

**Suggested Control Techniques and Procedures
for Enhancing a Firm's Ability to Comply with
the Securities and Futures (Client Securities) Rules
and the Securities and Futures (Client Money) Rules**

**Securities and Futures Commission
Hong Kong**

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Suggested Control Techniques and Procedures for Enhancing a Firm’s Ability to Comply with the Securities and Futures (Client Securities) Rules and the Securities and Futures (Client Money) Rules

Foreword

Purpose

This Guidance Note, which is published under section 399 of the Securities and Futures Ordinance (Cap. 571) (“the SFO”), provides guidance on internal control techniques and procedures that are generally expected of -

- (a) a licensed corporation, a registered institution and any associated entity of either of them in complying with the Securities and Futures (Client Securities) Rules (“Client Securities Rules”) that are made under section 148 of the SFO; and
- (b) a licensed corporation and any associated entity of such corporation in complying with the Securities and Futures (Client Money) Rules (“Client Money Rules”) that are made under section 149 of the SFO.

The two sets of Rules just mentioned are together referred to in this Guidance Note as the “Client Assets Rules”. Each entity that is required to comply with the Client Assets Rules is referred to in this Guidance Note as “a firm”, or “firms” where more than one is involved.

Unless otherwise specified or the context otherwise requires, words and phrases in this Guidance Note shall be interpreted by reference to any definition of such word or phrase in Part 1 of Schedule 1 of the SFO.

The Commission places great importance on licensed corporations and registered institutions being fit and proper to remain licensed or registered. In considering whether a licensed corporation or registered institution is fit and proper, the Commission may take into account, amongst other things, whether the firm has established effective internal control procedures and risk management systems to ensure its compliance with the Client Assets Rules. In this regard, the Commission will be guided by the suggested control techniques and procedures set out in this Guidance Note. Likewise, the Commission generally expects an associated entity of either a licensed corporation or a registered institution to implement similar control procedures.

This Guidance Note does not have the force of law and should not be interpreted in a way that would override the provision of any law.

Importance of internal controls

To ensure compliance with the Client Assets Rules, it is imperative that a firm establishes and maintains a system of controls that are designed to ensure that it complies with all applicable legal and regulatory requirements. Examples of such controls include adequate management oversight, appropriate policies and procedures, proper segregation of duties and appropriate general controls on high-risk areas (e.g. hold-mail arrangements for clients).

A firm should tailor its programme of supervision to meet its particular circumstances and needs. An adequate programme of supervision will include procedures for performing day-to-day monitoring and surveillance activities, conducting regular on-site visits of branch operations and providing ongoing training to its staff members.

Small firms may have difficulties in achieving an appropriate segregation of duties. Failure to properly segregate duties may result in undetected errors or abuses which may expose the firms or their clients to inappropriate risks. Whenever possible, small firms should assign duties in such a way as to ensure that the necessary checks and balances are present. Small firms should also have compensating controls to make up for any weakness as a result of being unable to properly segregate duties. Direct oversight of incompatible functions by management can provide the necessary compensating controls.

For further guidance on internal controls, a firm should refer to the rules, codes, guidelines, guidance notes and circulars issued by the Commission from time to time.

Alternative systems of internal controls

Given the significant differences that exist in the organizational structures of firms, this Guidance Note should not be construed as an exhaustive list of internal control techniques and procedures that will ensure a firm's compliance with the Client Assets Rules. It is recognized that different firms may require different internal control systems to suit their particular circumstances and needs. Factors that should be considered include the nature, size and volume of transactions undertaken by a firm, its mode of operation and the degree of control and supervision which members of management are able to exercise personally. Furthermore, there may be alternative ways of achieving the same control objectives.

