For discussion
on 9 July 2002

Paper No.14/02

Subcommittee on Draft Subsidiary Legislation to be made under the Securities and Futures Ordinance

Securities and Futures (Client Money) Rules

This paper sets out the proposals of the Securities and Futures Commission (SFC) to make rules under section 149 of the Securities and Futures Ordinance (SFO) (5 of 2002) to prescribe the manner in which licensed corporations and their associated entities must treat and deal with client money of the licensed corporations that they receive or hold in Hong Kong.

Proposal

2. The SFC proposes to make the Securities and Futures (Client Money) Rules, now in draft at **Annex 1**, under section 149 of the SFO.

Power to make the Rules

3. Section 149(1) of the SFO empowers the SFC to make rules requiring licensed corporations and their associated entities to treat and deal with client money of the licensed corporations in such manner as is specified.

4. The SFC is of the view that the draft Rules would be *intra vires* if made as drafted.

Major features of the draft Rules

5. The draft Rules at Annex 1 –

(a) require licensed corporations and their associated entities that receive or hold client money to establish and maintain segregated accounts for client money in Hong Kong, and generally to pay client money into such accounts within one business day of receipt (clause 4);

(b) specify the circumstances in which client money may be paid out of segregated accounts (clause 5);

(c) provide for the manner in which interest on client money held in segregated accounts is to be dealt with (clause 6);

(d) require money other than client money to be paid out of segregated accounts within one business day if licensed corporations or their associated entities become aware that such money is in such accounts (clause 10);

(e) require licensed corporations and their associated entities to report non-compliance with certain provisions of the Rules to the SFC (clause 11); and

(f) prescribe penalties for contraventions of certain provisions of the Rules (clause 12).

6. The SFC considers that by requiring licensed corporations and their associated entities to handle client money properly, the draft Rules would be consistent with the SFC's objectives in section 4(c) and (d) of the SFO "to provide protection for members of the public investing in or holding financial products" and "to minimise crime and misconduct in the securities and futures industry".

Public consultation

7. The SFC released a consultation document and an exposure draft of the Rules on 12 April 2001 for comment by the public. A total of 17 submissions were received. The SFC has considered all the comments received and revised the draft Rules as appropriate. We attach the following documents for Members' reference –

(a) Consultation Document on the draft Rules, at **Annex 2**, which sets out the underlying policy, together with the exposure draft of the Rules. The revised draft Rules are at Annex 1 for Members' consideration; and

(b) Consultation Conclusion and Summary of Comments and SFC's Responses, at **Annex 3**, which set out the conclusions from the consultation and the SFC's responses, in the form of a table, to the comments received. A list of respondents is attached to the Summary of Comments and SFC's Responses.

8. The SFC has introduced a number of initiatives and also further amended the exposure draft of the Rules to facilitate compliance, such as (a) permitting handling of client money in accordance with standing clients' authority; and (b) waiving the requirement to annually renew such standing clients' authority where the clients are professional investors, and also relaxing the renewal procedures. Such initiatives primarily reduce the administrative and operational burdens of licensed corporations and their associated entities.

Way forward

9. Subject to Members' views, the SFC will proceed to make the Rules under the authority vested in it and publish the Rules so made in the Gazette for tabling before the Legislative Council in the normal manner. The intention is that the Rules will come into operation on the commencement of the SFO.

Securities and Futures Commission
Financial Services Bureau
29 June 2002

Annex 1

D R A F T

[cf : Section 149 of the Securities and Futures Ordinance]

SECURITIES AND FUTURES (CLIENT MONEY) RULES

CONTENTS

SECURITIES AND FUTURES (CLIENT MONEY) RULES

(Made by the Securities and Futures Commission under section 149 of the Securities and Futures Ordinance (5 of 2002))

1. Commencement

These Rules shall come into operation on the day on which Part VI of the Securities and Futures Ordinance (5 of 2002) comes into operation.

2. Interpretation

In these Rules, unless the context otherwise requires –

"linked corporation" ( ) in relation to an associated entity of a licensed corporation, means a corporation –

(a) of which the associated entity is a controlling entity;

(b) which is a controlling entity of the associated entity; or

(c) which has as its controlling entity a person which is also a controlling entity of the associated entity;

"segregated account" ( ) means a segregated account established and maintained under section 4(1) and (2);

"standing authority" ( ) has the meaning assigned to it by section 8(1);

"written direction" ( ) has the meaning assigned to it by section 7.

3. Application

(1) Subject to subsections (2) and (3), these Rules apply to client money of a licensed corporation that is received or held by or on behalf of –

(a) the licensed corporation, in the course of the conduct of any regulated activity for which the licensed corporation is licensed; or

(b) an associated entity of the licensed corporation, in relation to such conduct of the regulated activity.

(2) These Rules do not apply to client money of a licensed corporation that is received or held outside Hong Kong by the licensed corporation or an associated entity of the licensed corporation.

(3) These Rules do not apply to client money of a licensed corporation that is –

(a) maintained in a bank account in the name of a client of the licensed corporation; and

(b) held by the licensed corporation or an associated entity of the licensed corporation solely as a result of that licensed corporation or associated entity –

(i) being in a position to transfer the client money to itself; or

(ii) otherwise having control of or power over the client money.

4. Payment of client money into segregated accounts

(1) A licensed corporation or any of its associated entities that receives or holds client money of the licensed corporation as referred to in subsection (3) shall establish and maintain in Hong Kong one or more segregated accounts for client money in accordance with subsection (2), each of which shall be designated as a trust account or client account.

(2) A segregated account referred to in subsection (1) shall be established and maintained with –

(a) an authorized financial institution; or

(b) any other person approved by the Commission for the purposes of this section, either generally or in a particular case.

(3) The following amounts of client money of a licensed corporation that are received or held by the licensed corporation or any of its associated entities shall be dealt with in accordance with subsection (4) –

(a) all amounts that are received in respect of dealing in securities or futures contracts on behalf of a client of the licensed corporation –

(i) less brokerage and other proper charges in connection with such dealing;

(ii) except those amounts that the licensed corporation is required to pay on the day of receipt or within the following 2 business days in order to meet the client's obligations to meet settlement or margin requirements in respect of such dealing; and

(iii) except those amounts that are reimbursements to the licensed corporation of money which the licensed corporation has paid at any time before the day of receipt in order to meet the client's obligations to meet settlement or margin requirements in respect of such dealing;

(b) all amounts that are received from or on behalf of a client of the licensed corporation to whom the licensed corporation provides financial accommodation to facilitate the acquisition 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 that are received from or on behalf of a client of the licensed corporation in respect of leveraged foreign exchange trading, less brokerage and other proper charges in connection with such trading;

(d) all other amounts that are received from or on behalf of a client of the licensed corporation, except –

(i) the amounts referred to in paragraph (a)(i), (ii) and (iii);

(ii) the amounts that are used to reduce the amount of financial accommodation owed by a client of a licensed corporation to the licensed corporation, as referred to in paragraph (b); and

(iii) the brokerage and other proper charges referred to in paragraph (c).

(4) Within one business day after a licensed corporation or any of its associated entities receives any amount of client money of the licensed corporation as referred to in subsection (3), the licensed corporation or associated entity shall pay it –

(a) into a segregated account;

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

(c) subject to subsection (6), in accordance with a written direction; or

(d) subject to subsections (5) and (6), in accordance with a standing authority.

