

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.

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SECURITIES AND FUTURES (CLIENT MONEY) RULES

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SECURITIES AND FUTURES (CLIENT MONEY) RULES

(Made by the Securities and Futures Commission under
section 145(1) of the Securities and Futures
Ordinance (of 2001)

1. Commencement

These Rules shall come into operation on the day
appointed for the commencement of Part VI of the
Ordinance.

2. Interpretation

(1) In these Rules, unless the context otherwise
requires -

"client contract" (客戶合約) includes any contract or
arrangement between -

(a) a licensed corporation and its client
containing terms on which the licensed
corporation is to provide services the

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provision of which constitutes a regulated activity;

- (b) an associated entity of a licensed corporation and a client of the licensed corporation, which contains terms regarding the treatment of client money;

"client's authority" (客戶授權) means the authority given in writing by a client to a licensed corporation or its associated entity concerning the treatment of client money and such authority -

- (a) is effective only if it specifies the period for which it is current;
- (b) remains in force for the period so specified or 12 months, whichever is the shorter; and
- (c) may be renewed in writing or otherwise for one or more further periods not exceeding 12 months at any one time.

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(2) These Rules do not apply to an associated entity that is an authorized financial institution.

3. Payment of client money into segregated accounts

(1) A licensed corporation that receives or holds client money as referred to in subsection (2) and any associated entity of the licensed corporation that receives or holds such client money must establish and maintain in Hong Kong one or more segregated trust accounts or client accounts, each of which must be designated as such and maintained with -

- (a) an authorized financial institution; or
- (b) any other institution approved by the Commission for the purposes of these Rules, either generally or in a particular case.

(2) The following amounts of client money received or held in Hong Kong by a licensed corporation or any of its associated entities must be dealt with in accordance with subsection (3) -

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- (a) all amounts received in respect of dealing in securities or dealing in futures contracts on behalf of a client -
- (i) less brokerage and other proper charges;
 - (ii) other than those amounts that the licensed corporation is required to pay out on the day of such receipt or within the following 2 business days in order to meet settlement or margin requirements which are the client's obligations in respect of such dealing;
 - (iii) other than those amounts that are reimbursements of money which the licensed corporation has paid out before the day of such receipt in order to meet the client's obligations in respect of such dealing;
- (b) all amounts that are received from or on behalf of a client to whom the licensed corporation provides financial accommodation to facilitate the acquisition

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and, where applicable, the continued holding of securities, except those amounts that are used to reduce the amount owed by the client to the licensed corporation;

- (c) all amounts, less brokerage and other proper charges, that are received from or on behalf of a client in respect of leveraged foreign exchange trading;
- (d) all other amounts received from or on behalf of a client;
- (e) subject to any agreement with a client to the contrary, all amounts derived by way of interest from the retention of any amount mentioned in paragraph (a), (b), (c) or (d).

(3) Within one business day after the receipt of any client money as referred to in subsection (2), the licensed corporation or associated entity that received it must pay it -

- (a) into an account referred to in subsection (1);

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(b) to the client from whom or on whose behalf it has been received;

(c) in accordance with an oral or written direction from the client from whom or on whose behalf it has been received; or

(d) in accordance with the client's authority of the client from whom or on whose behalf it has been received, except where -

(i) this would be unconscionable in the sense used in the Unconscionable Contracts Ordinance (Cap.458), as if the client's authority were a contract under that Ordinance; or

(ii) subsection (4) applies.

(4) Neither the licensed corporation nor the associated entity as referred to in subsection (3) may apply, or permit to be applied any client money as referred to in subsection (2) to -

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(a) its account in Hong Kong, or the account in Hong Kong of any corporation with which it is in a controlling entity relationship, other than an account referred to in subsection (1); or

(b) an account of -

(i) any of its officers or employees;
or

(ii) any officer or employee of any corporation with which it is in a controlling entity relationship,

unless that officer or employee is the client from whom or on whose behalf such client money has been received.

(5) No amount may be paid into an account referred to in subsection (1) unless it is -

(a) client money;

(b) received in a form in which it is aggregated with client money; or

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(c) authorized to be paid into the account by the Commission in a particular case on an application being made for that purpose.

4. Payment of client money out of segregated accounts

(1) All client money as referred to in section 3(2) that is paid into an account referred to in section 3(1) must be retained there by the licensed corporation or associated entity maintaining that account until it is -

(a) paid to the client on whose behalf it is being held;

(b) paid in accordance with section 3(3)(c) or (d);

(c) required in order to meet settlement or margin requirements -

(i) which arise in respect of dealing in securities or dealing in futures contracts carried out by the licensed corporation on behalf

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of the client on whose behalf it
is being held; and

(ii) which are the client's obligations
in respect of such dealing; or

(d) required to pay money that the client on
whose behalf it is being held owes to the
licensed corporation in respect of
regulated activity carried out by the
licensed corporation in accordance with a
client contract.

(2) An amount that is paid with client money into
an account referred to in section 3(1) in the form
described in section 3(5)(b) must be paid out again by
the licensed corporation, or the associated entity of the
licensed corporation, which received it, within one
business day after -

(a) the receipt of such an aggregated sum; or

(b) the identification of such amount,

whichever occurs later.

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5. Payment of interest on client money held in segregated accounts

Subject to any agreement with a client to the contrary, a licensed corporation or any associated entity of the licensed corporation must distribute at least once every 6 months to the client all amounts derived by way of interest from the retention in an account referred to in section 3(1) of client money as referred to in section 3(2) received from or on behalf of the client.

6. Notification where client money becomes subject to exchange control

Where client money held by a licensed corporation or an associated entity of the licensed corporation becomes subject to exchange control, the licensed corporation or associated entity must inform -

(a) the client on whose behalf it is being held; and

(b) the Commission,

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within one business day after becoming aware of this fact.

7. Reporting of non-compliance with certain provisions of the Rules

A licensed corporation or an associated entity which becomes aware that it is not in compliance with section 3 or 4(1) must notify the Commission within one business day.

8. Penalties

(1) A licensed corporation or an associated entity that contravenes section 3 or 4 -

(a) without reasonable excuse commits an offence and is liable -

- (i) on conviction on indictment to a fine of \$200,000 and to imprisonment for 2 years; or
- (ii) on summary conviction to a fine at level 6 and to imprisonment for 6 months;

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(b) with intent to defraud commits an offence
and is liable -

(i) on conviction on indictment to a
fine of \$1,000,000 and to
imprisonment for 7 years; or

(ii) on summary conviction to a fine of
\$500,000 and to imprisonment for 1
year.

(2) A licensed corporation or an associated entity
that contravenes section 5, 6 or 7 -

(a) without reasonable excuse commits an
offence and is liable on conviction to a
fine at level 3;

(b) with intent to defraud commits an offence
and is liable on conviction to a fine at
level 6.

Chairman,
Securities and Futures
Commission

2001

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Explanatory Note

These Rules are made by the Securities and Futures Commission under section 145(1) of the Securities and Futures Ordinance (of 2001). They prescribe the manner in which licensed corporations and certain associated entities must treat and deal with client money received or held in Hong Kong. There is provision for the payment of client money into segregated trust accounts or client accounts within one business day after receipt. Requirements are specified in respect of: payments out of such accounts, the payment of interest on client money held in such accounts, notification where client money becomes subject to exchange control, and self-reporting of non-compliance. Penalties are prescribed for breach of the Rules.