A. Controls for complying with the Client Assets Rules

Compliance with the Client Assets Rules

1. Depending on the size and organizational structure of a firm, it should assign one or more designated staff member(s) to regularly review and monitor its compliance with the Client Assets Rules and its established policies and procedures in respect of handling of client assets. The designated staff member(s) ^(Note 1) should report to the firm's

(Note 1) The latter part of this Guidance Note specifies that a designated responsible staff member of a firm should perform certain specified duties. It is up to the management of a firm to decide whether one or more designated staff member(s) referred to here should also perform these other duties.

management as soon as he is aware of any non-compliance with the Client Assets Rules.

Provision of client instructions

2. Except for trade instructions, ^(Note 2) a firm should generally ask its clients to give written instructions in all their dealings with the firm. Instructions written on paper should bear the client's signature which the firm should match against that appearing in the client's account opening documents kept in the firm's records. Written instructions provided in the form of an electronic record should comply with the requirements of the Electronic Transactions Ordinance. Where the instructions provide for acts by a third party on a client's behalf, a firm should verify the identity of the designated third party. A firm should keep proper records of all written instructions.
3. The situations in which a client should provide written instructions include but are not limited to the following:
 - (a) when a client gives a firm a standing authority or direction on how his assets are to be handled (e.g. when a client asks for withdrawal of cash or authorizes collection of physical scrip);
 - (b) when a client asks a firm to amend his particulars (including his contact details); or
 - (c) when a client asks a firm to withhold his mail (including contract notes and/or statements of account) for collection by himself or at his own risk by a designated third party.
4. Implementation of the above types of client instructions should be subject to the prior written approval of a designated responsible staff member of the firm.

Clients' standing authorities or directions

5. When a firm receives a client's standing authority or direction, it should ensure that it satisfies the requirements in relation thereto set out in the Client Assets Rules.
6. A firm should keep proper records of all clients' standing authorities and directions. The records of clients' standing authorities should show the period for which they remain in force and the dates on which the firm communicates with its clients about the renewal or revocation of standing authorities.

(Note 2) It should be noted that when a client provides trade instructions to a firm, he may do so orally or in writing.

Updating of client particulars (including client contact details)

7. A firm should subject any amendment of client particulars (including client contact details) on its computer and other systems to dual control. Any input of an amendment by a staff member should be subject to review and authorization by another designated responsible staff member before the amendment is accepted by the systems. Furthermore, a firm should promptly follow up on any undelivered contract notes and/or statements of account to ensure that client contact details are accurate and up-to-date.

Issue of statements of account

8. A firm that holds any client money and/or client securities during or at the end of a month should send a statement of account to the client.

Handling of client complaints in relation to client assets

9. A firm should assign a designated responsible staff member to oversee and follow up on all complaints relating to client assets,^(Note 3) whether oral or written, lodged with the firm by, or on behalf of, a client including but not limited to the following:
 - (a) no contract note(s) and/or statement(s) of account are received;
 - (b) there are unauthorized transactions on the client's account; and/or
 - (c) there are discrepancies in account balances and/or stock holding between the client's own records and those shown on his statement(s) of account.
10. A firm should keep proper records of all client complaints relating to client assets and details of follow up actions. A pragmatic approach should be taken in respect of the level of detail of information to be kept of each complaint, having regard to the cost and benefit to a firm of using the client complaint records as a supervisory tool as well as the need to ensure that a sufficient record remains for future reference. Generally, the client complaint records will not be complete without details of the substance and resolution of each complaint.

Access to computer and other systems

11. A firm should allow only authorized personnel to access its computer and other systems on a needs basis. Authorized users should be given the minimum number of functions and value of transactions necessary to enable them to perform their day-to-day duties.

^(Note 3) For the avoidance of doubt, the client complaints referred to here do not include enquiries from clients in relation to the execution price for orders.

12. For access control purposes, a firm should assign unique access identification to each authorized user on its computer and other systems. The firm should also take reasonable steps to ensure that an authorized user will not release his access identification to any other person. Where user passwords are used, they should be changed regularly. Any access rights to the systems should be removed when an authorized user no longer performs duties associated with use of such systems.