(5) A licensed corporation or any of its associated entities shall not pay any amount of client money of the licensed corporation under subsection (4)(d) if –

(a) to do so would be unconscionable in the sense used in the Unconscionable Contracts Ordinance (Cap. 458), as if the standing authority in question were a contract under that Ordinance; or

(b) the standing authority authorizes payment to an account in Hong Kong of the licensed corporation or the associated

entity, or an account in Hong Kong of any corporation with which the licensed corporation is in a controlling entity relationship or in relation to which the associated entity is a linked corporation, and that account is not a segregated account.

(6) Neither a licensed corporation nor an associated entity of the licensed corporation may pay, or permit to be paid, any amount of client money of the licensed corporation to –

(a) any of its officers or employees; or

(b) any officer or employee of any corporation with which the licensed corporation is in a controlling entity relationship or in relation to which the associated entity is a linked corporation,

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

5. Payment of client money out of segregated accounts

(1) A licensed corporation or associated entity that holds any amount of client money of the licensed corporation in a segregated account shall retain it there until it is –

(a) paid to the client of the licensed corporation, being the client on whose behalf it is being held;

(b) subject to subsection (3), paid in accordance with a written direction ;

(c) subject to subsections (2) and (3), paid in accordance with a standing authority;

(d) required in order to meet the client's obligations to meet settlement or margin requirements in respect of dealing in securities or futures contracts carried out by the licensed

corporation on behalf of the client of the licensed corporation, being the client on whose behalf it is being held; or

(e) required to pay money that the client of the licensed corporation, being the client on whose behalf it is being held, owes –

(i) to the licensed corporation in respect of the carrying on by the licensed corporation of any regulated activity for which it is licensed; or

(ii) to the associated entity in respect of the receipt or holding of client money for or on behalf of the client by the associated entity.

(2) A licensed corporation or any of its associated entities shall not pay any amount of client money of the licensed corporation under subsection (1)(c) if –

(a) to do so would be unconscionable in the sense used in the Unconscionable Contracts Ordinance (Cap. 458), as if the standing authority in question were a contract under that Ordinance; or

(b) the standing authority authorizes payment to an account in Hong Kong of –

(i) the licensed corporation or the associated entity in circumstances other than those set out in subsection (1)(d) or (e); or

(ii) any corporation with which the licensed corporation is in a controlling entity relationship or in relation to which the associated entity is a linked corporation,

and that account is not a segregated account.

(3) Neither a licensed corporation nor an associated entity of the licensed corporation as referred to in subsection (1) may pay, or permit to be paid, any client money of the licensed corporation to –

(a) any of its officers or employees; or

(b) any officer or employee of any corporation with which the licensed corporation is in a controlling entity relationship or in relation to which the associated entity is a linked corporation,

unless that officer or employee is the client on whose behalf such client money is being held.

6. Treatment of interest on client money held in segregated accounts

(1) Subject to subsection (2), a licensed corporation or any of its associated entities that holds client money of the licensed corporation shall deal with amounts of interest derived from the holding of the client money in a segregated account in accordance with section 5(1).

(2) Any amount of interest retained in a segregated account which the licensed corporation or associated entity that holds the client money in question is entitled to retain under an agreement with a client of the licensed corporation, being the client on whose behalf the client money is being held, shall be paid out of the account by the licensed corporation or the associated entity within one business day after –

(a) the interest is credited to the account; or

(b) the licensed corporation or associated entity becomes aware that the interest has been credited to the account,

whichever is the later.

7. Requirements in respect of a client's written direction

For the purposes of section 4(4)(c) or 5(1)(b), a written direction is a written notice that –

(a) relates to an amount of client money of a licensed corporation referred to in the section;

(b) is given to the licensed corporation or an associated entity of the licensed corporation by the client of the licensed corporation –

(i) from whom or on whose behalf that amount of client money was received; or

(ii) on whose behalf that amount of client money is being held;

(c) directs the licensed corporation or associated entity to pay that amount of client money in a particular manner; and

(d) ceases to have effect after the client money to which it relates has been paid by the licensed corporation or associated entity in the manner directed.

8. Requirements in respect of a client's standing authority

(1) For the purposes of section 4(4)(d) or 5(1)(c), a standing authority is a written notice that –

(a) is given to a licensed corporation or an associated entity of the licensed corporation by a client of the licensed corporation;

(b) authorizes the licensed corporation or associated entity to deal with client money from time to time –

(i) received from or on behalf of; or

(ii) held on behalf of,

the client, in one or more specified ways;

(c) subject to subsection (2), specifies a period not exceeding 12 months during which it is valid; and

(d) specifies the manner in which it may be revoked.

(2) Subsection (1)(c) shall not apply to a standing authority which is given to a licensed corporation or associated entity by a client of the licensed corporation who is a professional investor.

(3) A standing authority which is not revoked prior to its expiry may be renewed for one or more further periods –

(a) not exceeding 12 months, if the client of the licensed corporation who gave it is not a professional investor; or

(b) of any duration, if the client of the licensed corporation who gave it is a professional investor,

at any one time, in any of the following ways –

(c) at the written request of the client of the licensed corporation who gave it;

(d) by means of the following procedure –

(i) at least 14 days prior to the expiry of the standing authority, the licensed corporation or associated entity to which it was given, gives a written notice to the client of the licensed corporation who gave the standing authority, reminding the client of its impending expiry, and informing the client that unless the client objects, it will be renewed upon expiry upon the same terms and conditions as specified in the standing authority and for –

(A) an equivalent period to that specified in the standing authority;

(B) any specified period not exceeding 12 months, if the client of the licensed

corporation is not a professional investor; or

(C) a period of any duration, if the client of the licensed corporation is a professional investor; and

(ii) the client does not object to the renewal of the standing authority before its expiry.

(4) Where a standing authority is renewed in accordance with subsection (3)(d), the licensed corporation or the associated entity (as the case may be) shall give a written confirmation of the renewal of the standing authority to the client of the licensed corporation within 1 week after the date of expiry.

9. Receipt of cheques for client money

For the purposes of section 4(3)(a) and (4), a licensed corporation or an associated entity of a licensed corporation that receives a cheque for an amount of client money is regarded as having received such amount only upon receipt by it of the proceeds of that cheque.

10. Requirement to pay money other than client money out of segregated accounts

A licensed corporation or any of its associated entities which becomes aware that it is holding an amount of money in a segregated account that is not client money of the licensed corporation shall, within one business day of becoming so aware, pay that amount of money out of the segregated account.

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

If a licensed corporation or an associated entity of a licensed corporation to which section 4(1), 4(4) or 5(1) applies becomes aware that it does not comply

with such section, it shall, within one business day thereafter, give written notice of that fact to the Commission.

12. Penalties

(1) A licensed corporation, or an associated entity of a licensed corporation, which, without reasonable excuse, contravenes section 4 or 5 commits an offence and is liable –

(a) on conviction on indictment to a fine of $200,000 and to imprisonment for 2 years; or

(b) on summary conviction to a fine at level 6 and to imprisonment for 6 months.

(2) A licensed corporation, or an associated entity of a licensed corporation, which, with intent to defraud, contravenes section 4 or 5 commits an offence and is liable –

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

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

(3) A licensed corporation, or an associated entity of a licensed corporation, which, without reasonable excuse, contravenes section 6, 8(4), 10 or 11 commits an offence and is liable on conviction to a fine at level 3.

(4) A licensed corporation, or an associated entity of a licensed corporation, which, with intent to defraud, contravenes section 6, 8(4), 10 or 11 commits an offence and is liable on conviction to a fine at level 6.

Chairman,
Securities and Futures Commission

2002

Explanatory Note

These Rules are made by the Securities and Futures Commission under section 149 of the Securities and Futures Ordinance (5 of 2002). They prescribe the manner in which licensed corporations and their associated entities shall treat and deal with client money received or held in Hong Kong. There is a provision for the payment of client money into segregated accounts designated as trust accounts or client accounts within one business day after receipt. Requirements are specified in respect of payments out of such accounts, the treatment of interest on client money held in such accounts and self-reporting of non-compliance. Penalties are prescribed for breach of the Rules.

