

## **Consultation Document**

### **The Draft Securities and Futures (Client Money) Rules** **(the “draft Rules”)**

#### **Introduction**

1. Unlike the Securities Ordinance, Commodities Trading Ordinance and the Leveraged Foreign Exchange Trading Ordinance, the Securities and Futures Bill does not contain detailed requirements in relation to client money; it merely gives the SFC the necessary rule-making power under clause 145 to prescribe requirements in the subsidiary legislation. The basis for this approach is that, consistent with modern securities legislation such as the UK Financial Services and Markets Act, effective regulation depends upon the regulator having the flexibility to quickly address changing market practices and global conditions, by amending the rules rather than the primary legislation.
2. There are controls already built into the legislative system, whereby any rules made by the SFC must be subject to negative vetting by the Legislative Council. In addition, the SFC now releases the draft Rules for public consultation.
3. The SFC has used the new FinNet communication network to send copies of this consultation document to registered dealers that have lodged their Financial Resource Rules returns electronically with the SFC via FinNet. In addition, copies of the consultation document are available free of charge at the SFC’s office and can also be found on the SFC’s Internet website at <http://www.hksfc.org.hk>.
4. The public is invited to submit comments before close of business on 24 May 2001 by sending them by fax to 2523-4598 or by mail or e-mail to the following address :

SFC Client Money Rules  
12/F, Edinburgh Tower  
The Landmark  
15 Queen’s Road Central  
Hong Kong

or:

client\_money\_rules@hksfc.org.hk

5. It should be stressed that the draft Rules must be read in conjunction with the Securities and Futures Bill itself. For example, it will be imperative to understand the intended scope of application of the Rules is limited to client money received or held by a licensed corporation and an associated entity that is not an authorized financial institution.
6. To better ensure that our proposed Rules appropriately balance investor protection and general market practice, the SFC has formulated the draft Rules after consulting selected brokerage firms. We wish to acknowledge and thank them for their invaluable input.

### Background

7. A copy of the draft Rules is attached for reference. In short, the draft Rules require segregation of client money received or held in Hong Kong by licensed corporations and their associated entities. For client money received or held outside Hong Kong, the only requirement is notification to the clients and the SFC in case of exchange controls imposed on the money held.
8. The draft Rules are based on the existing section 84 and Division 6 Part XA of the Securities Ordinance, section 46 of the Commodities Trading Ordinance and section 23 of the Leveraged Foreign Exchange Trading Ordinance regarding treatment of client money by registered or licensed persons. These provisions require securities dealers, securities margin financiers, commodity dealers and leveraged foreign exchange traders to segregate client money in a trust account opened with an authorized financial institution. The time limit for segregation by securities dealers, securities margin financiers and commodity dealers is four business days whereas for leveraged foreign exchange traders the time limit is one business day after receipt of client money.

### New Policy Initiatives

9. Several policy changes have been incorporated into the draft Rules:
  - (a) extending the rules to cover client money held by an associated entity of a licensed corporation (except where the associated entity is an authorized financial institution);
  - (b) revising the scope of client money covered by the rules to include funds received from clients for settlement;
  - (c) confining the segregation requirement to client money received or held in Hong Kong;

- (d) accepting client's standing fund transfer instructions;
- (e) reducing the time limit for segregation;
- (f) setting a time limit for payment of non-client money out of trust account; and
- (g) requiring notification of client money subject to exchange control.

Inclusion of associated entity (Clause 2(2))

10. The use of a nominee company to hold client securities is a common practice amongst securities dealers. Such nominee companies are very often shelf companies with nominal share capital. In the past, we have also noticed some registered persons deploying such nominee companies to hold client money. The current law does not forbid such a practice but we believe these entities should be included in the regulatory net in view of the potential risk to investors.
11. To minimise supervisory overlap with the Hong Kong Monetary Authority, the draft Rules will not apply to an associated entity which is an authorized financial institution.