Access to important office machines, records and stationery

13. A firm should allow only authorized personnel to access important office machines, records and stationery on a needs basis. For example, front-office staff members should not be allowed access to any dedicated facsimile machine that is earmarked for use by settlement staff, as for example for receiving clients' advice regarding their direct payment into a firm's designated bank account(s). Furthermore, a firm should restrict access to client account opening records, blank contract notes/statements of account, blank forms of official receipt, blank cheques, company chops, etc.

B. Controls for complying with the Client Securities Rules

Control over physical scrip

14. A firm should require a client to give written instructions for any collection of physical scrip by himself or, at his own risk, by a designated third party on his behalf. ^(Note 4) Upon deposit of physical scrip, a designated responsible staff member should issue an official receipt to the client or his designated third party, whoever has made the deposit. For withdrawal of physical scrip, the designated responsible staff member should require the client or his designated third party (as the case may be) to acknowledge receipt. A firm should keep proper records of all deposits and withdrawals of physical scrip.
15. A firm should perform routine counts at least on a monthly basis of any physical scrip belonging to its clients held by it. It should promptly follow up on all discrepancies and keep proper records of all reconciliations and follow up actions.

Control over settlement instructions

16. For issue of settlement instructions ("SI") through the Central Clearing and Settlement System ("CCASS"), a firm should ensure that the access control (for example, via smart card and password) and the limits for input or authorization functions granted to each authorized person are given on a needs basis and are set in such a way as to ensure proper checks and balances are present. A designated responsible staff member of the firm should review the SI activities reports on a daily

(Note 4) The procedures specified in paragraph 2, above, apply to written instructions as referred to in paragraph 14 also.

basis looking for any exceptional items or irregularities and ensure completeness.

Stock reconciliation and review

17. A firm should on a daily basis reconcile its internal stock records with the CCASS stock holding records. For stocks held in other locations, a firm should at least on a monthly basis reconcile its stock records with those of third party custodians (including banks). The firm should promptly follow up on all discrepancies and closely monitor those that are material or long overdue. It should keep proper records of all reconciliations and follow up actions.
18. A firm should as soon as practicable transfer any stocks in its CCASS clearing account that are not required for settlement into an appropriate segregated account at CCASS ^(Note 5).
19. A designated responsible staff member of the firm should immediately report to senior management and investigate any negative stock balances on any client's account.

C. Controls for complying with the Client Money Rules

Direct deposit of funds by clients

20. Where a client makes a direct payment into a firm's designated bank account(s), the firm should arrange for the client to promptly advise its settlement department directly that such a deposit has been made.

Issue of cash cheques/third party cheques

21. Generally, a firm should not issue either a cash cheque or a third party cheque to a client for settlement purposes. This will only be allowed in special circumstances when a client gives signed written instructions to this effect and a designated responsible staff member of the firm has given written approval.

Unidentified receipts

22. A firm should use its best endeavours to match any unidentified receipts in its bank accounts (including segregated accounts) ^(Note 6) with all relevant information in order to establish the nature of a payment and the identity of the person who has made it. As soon as the firm is reasonably sure that a receipt represents client money, the firm should promptly transfer the amount into a segregated account,

(Note 5) A segregated account here refers to an account at CCASS that is designated as a trust account or client account established and maintained under section 5(1) or section 5(2) of the Client Securities Rules.

(Note 6) A segregated account here means a segregated account established and maintained under section 4(1) and section 4(2) of the Client Money Rules.

even if it has not been able to identify which specific client has made the payment.

Maintenance of segregated account(s)

23. On a daily basis, a firm should update its ledger accounts, reconcile the balances on client and bank ledger accounts and effect transfers to or from the segregated account(s) in accordance with the Client Money Rules.

Bank reconciliation and review

24. Generally, a firm should arrange with its bankers to receive bank statements at least on a monthly basis. As soon as the bank statements are received, it should reconcile them with its ledger accounts and promptly follow up on all discrepancies and closely monitor those that are material or long overdue. It should keep proper records of all reconciliations and follow up actions.