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

(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

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.

(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) -

(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

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);

(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 -

(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

(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

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.

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,

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;

(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

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.

Annex 3

Consultation Conclusions on the Draft Securities and Futures (Client Money) Rules

Hong Kong
June 2002

INTRODUCTION

1. On 12 April 2001, the Securities and Futures Commission (the "SFC") released a consultation document ("Consultation Document") on the draft Securities and Futures (Client Money) Rules(the "Draft Rules") .

2. The Draft Rules contained detailed requirements to regulate the receipt and holding of client money with a view to protect the interests of the investing public by requiring licensed corporations and their associated entities to segregate and hold in trust client money received.

3. The consultation period closed on 24 May 2001.

4. A summary of comments received on the Draft Rules ("Summary of Comments") is attached as Appendix A.

5. Taking into account the submissions received and following discussions with commentators, several revisions to the Draft Rules were considered appropriate.

6. The purpose of this report is to provide interested persons with an analysis of the main comments raised during the consultation process and the rationale for the SFC's conclusions. This report should be read in conjunction with the Securities and Futures Ordinance (the "SFO"), Consultation Document and the Summary of Comments.

PUBLIC CONSULTATION

A. Background

7. The Draft Rules were prepared to ensure that clients' money received by licensed corporations or their associated entities were properly segregated and held in safekeeping for use by the clients.

8. From a policy perspective, the Draft Rules are intended primarily to:

   (a) rationalize the existing requirements for treatment of client money found in three different ordinances (i.e., 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);

   (b) expand the scope of the requirements to apply to all licensed corporations and their associated entities (except authorized financial institutions);

   (c) relax the segregation requirement to only those client funds received or held in Hong Kong; and

(d) modify the pre-existing requirements under the various ordinances relating to funds received for settlement purposes, transfer instructions by the clients and various timing deadlines (i.e., for segregation and for payments out of segregated account).

9. Basically, the Draft Rules impose a requirement upon licensed corporations and their associated entities to segregate client money from the licensed corporations' or their associated entities' money. The client money must be deposited into a segregated account within 1 business day of receipt if:

(a) the money is held or received in Hong Kong by either the licensed corporation or the associated entity; and

(b) the money will not be used for settlement purposes within the next two business days.

10. The Draft Rules also do not require segregation for client funds intended for payment of commission or fees or outright payment to or reimbursement made to the licensed corporation or associated entity.

B. Consultation Process

11. In addition to the public announcement inviting comments, the Consultation Document was distributed to all registered persons connected to the FiNnet and various professional bodies. The Consultation Document was also published on the SFC website.

12. Sessions were held with industry participants and with their legal advisors during the consultation period to discuss their comments.

13. 17 submissions were received from practitioners including fund management firms, international brokerage firms, legal firms, industry representative bodies, professional associations and industry regulators.

14. The overall tone of the comments was positive. Commentators generally welcomed the proposed Rules. Comments varied considerably in range and depth, with some focusing on broad principles and others on points of detail and clarification.

15. Taking into account the submissions received and following discussions with commentators, certain amendments to the original Draft Rules are considered appropriate.

CONSULTATION CONCLUSIONS

16. The following are the main changes made to the Draft Rules originally set out in the Consultation Document in response to market comments:

Clarification of Scope of Application

17. Some commentators asked for clarification as to the scope of application of the Draft Rules to money that is received by affiliates of licensed corporations not in connection with the regulated activities conducted by the licensed corporations and to licensed corporations that hold client money only by reason of their having power to operate the clients' bank accounts.

18. The Draft Rules have been revised to state expressly that they apply to client money received or held by or on behalf of a licensed corporation in the course of the conduct of any regulated activity for which the licensed corporation is licensed, or in case of client money received or held by or on behalf of an associated entity of the licensed corporation, in relation to such conduct of the regulated activity. The Draft Rules have also been revised to state expressly that they do not apply to client money that is in a client's bank account and that the licensed corporation or its associated entity "holds" solely because it has control over the account.

Renewal of Client Authority

19. The Draft Rules required that the handling of client money be in accordance with the Draft Rules or as authorized by "client authority" which is defined in the Draft Rules. Such authority must be in writing and may only be valid for up to 12 months and had to be positively renewed by the client. Many commentators were concerned that administratively, it would be difficult to obtain such renewals..

20. We appreciate these concerns and have accordingly modified the Draft Rules so that, subject to objection by the clients, the renewals may be by way of pre-expiry reminder notice and a post-expiry renewal confirmation from the licensed corporations or associated entities and the authority would be renewed for up to another 12 months upon the same terms and conditions as the original authority. The revised Rules also allow the licensed corporation or associated entity to specify for the renewal a period not exceeding 12 months, which should facilitate minimizing the administrative burden arising from the renewal process.

Client Direction

21. Some commentators asked for clarification as to the meaning of a client "direction". Our intent is that this is a one-off instruction for the firm to act in a certain manner in relation to handling of a specific amount of client money, as opposed to a client's "authority", which is a standing authorization

regarding the handling of client money in general. We have revised the Draft Rules to elaborate on the meanings of these terms.

22. In order to properly protect client interests and ensure proper audit trails of client direction, all direction must be in writing under the revised Draft Rules.

Exemption for Professional Investors

23. One commentator asked that clients who are professional investors be exempted from the Draft Rules and some asked for relaxation of the renewal requirement in case of authority in respect of treatment of client money if the client is a professional investor.

24. We remain of the view that professional investors' money should be protected in a similar manner as retail investors' funds. However, we accept that there may be a lesser need to subject authority given by professional investors to the renewal requirement and therefore have relaxed the requirement so that a professional client's authority need not specify a period, but if it does, that period may exceed 12 months.

Deadline to Segregate Client Money

25. The Draft Rules required that within 1 business day of receiving client money in Hong Kong, the licensed corporation or its associated entity must separate the client money from the firm's own money and deposit the client money into a segregated account maintained at an authorized financial institution Major concerns were expressed over the practical difficulties in meeting the deadline giving the time required to clear cheques received from clients.

26. When we maintain that the 1 business day deadline is both practicable and necessary in order to better protect client funds, we have revised the Draft Rules to clarify that the relevant time limit in relation to a cheque received by the licensed corporation will count from the time the proceeds of the cheque have been received.

Transfers to accounts of the licensed corporation or its affiliates, employees etc.

27. The market asked for clarification as to under what circumstances transfer of client money out of the client account may not be effected pursuant to client direction or authority.

28. We have revised the Draft Rules to clarify that client funds may not be paid pursuant to client authority to

(a) any employee or officer of the respective firm or its corporate affiliate pursuant to a client direction or client authority (unless such employee or officer is the actual client); or

(b) the account in Hong Kong, that is not a segregated account, of the firm or any of its corporate affiliates.

29. For the avoidance of doubt, payment of client money out of segregated account will be subject to similar restrictions, except where the payment to the licensed corporation or its associated entity is for meeting settlement or margin requirements of the client or for payment of amount owed by the client to the licensed corporation or the associated entity.

Cash Collateral

30. A few commentators queried as to whether cash collateral provided in the context of different transactions need to be treated as client money and segregated.

31. Our policy position is to require segregation of cash collateral if the client still retains an interest in that cash provided as collateral. However, where the sum received from the client is no longer within the scope of client money to which the Draft Rules apply, the licensed corporation or its associated entity shall not be required to follow the requirements of the Draft Rules.

