 13 of the draft Rules requires an intermediary "which becomes aware that it is not in compliance with **any** provision of Part II shall, within one business day thereafter, notify the Commission by notice in writing of that fact". It would be more appropriate to require an intermediary to report only material non-compliance. From the practical point of view, a requirement for an intermediary to report all technical and minor non-compliance appears to be unduly burdensome. Moreover, one business day

may not be sufficient for an intermediary to perform a proper internal review to ascertain the facts. The requirement seems especially onerous given that any non-compliance with the Rules may give rise to criminal sanctions.

5. Section 14

Section 14 of the draft Rules stipulates that an intermediary breaching the Rules without reasonable excuse is liable to a fine of HK$200,000 and to imprisonment for 2 years. While it is appropriate to impose criminal sanctions on an intermediary who contravenes the Rules with intent to defraud, it appears unnecessary and inappropriate to treat potentially every minor technical breach of the Rules as a criminal offence. As a minimum, the SFC should provide further clarification on what constitutes "reasonable excuse" for the purposes of the Rules.

6. Schedule 1, paragraph 1(b)(i) and Schedule 2, paragraph 1(a)(i)

Paragraph 1(b)(i) of Schedule 1 requires an intermediary to keep copies of all "contracts, order forms, confirmations, statements, registers, records, memoranda and correspondence created or received by it in the course of the business ….". Paragraph 1(a)(i) is similarly broad in relation to an associated entity of an intermediary. The coverage of these provisions appears to be extremely wide. It could be argued that they require an intermediary/associated entity to maintain all papers and documents regardless of their content, materiality and importance. Misallocation of insignificant documents, disposal of unimportant papers or even deletion of trivial e-mails could technically constitute non-compliance with the Rules and may give rise to criminal liability. It would be more practicable to require an intermediary/associated entity to maintain only such records as are sufficient to explain its transactions and regulated business activities.

If you have any queries on the above, please feel free to contact me.

Yours sincerely,

PETER TISMAN
DEPUTY DIRECTOR
(BUSINESS & PRACTICE)
HONG KONG SOCIETY OF ACCOUNTANTS

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