Revised scope of client money (Clause 3(2))

12. Currently, section 84 of the Securities Ordinance does not require segregation of client money received for settling purchases of securities which are delivered to the dealer within 4 business days. Whilst this grace period may be too generous for purchases of securities to be settled under the local T+2 clearing system, it fails to deal with the situation where payment is required well before the securities are delivered to the dealer in the case of dealings in overseas markets.
13. The draft Rules have now refined the existing position by excluding, instead, any amounts which will be paid out on the date of receipt or within the two following business days to meet the client's settlement obligations or margin requirements for the clients' securities or futures contracts dealing. This proposal allows the licensed corporation two days to make the necessary fund transfer to pay for trades effected for clients. The period of exposure of client money is thereby significantly reduced and the licensed corporation should still have sufficient time to arrange payment.

Segregation of client money received or held in Hong Kong (Clause 3(2))

14. Unlike the current segregation requirements, the draft Rules only require client money received or held in Hong Kong to be deposited into a trust account. The draft Rules do not impose similar requirements on client money received or held outside Hong Kong.
15. This change from the existing requirements recognises the practical difficulty of compliance with the segregation requirement in overseas countries, especially where there is no trust law or where no authorized financial institution has any office in that country. It also rationalises the requirements on licensed corporations which operate branches outside Hong Kong handling overseas investors' trading in overseas markets. Although the draft Rules do not specify treatment of client money received or held overseas, licensed corporations should still ensure proper safeguarding of such client money to comply with Code of Conduct For Persons Registered with the Securities and Futures Commission.

Accepting client's standing fund transfer instructions (Clause 2(1) & 3(3)(d))

16. Under the draft Rules, client money may be withdrawn in accordance with the client's written authority provided that such authority is not unconscionable in the sense used in the Unconscionable Contracts Ordinance. The client authority needs to be renewed annually.
17. This proposed change gives greater flexibility to clients in managing surplus funds and facilitates fund transfer to clients' custodians or settlement agents.
18. The draft Rules still forbid payment of client money to an account of an employee or officer of the licensed corporation or its associated entity or to an account of the licensed corporation or its associated entity in Hong Kong other than a trust account.

Time limit of segregation (Clause 3(3))

19. The time limit for segregation is reduced from four business days to one after the client money is received. The shortened time limit can significantly reduce the exposure of client money that is not segregated. Some market participants are concerned that one day may be too short to segregate client money received. Having considered that only client money received in Hong Kong will be subject to this segregation requirement, the SFC thinks one day should be enough for transferring receipts from a non-designated account to a trust account. In addition,

the one-day time limit has been instituted in the Leveraged Foreign Exchange Trading Ordinance since 1994 and has been complied with by licensed leverage foreign exchange traders. We welcome the market's view in this area.

Payment of non-client money out of trust account (Clause 4(2))

20. Sometimes, non-client money may be paid into a trust account in aggregated sum with client money. Under the current regime, securities dealers, securities margin financiers and commodity dealers are not allowed to pay non-client money into a trust account. Whilst leverage foreign exchange traders are allowed to pay non-client money received in a form of aggregated sum with client money into a trust account, they must pay such non-client money out within one business day after receipt of the aggregated sum. Some market participants are concerned that the time limit may be too short to ascertain or identify the non-client money portion from the aggregated sum. To remove any potential hardship in the treatment of such non-client money, we propose to allow payment of such non-client money out of the trust account within one day after the later of the date on which it is identified or received.

Notification of exchange control (Clause 6)

21. Licensed corporations and associated entities need to inform clients and the SFC within one business day if client money becomes subject to exchange controls. This requirement applies to both client money held in Hong Kong and outside Hong Kong.

Cash collateral

22. There is an argument that cash collateral should not receive the same protection as trust money because they are different in nature. We recognise that licensed corporations have an interest in cash collateral. However, it is not a common practice of licensed corporations to take cash collateral from clients. In the only example we noted of cash collateral received by a dealer, the money was placed with a bank as a time deposit. Therefore, we are of the view that cash collateral should be subject to the same requirements as other client money. Any hardship situations may be dealt with on individual case basis by application for modifications.