Exchange Control Notification Requirement

32. The Draft Rules required the licensed corporation and its associated entity to notify its clients if any client money, including money held offshore, becomes subject to exchange control within one business day after becoming aware of the event.

33. There were various comments on this requirement, ranging from requests for clarification as to when the notification would be triggered to questioning the need for this provision. In response, we agree that this requirement should more appropriately be dealt with under the general client asset safeguard requirements, such as those under the Code of Conduct. We have accordingly deleted this requirement from the Draft Rules.

Other Comments

Segregated Account

34. In response to market query about the types of client accounts envisioned, we have clarified that a "segregated account" is an account designated as a trust account or client account maintained with an authorized financial institution or a person approved by the SFC.

Interest

35. Many commentators queried whether interest accrued on client money would be considered "client money" for segregation purposes. In response, we have revised the Draft Rules to clarify that subject to agreement to the contrary, interest arising from client money is client money and must be dealt with in the same way as other client money. Interest given up by clients must be paid out of the segregated account within 1 business day after it is credited, or the

licensed corporation or associated entity becomes aware that it has been credited to the segregated account.

EFFECTIVE DATE AND TRANSITIONAL ARRANGEMENTS

36. The Securities and Futures (Client Money) Rules will become effective on the day appointed for the commencement of Part VI of the SFO.

Summary of comments received on the draft Securities and Futures (Client Money) Rules

	Section reference	Details of the Rules	Respondent's comments	SFC's response
General comments				
1	-	Confinement of application of the Draft Client Money Rules	[commentator has reserved anonymity] The SFC should properly address all potential issues arising from the lack of similar prescribed Rules to guard against risks of client money received or held outside Hong Kong - client money held overseas should be properly safeguarded and clients should be fully aware of the level of protection available to such money.	This topic is more appropriately addressed in the Code of Conduct.
2	-	Confinement of application of the Draft Client Money Rules	[commentator has reserved anonymity] The potential risks in situations where licensed corporations operate branches outside Hong Kong (e.g. Macau and Shenzhen) and which also handle client money overseas should not be undermined, especially those overseas investors trade in securities listed on the Stock Exchange and the new Investor Compensation Fund (the "the ICF") intends to cover loss incurred in relation to trading in HKEx products (disregarding whether client money is held in Hong Kong). A distinction should be drawn between dealing in HKEx and non-HKEx products for purposes of the ICF. Thus, the Rules should require licensed corporations to segregate client money received in respect of dealing in non-HKEx products.	The risks identified are not relevant to these Rules and we are of the view that the proposed segregation is not necessary for ICF purposes.

3	-	Application to sole proprietors	[commentator has reserved anonymity] It is noted that the Rules apply to licensed corporations but not sole proprietors and partnerships conducting regulated activities. There should be a system or policy in place upon the Bill becoming effective to subject sole proprietors and partnerships to the Rules during the transitional period for the migration to the new licensing regime.	Sections 27, 30 and 53(4) of Part III of Schedule 10 to the Ordinance already provide for partnerships and sole proprietorships to be treated as licensed corporations during the transition period, and that the provisions of the Ordinance shall apply to them.
4	-	General	[LSHK] The Draft Client Money Rules use various terms which are defined in the Securities & Futures Bill, such as "client money" and "client securities". For convenience, it would be helpful if the defined terms were set out in the Explanatory Notes, or in an Introduction or Annex to the Rules. [LTP, Lim] The SFC should define "regulated activity", "associated entity" and "authorized financial institution" and "client money".	This is not considered necessary; subsidiary legislation should always be read in conjunction with the primary legislation. It is not necessary to define terms already defined in Part 1 of Schedule 1 to the Ordinance.
5	-	General	[JFAM] The general comment on the Client Money Rules is that they are drafted with a focus on the stock broking industry. It is suggested that the SFC should provide clarification regarding the application of the Rules to the asset management industry in Hong Kong. For example, where a fund manager does not normally hold client securities nor client monies albeit that it has discretion from clients to operate their bank accounts and instruct clients' custodians for settlement purposes.	We propose to post answers to frequently asked questions to our website in due course. This is consistent with what we are currently doing when we introduce the revised financial resources rules and the Code of Conduct etc. Section 3(3) of the revised Rules shall make it clear that these Rules do not apply to situations such as this one.

6	-	General	[L&A] It is questioned whether the Rules should apply in respect of money and securities held for professional investors as this type of investors should not require the same protection as retail investors. For example, in the United Kingdom, both under the existing rules and the rules to be made under the Financial Services & Markets Act, market counterparties and other non-private customers can opt-out of the client money rules (and often do so). Also, the more detailed requirements of the custody rules can be disapplied in respect of assets held for market counterparties.	We are of the view that the same principle should apply to protection of client assets, whether the clients are professional investors or otherwise. However, we agree that professional investors should be able to waive the annual renewal requirement for client's authority. It should be noted that the Rules only apply to clients and not to market counterparties and hence some of the concerns raised by the commentator are not relevant.
Specific comments				
7	2(1)	Interpretation (a) Definition of "client contract"	[L&A] It is unnecessary to define "client contract" as <u>including</u> the types of contract or arrangements specified in the definition. Also, in the situation where the client is a professional, the Code of Conduct does not require a client agreement to be entered into. In any event, we question the need for a definition of "client contract".	We have deleted the term "client contract" from section 2(1) and section 4(1)(d).

8			[L&A] The definition of "client money" in the Ordinance is extremely wide. It includes not just money received by a licensed corporation or an associated entity, but also money received by any corporation that is in a controlling entity relationship with the licensed corporation. Read literally, this would extend, for example, to a situation where a person, who happens to be the client of a securities dealer which is a subsidiary of a licensed bank, puts money into his or her account with the licensed bank, even though this is completely unconnected with the client relationship with the securities dealer. It would also apply where an offshore entity that was in a controlling entity relationship with a Hong Kong licensed corporation was acting as a custodian for its clients who are also clients of the licensed corporation.	A new section 3(1) has been added to the Rules to state expressly that the rules apply to client money received or held in the course of or in relation to the conduct of any regulated activity for which the licensed corporation is licensed. Specifically, in the examples described, these Rules would not apply to the money unless it was received or held in Hong Kong by a licensed corporation or associated entity. Further, pursuant to section 149(7), these Rules do not apply to associated entities that are authorized financial institutions.
10			[L&A] The definition of "associated entity" should exclude a foreign corporation who has a registered Hong Kong branch under Part XI of the Companies Ordinance if the foreign corporation itself is subject to an acceptable overseas regulatory regime in relation to client money and securities it receives in Hong Kong.	We disagree. In developing the definition of associated entity, the policy intention was that there should be uniform treatment of associated entities holding client assets in Hong Kong. That policy intention remains.

12	2(1)	Interpretation Definition of "client's authority"	[Lim, AP, LTP, LSHK, JFAM, L&A, HKSbA] An annual renewal of "client's authority" is unnecessarily burdensome and costly to the licensed corporation. It is suggested that rather than an annual affirmative renewal by the client, authority could be renewed by the licensed corporation annually notifying the customer that authority will continue unless a reply, objection or revocation is received within a specified period. One commenter pointed out that annual renewal is not necessary given there were already other safeguards in sections 3(3) and 4(1).	The Commission recognizes the market's concern and has revised the Rules in section 8(3) by allowing for either a renewal of that authority by the client in writing or by procedures similar to that suggested.
13			[AP] The need to restrict client's authority in the manner proposed is questioned. SFC is asked to reconsider whether the Rules still need the definition of "client's authority".	We have renamed the term "client's authority" as "standing authority" and elaborated on the meaning of standing authority in section 8 of the revised Rules. We remain of the view that certain basic statutory protection should not be overridden by standing authority provided by clients; they can still waive the protection by giving specific directions.

14			[L&A, LSHK] The requirements for written client's authority with annual renewal should not be applicable to accounts of "professional investors" (for example, where the client is a fund manager, and cash is being transferred to accounts in the name of different funds that it manages) as defined in the Securities and Futures Ordinance and/or who are professional investors for the purposes of the SFC Code of Conduct.	The Commission remains of the view that, in general, professional investors' money should be offered protection in the same manner as retail investors' money for purposes of these Rules. For fund managers who are managing several funds, particularly funds or unit trusts where the underlying investors are the retail public, it is particularly important that proper and clear transfer instructions are obtained from the fund manager regarding the movement of the money of the funds. However, we agree that professional investors should be able to waive the annual renewal requirement for client's authority and have revised the Rules so that under section 8(2) of the revised Rules, the requirements to specify a period in which standing authority is valid and restrict the period to not more than 12 months shall not apply to authority given by professional investors.
15			[Lim] Please clarify the meaning and possibilities of the word "otherwise" when the draft rules stipulate that client's authority may be renewed in writing or otherwise.	This comment has been superseded by an amendment requiring client authority to be in writing in section 8(1) of the revised Rules.
16			[JFAM] Is the "client's authority" referred to in 2(1) and 3(3)(d) applicable to mutual fund dealing accounts and associated standing settlement instructions by the clients of such accounts?	The requirements in relation to "client authority" would apply to mutual fund dealing accounts and associated settlement instructions.

18			[commentator has reserved anonymity] In view of the increasing popularity of on-line trading, it is recommended to include other electronic means of communication (e.g., e-mail) for such an authority.*)* In addition, it is not clear if an authority signed by a client stating that it will remain valid unless otherwise instructed will meet the requirement of para. (c). If not, this will impose heavy administrative burden on the industry. It is, therefore, recommended that the said provisions be modified to allow more flexibility.	An authority in writing can be made in an electronic form provided that there is compliance with the Electronic Transactions Ordinance . The example given by the commentator is not acceptable. Please refer to our response to comment 12 regarding the renewal procedures suggested in the revised Rules. Administrative burden should have been substantially reduced by our allowing renewal in accordance with section 8(3). It is important for investor protection to remind investors of such authority on a yearly basis.
19	2(2)	Interpretation These Rules do not apply to an associated entity that is an authorized financial institution.	[LTP] If "authorized financial institution" refers only to entities that are authorized in Hong Kong, the Draft Rules could cause difficulties. An example would be where a client had an account with the SFC licensed entity and also with a bank which was an affiliate of the entity but which was not an authorized institution in Hong Kong. Even though these extra territorial controls over the client's account with the overseas, non-Hong Kong authorized bank, would not be enforceable, the SFC registered entity would be in breach of the Draft Rules.	We have deleted section 2(2) as section 149(7) of the SFO makes it superfluous. Regarding the scenario quoted in the example, please note that an "authorized financial institution" is defined in Part I of Schedule 1 to the Ordinance as "an authorized institution as defined in section 2(1) of the Banking Ordinance (Cap. 155)". In addition, these Rules only apply to client money held in Hong Kong by the "licensed corporation" or its "associated entity", both as defined under Part I of Schedule 1 to the Ordinance. Besides, please also see our response to comment 8 above.

20			[commentator has reserved anonymity] These draft Client Money Rules are not intended to apply to an associated entity which is an authorized financial institution. Recognizing the SFC's intention to minimize supervisory overlap with the Hong Kong Monetary Authority (the "HKMA"), there is a concern about ensuring a level playing field between licensed corporations and authorized financial institutions and asked whether, in particular the same or similar segregation requirements are imposed by the HKMA.	The monetary settlement between authorized financial institutions and their clients is usually transacted through the clients' deposit accounts maintained with the authorized financial institutions. The deposit taking activities of authorized financial institutions are subject to a separate regulatory regime with rules and requirements that are not necessarily comparable to the regime governing licensed corporations. It is beyond the scope of these Rules to attempt to equalize these two separate regulatory regimes.
21	3(1)	Payment of client money into segregated accounts	[Lim] We support widening the rules to cover client money held by a nominee company associated to a licensed corporation in order to close the regulatory gap and uphold the spirit of the rules.	We appreciate the support.
22			[L&A] It is assumed that the Client Money Rules are applicable only if the associated entity is receiving assets as part of services being provided by the licensed intermediary to its clients and not, for example, where the associated entity itself provides custodial or other services to the client, without the licensed intermediary assuming any responsibility to the client in relation to those services. It is assumed that cash or assets transferred by the client to the unregulated company would not be regarded as client assets of the intermediary.	Please also see our response to comment 8 above.

23			[L&A] It is confusing to refer to establishment or maintenance of one or more "segregated trust accounts or client accounts", each of which must be designated as such. It is assumed that only one type of account is being referred to (i.e., an account in respect of which the licensed corporation or associated entity is a trustee for the client).	The assumption is correct. We have revised section 3(1) to clarify that a segregated account must be designated as a trust account or client account.
24			[LSHK] It may be useful for SFC to require that, in order to establish any client account, the licensed corporation or associated entity must obtain an acknowledgment, from the authorized financial institution or other approved institution, that the licensed corporation or associated entity is a trustee in respect of balances maintained in the account and, therefore, that the relevant institution has no rights of consolidation or set-off against the account in respect of other liabilities owing to it by the licensed corporation or associated entity.	This is a good suggestion and we agree that obtaining such an acknowledgment could be useful. However, it is questionable whether such an acknowledgement may be obtained in practice. Additionally, if the account is designated as a trust account or client account, authorized financial institutions will have notice of the trust nature of those accounts and be able to distinguish such accounts from other account(s) belonging to the licensed corporation or its associated entity.

25	3(2)		[commentator has reserved anonymity] If the new Client Money Rules are limited to applying to client money received or held in Hong Kong as opposed to the current rules which apply to client money held anywhere, the limitation could create loopholes for circumventing the rules by ensuring that client money is received or held outside of Hong Kong.	The rationale behind the change in the scope of application of these Rules from the current rules is set out in paragraph 15 of the Consultation Document. The change is intended to deal with the practical difficulty of compliance with the segregation requirement in respect of client money held overseas, in particular in countries where there is no trust law. Licensed corporations would be required under the Code of Conduct to disclose the potential risks to their clients. If the money has first been received in Hong Kong before remitting to overseas, then that money would be subject to these Rules and the client would then need to make a conscious decision to arrange for his money to be sent offshore.
26			[General comment] It appears that client money either received or held in Hong Kong by a licensed person is required to be segregated and as a result, money received in Hong Kong which is later deposited/held in overseas financial institutions (e.g. Taiwan) will also need to be segregated.	Client money received or held in Hong Kong must be segregated. Client money cannot be transferred out of the segregated account except in accordance with section 5(1) of the revised Rules. If pursuant to that section, the money is transferred outside of Hong Kong, no segregation is required under the rules for the money held offshore.

27			[BNP] Please confirm that the "one business day" rule does not apply to client money paid into and held in our bank account with an overseas branch of a bank as such client money will not be considered "client money received or held in Hong Kong.	Assuming that the client money was initially received outside Hong Kong or, if received in Hong Kong, paid out in accordance with these Rules to the overseas account, we confirm that the "one business day" rule does not apply.
28			[L&A, LSHK] Section 3(2)(d) might be too wide. It could apply to cash collateral provided by way of outright transfer, and to other amounts that are intended as outright payments to the licensed corporation from the client (e.g. payments from a corporate client pursuant to a currency swap). It could also apply to payments that are not connected with services provided by a licensed corporation the provision of which constitutes a regulated activity.	The definition of client money in Part 1 of Schedule 1 to the Ordinance restricts the money to that "received or held on behalf of a client … or in which the client … has a legal or equitable interest…". In the examples cited, if the client does retain a legal or equitable interest in the money provided as cash collateral, such "cash collateral" is client money and, if held or received in Hong Kong, must be segregated. As for other amounts intended as outright payments, whether such money constitutes client money can only be determined based on the relevant legal documentation.
29			[L&A, LSHK] It also seems anomalous that the definition of "client money" in the Ordinance extends to money held by an exempt person in his capacity as such, since the relationship between a bank and its customer is a debtor-creditor relationship	We do not agree. The relevant part of the definition of "client money", insofar as it applies to a registered institution, is defined by reference to the registered institution's conduct of regulated activity, not money received or held by the registered institution in the course of its banking business. In any event, the Rules do not apply to registered institutions.

30			[ISD, AP] Two commentators welcomed the proposed rules' refinement of the current law by excluding any amount that 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. However, the position on monies received with respect to overseas securities are asked to be clarified.	We thank the commentator for the support. As to client money received with respect to overseas securities, the same rules apply, that is the money must still be segregated if not paid out for settlement purposes within 2 business days of receipt.
31			[L&A] One commentator queried if cash is received for settlement of a transaction on T+2 but there is a settlement delay for some reason, should there be a grace period before the cash has to be treated as client money and transferred into a client bank account.	The cash remains as client money until it is applied to settle the transaction and therefore should be segregated if it is foreseeable that it will not or cannot be used for settlement within the following 2 business days.
32			[L&A] A commentator made a point that because many client agreements contain provisions enabling a licensed person to apply cash of a client in settlement of amounts owing by the client of the licensed person to the licensed person or its affiliates, section 3(2) and/or section 3(3) should be amended to permit the licensed person to deduct such amounts from cash received from or on behalf of the client. It should not be necessary to pay such amounts into a client account before withdrawing funds to settle the amounts due.	The client is already free to do this by giving specific directions under section 3(3)(c) or standing authority under section 3(3)(d). We do not think it serves any purpose to specifically permit the proposed deductions in the Rules, especially where the facts and circumstances of each transaction giving rise to a possible deduction scenario as well as the actual terms, validity and enforceability of such agreements between the client and the licensed corporation are particular to each case.

33			[JFAM] Assuming a licensed intermediary who receives and holds client money for the client's subscription for collective investment schemes. The intermediary will then pay the client money into the designated funds' accounts shortly thereafter. It is usual for settlement to occur after 2 business days particularly if the settlement currency is not in HK$ or US$. Please further clarify how the definition of "client money" in section 3(2) would apply in relation to the above mutual funds' dealing of client money.	Fund subscription money held in the licensed corporation's account is subject to these Rules and such money needs to be segregated if received or held in Hong Kong. Segregation is not required, however, where the client money is required to be paid out to settle a transaction within two business days following receipt.
34			[commentator has reserved anonymity] A query was raised as to how deduction of brokerage from the amount received is possible if it is received from a client and no order has yet been placed by the client. It is suggested that wording such as "where applicable" should be considered for addition to the end of the phrase to clarify the requirement.	In the scenario described, the amount would fall within "all other amounts received from clients" under section 3(2)(d).
35	3(3)		[commentator has reserved anonymity] One commentator supported shortening the period of time before which client money has to be segregated (in Clause 3(2)(ii) and Clause 3(3)) recognizing that the shorter the period of time, the less the exposure of client money.	The Commission agrees and appreciates the support.
36			[L&A] Clarification was sought as to the meaning of "written direction" in Section 3(3)(c).	We have introduced a new section 7 in the revised Rules to elaborate on the meaning of a written direction.

37			[ISD, HKSbA] The one business day rule may be too short, administratively too burdensome and too drastic for practical compliance, particularly when there are unidentified deposits and it may take two business days to identify the client. Additionally, imposing criminal liability for a breach as a result of occasional operational problems or inadvertence is objectionable. Two or three business days as a time limit for segregation is suggested.	We expect that licensed corporations will have standard controls and procedures enabling them to take reasonable steps to track client deposits and reconcile unknown receipts promptly. The criminal liability imposed under section 8 does not arise unless the failure to comply with section 3 or 4 was without reasonable excuse or with intent to defraud. If despite there being controls and procedures in place it still takes more than 1 business day to identify a particular deposit as being client money, it seems unlikely that criminal liability would arise.
38			[AP] For client money received in the form of a cheque, does "receipt" refer to purely physical possession of the cheque and if so, would the licensed corporation need to deposit its own funds into the segregated account to cover the non-cleared client cheque amount on behalf of its clients in the event the client cheque did not clear on time?	Recognizing that it may take a few days for a cheque to clear, we have amended the Rules to provide that a cheque will be regarded as being received when the proceeds of the cheque are received.
39			[L&A, LSHK} Clarification is sought that the Rules would not cover the situation where (for example) a cheque in New Taiwanese dollars is received by a dealer in Hong Kong from a client, for forwarding to the dealer's Taiwan branch.	If the cheque is not payable to the dealer, it should not be subject to the Rules as client money would neither be received nor held in Hong Kong by the dealer.

40			[AP] When investors effect fund payment through on-line banking, electronic fund payment (such as Payment by Phone Service) or autopay after office hours, the licensed corporation will face an extremely tight segregation schedule in order to follow the Client Money Rules.	We recognize that given certain administrative processing requirements, payments through PPS, or autopay after banking hours may take one business day or so before the funds are actually transferred into the licensed corporation's accounts. When the funds are received by the licensed corporation or the associated entity after normal banking hours, we interpret the timing requirements to start on the following business day.
41			[AP] More time should be allowed in respect of dividends or other income payment.	With respect to dividends and other income payments, as long as such payments have been initially identified as client money, they should first be deposited into the segregated account. Thereafter, the licensed corporation may allocate the exact amount of dividends or other income to their respective client on a client-by-client basis.
42			[General comment] Is it the client's or licensed corporation's decision as to what to do with the client money (i.e., pay it into a segregated account or pay it to the client or pay in accordance with the client's instruction within one business day after the receipt of any client money)?	Section 3(3) permits a licensed corporation to deal with client money in any of the ways specified in (a) to (d).

43			[AP] As a prudent and conservative approach, most licensed corporations will segregate all client money upon receipt regardless of whether the client money will be paid out for settlement within 2 business days. Moreover, it will be both difficult and administratively cumbersome for the licensed corporation to firstly distinguish whether the client money is for settlement and then adjust the said settlement amount from client payable account before segregation of client money. In case the licensed corporation cannot comply with such technical requirement within one business day without any intention to defraud, we consider it highly unfair to treat it as a criminal offence.	Under section 3(2)(a)(ii), a licensed corporation is not required to segregate client money required to be paid out within the next 2 business days for settlement or margin requirement purposes. If a licensed corporation, however, wishes to segregate such funds for operational convenience, it may certainly do so as those funds will be client money.
44			[HKSbA] After a client has placed an order to the broker for buying shares, he will immediately deposit money into the account. However, if the price does not perform as what the client expects, the order cannot be completed within the day and becomes a standing order on the following trading day. In such circumstances, under the draft Rules, the broker is required to transfer the money in and out of segregated accounts, thereby increasing the burden of the broker in its daily routine.	Assuming that the transaction is in Hong Kong stocks, if the client's order cannot be executed during the day, the money will not be needed for settlement within the next 2 days. Therefore, the money should be segregated. The argument of the order being carried forward to the next trading day can create a situation where client money may be continuously "rolled over" in a house account on a daily basis in order to execute a pending order (for example, a limit order where the price target is never reached). This situation is clearly undesirable from an investor protection point of view.

45			[HKSbA, Lim] The current practice of depositing client money into segregated accounts within the T+4 limit should be maintained.	We have explained in the Consultation Paper our policy intent to reduce the exposure of client money by shortening of segregation deadline.
46	3(3)(d)		[commentator has reserved anonymity] It is difficult for market practitioners to determine what would be unconscionable and request the SFC to clarify this by highlighting any particular sections in the Ordinance which should be taken into account by market practitioners.	We think that it is clear from section 6 of the Unconscionable Contracts Ordinance (Cap. 458) what amounts to "unconscionable". We therefore do not think the Rules need to be more prescriptive in this respect. If a licensed corporation is in doubt, it should seek professional legal advice.
47			[Lim] Please clarify whether a standing instruction by client to transfer excess cash to a money market fund, is considered as an unconscionable contract.	Each case will depend upon its own particular facts. On the face of it, there is nothing in the circumstance described to indicate that there is anything unconscionable about this client instruction or carrying it into effect. However, if a licensed corporation is in doubt of whether a client instruction or carrying it into effect is unconscionable, it should seek professional legal advice.
48			[LTP] One commentator queried whether Section 3(3)(d)(i) is necessary as one would expect the statutory provisions of the Unconscionable Contracts Ordinance to apply whether or not this is explicitly stated in the draft Rules.	Section 3(3)(d)(i) is necessary to apply the Unconscionable Contracts Ordinance to any "client's authority", in case this might not otherwise fall under that ordinance.

49	3(4)		[LTP] Does section 3(4)(a) include situations where the client has given specific instructions to remit money to such an account? If so, that would seem to be an inappropriate restriction. If not, what do the words "apply or permit to be applied" mean? If it means unilaterally applying client money, there would be, in any event, a prohibition from doing this.	We agree with the comment and have revised sections 3(3)(d) and 3(4)(a) to clarify this. The restriction only applies to standing authority but not specific directions.
50			[L&A, LSHK] As a drafting point, it is unclear whether section 3(4) is simply intended as a restriction on the ability of a licensed corporation/associated entity to rely on a standing authority from a client pursuant to section 3(3)(d), or whether it is a more general prohibition on transfers of client money to an account of the licensed corporation or to the other persons referred to in section 3(4). We assume that section 3(4) is only intended to apply in respect of transfers effected pursuant to section 3(3)(d), but this should be clarified.	We have revised section 3(3) and 3(4) to clarify this. Please also see response to comment 49.
51			[AP] Section 3(4) should be subject to section 4 so that a licensed corporation may transfer funds from trust accounts to house accounts if it is within the permitted purposes under section 4.	Please see response to comment 49 in relation to the prohibition on transferring client money to a licensed corporation or its associated entity. Subsections (3) and (4) in section 3 are now independent from each other under the revised Rules.

52	3(5)		[FFHK] All the renowned financial centers in the world have been allowing FCM to "top up" segregated funds by its own house money. In fact, in Hong Kong, it has been the practice of HKFE to allow its FCMs to use its house money to cover shortfall in the customer segregated fund. The new Rules should be revised to allow FCM to top up segregated funds legally.	If client money is dealt with in compliance with these Rules, there should not be any shortfall in the segregated account. The purpose of the Rules is to keep client money separate from the licensed corporation's or the associated entity's own money. To explicitly allow "topping up" a client account with house money and commingling client funds with house funds would undermine this purpose.
53			[Lim] The Commission should consider allowing house money to be paid into trust accounts. Any amount over-segregated will be deducted against the liquid capital so as not to compromise the financial integrity of the licensed corporation. This practice will minimize the technical breaches and violations due to inadvertent clerical errors that occur from time to time.	See our response to comment 49 above.
54			[commentator has reserved anonymity] The practicality of complying with this requirement should be considered in that the SFC might need to allow the licensed corporation to maintain a minimum amount of non-client money in the account in order to avoid the account being closed in the case where the balance falls to zero. Also, the requirement to deduct brokerage from the account daily renders it more necessary to maintain a minimum amount in the account.	We appreciate that this might be a concern in very exceptional situations. Should hardship be encountered in complying with this requirement, the SFC may modify the requirement upon application.

55			[commentator has reserved anonymity] Clause 3(5)(b) permits payment of an amount that is not client money but aggregated with client money into a trust account. Under section 84(5) of the current Securities Ordinance, only client money to be paid into a trust account. We query whether this expansion under the new Rules is a desirable change. Mixing trust money and the trustee's money has been known to give rise to numerous intractable problems. The Client Money Rules should aim at avoiding such problems by preventing rather than allowing mixing.	The clause has been removed. We also now provide in section 10 of the revised Rules that any non-client money must to be paid out of the segregated accounts.
56	4(1)	Payment of client money out of segregated accounts	[L&A, LSHK] Section 6 of the draft Client Securities Rules permits clients securities or securities collateral to be applied in settlement of any liability owed by or on behalf of the client to an intermediary, its associated entity or a third person. Why should the Client Money Rules be more restrictive as to the circumstances in which money can be applied to meet the client's liabilities?	We do not agree that these Rules are more restrictive than the Client Securities Rules because under these Rules, client money received or held by a licensed corporation or associated entity can be paid in accordance with client's direction or pursuant to client's authority. To apply section 6 of the Client Securities Rules, the licensed corporation also requires client's agreement in writing to allow it to dispose of the client's securities.

57			[AP] Clause 4(1) allows a licensed corporation to use client money to meet settlement or margin requirements of the licensed corporation in respect of the securities dealing or futures contract trading activities of the client. Since market practice involves licensed corporations using separate affiliates to conduct securities dealing and futures contract trading activities, one suggested that clause 4(1)(c)(i) and 4(d) should be amended to include the client's obligations towards the licensed corporation or its associated entities.	Section 4(1)(c)(i) does not prohibit transfers in accordance with client's authority between segregated accounts of licensed corporations or their associated entities since the licensed corporation or associated entity at the receiving end is also subject to the same requirements in the Rules.
58			[AP] As one of their risk control measures, licensed corporations would require related parties to enter into a cross-margining arrangement. The current wording of Clause 4(1) does not allow this. As a result, a licensed corporation cannot use the credit balance in Mr. A's account to offset the debit balance in the account of Mr. A Co Ltd, the investment vehicle of Mr. A. Such situation is highly undesirable and not in line with international commercial practice.	With respect to the cross-margining arrangement described, the Commission is unable to comment on the exact nature and enforceability of legal agreements entered into by the licensed corporation and its clients as such agreements will vary on a case by case basis. Given the varying set of facts and circumstances that can be present in each case, we see no reason to amend the Rules to permit automatic rights of setoffs. However, we note that section 4(1) permits client money to be paid according to client's authority or direction. We leave it to the licensed corporation to determine whether client's authority has been obtained in each particular case. In the scenario described, any money moved from Mr. A's company account to Mr. A's personal account or vice versa would require the relevant authority from each of these accountholders as Mr. A's company is a separate legal entity from Mr. A.

59			[commentator has reserved anonymity] One commentator believed that an active client would not normally want to transfer the money outside Hong Kong except perhaps for the purpose of closing the account or simply discontinuing transaction activities. In this respect, the SFC should consider requiring such client money received in Hong Kong to be kept in Hong Kong subject to the client's written instruction to transfer the money outside Hong Kong. Such an instruction should state the client's reason(s) for doing so. To further safeguard the client, client's written acknowledgement of a risk disclosure statement stating that there are risks associated with transferring client money overseas as such money will no longer be subject to any specific segregation rule or requirement should be obtained.	In the scenario above, be it either overseas clients trading in Hong Kong stocks or Hong Kong clients trading in overseas securities, section 4(1)(b) require a client's direction (similarly, section 4(1)(c) requires a client's authority) to transfer funds offshore from a segregated account. Requiring a client to state his/her reasons for the transfer is not warranted. The Code of Conduct imposes the obligation for licensed corporation to properly safeguard client assets held by it, regardless of the assets' physical location. This is also a matter of investor education for the client to protect his/her assets. With respect to the risk disclosure suggested, this will be considered under the context of requirements under the Code of Conduct.
60			[Lim] The definition of a client's "securities" and "securities collateral" should include implicitly "money". While it is possible to pledge client securities collateral with banks to raise funding for margin financing, by the same analogy, if the dealer has clients' authority, the dealer should be able to use the credit balances of margin clients as working capital for margin financing.	By definition under Part 1 of Schedule I of the Ordinance, "securities" and "securities collateral" do not include "money". In general, we do not think credit balances held for margin clients is in the nature of collateral. In addition, a licensed corporation owes a fiduciary duty to its clients for money held on trust for them and cannot apply the money as if it were his own money.

61			[L&A] It would be useful to include an express provision in section 4(1), as in the UK rules, that a licensed corporation can cease to treat as client money any unclaimed client money balance if it can be demonstrated that the corporation had taken reasonable steps to trace the client concerned and return the balance.	We do not consider this to be necessary. The circumstances leading to a sum of client money becoming an unclaimed amount varies. Therefore, the treatment of unclaimed client money should best be decided on a case-by-case basis.
62	4(2)		[AP] In the event of over-segregation, it is suggested that the Rules could specify that the licensed corporation's right towards any over-segregated assets in clients' trust accounts would be subordinated to clients' claim. As a result, neither the licensed corporation or its successor or liquidator may assert any right in the trust account unless and until all clients' claims are fully satisfied.	We do not consider this to be necessary. The segregated account should only contain client money. The Rules do not promote nor permit keeping non-client money in the segregated account.
63			[Lim] For consistency, a four business day time limit for the payment of non-client money out of trust account should be applied.	The Rules require segregation of client money within 1 business day of receipt. Payment of non-client money out of the account must also be made within 1 business day. We do not see how a 4-day time limit as suggested would result in consistency.

64			[L&A] The position in the U.S. is that cash held for customers can be commingled with a broker-dealer's own cash. Customers are protected through the requirement that a broker-dealer maintain a bank account for the benefit of its customers in which it must deposit funds equal to the excess of amounts owing to customers over amounts owed by customers to the broker-dealer.	The Commission understands that in the United States, a special reserve bank account concept is utilized as part of the customer protection – reserves and custody of securities rule under US Securities Exchange Act Rule 15c3-3. While this works in the United States, the US scheme encompasses both securities as well as client money, as well as accounting for the value of other liabilities including securities not received, borrowed securities, failed delivery securities and margin loan shortfalls and excesses, etc. There is also a monthly reporting requirement to the regulator under the US rules. In effect, the US model is not directly applicable nor easily adoptable into our client money rule.
65	5	Payment of interest on client money held in segregated accounts	[Lim] Can brokers retain the interest difference derived from client money, provided it is stated in the client's agreement?	Yes they can, subject to an agreement to that effect. We have added a new section 6(2) to clarify this point and deleted section 3(2)(e).

66			[L&A, LSHK] The definition of client money deems interest arising on client money itself to be client money, which would appear to mean that (contrary to what is stated in the Client Money Rules) the licensed corporation could not agree with its clients that the licensed corporation could retain some or all of the interest for its own account. It would be more satisfactory if the definition in the Ordinance was amended such that (consistent with the Client Money Rules) it only applied to money held or received (in Hong Kong) by a licensed corporation or an associated entity, and if the reference to "accretions thereto whether as capital or income" were deleted.	We see no reason to change the general definition of "client money" in the manner suggested. Client money is defined to include accretions thereto, which would include interest. As the interest accrued is therefore the client's, the client should be entitled to agree to relinquish such accrued interest to the licensed corporation. However, if the client does not agree, any accrued interest remains client money.
67			[FFHK] The wordings should be revised to ' subject to any agreement with a client to the contrary, a licensed corporation or any associated entity of the licensed corporation is entitled to retain 100% of all amounts derived by way of interest from the retention in an account referred to in section 3(1) of the client money as referred to in section 3(2) received from or on behalf of the client.	See response to comment 65.

68	6	Notification where client money becomes subject to exchange control	[L&A, LSHK, ISD, AP, BNP] Comments were received in respect of the practical difficulties in complying with this requirement, the benefit to investors, the timing of notification.	After considering all the market comments relating to section 6, we have concluded that it is preferable from a policy perspective to delete this requirement.
69	7	Reporting of non-compliance with certain provisions of the Rules	[BNP] A commentator suggested that a "materiality" threshold or standard be incorporated into section 7 to exempt reporting of minor or immaterial errors of an administrative or calculating nature should be incorporated. The section was viewed as very wide and encompassing and seemed to apply to all non-compliance irrespective of the amount and the reason. It was noted that in actual operations, there would bound to be occasional calculation errors, erroneous entry and discrepancies in reconciliation. Without some	Materiality of a breach needs to be assessed in view of all the circumstances and it is not desirable to set a rigid rule in the law. Monetary limits are also difficult as the impact of such limits could vary firm by firm. It is in the interest of client protection to have the regulator informed of a failure of segregation of client money irrespective of the reason of that failure. The Commission needs to know as soon as possible that a breach has happened in order to evaluate the implications. After receiving the notification, the Commission and the firm can

			materiality standard, the actual reporting would create a tremendous amount of administrative and paper work for all parties. Additionally, it was pointed out that the notification requirement in the Revised Code of Conduct applied to material breaches only.	confer as to the reasons for the breach as well as a more detailed timetable for a full report. We note that rules in the United States require an immediate reporting on any failure to comply with their client money and securities segregation and safe custody rules.
70	8	Penalties	[L&A, LSHK] In principle, criminal liability for conduct committed with intent to defraud is unobjectionable. However, section 8 effectively creates offence of strict liability for matters that are likely to arise through administrative errors, the maximum penalty in Section 8(i)(a), of 2 years imprisonment and a fine of HK$200,000, appears unduly severe.	We disagree that the rule effective creates a strict liability offence. Liability is created only if there is either intent to defraud or a breach without reasonable excuse.
Other comments on Consultation Document of the Rules				
71	Para. 13	On the revised scope of client money	[HKSbA] The Rules increase the broker's workload and create difficulties if a client sold securities but did not collect his/her cheque promptly or opts to reserve the money for future purchases without notifying the broker beforehand.	The licensed corporation should clarify the client's intentions with the client and transfer the sum to trust account if there is no instruction otherwise.
72			[HKSbA] Some are of the opinion that due to the vast differences between the operations of leveraged forex trading and the sophisticated dealing practices in the securities trading business, it is not advised to draw any comparison between the two industries in this regard.	We disagree. The receipt and payment practice is essentially the same for foreign exchange trading and securities dealing business.

73	Para. 22	On cash collateral	[L&A, HKSbA, AP] Many commentators generally objected to inclusion of cash collateral within the coverage of the money protection rules while others requested reconsideration of the policy reasons for the inclusion or clarification of the scope of the coverage. It was pointed out that the nature of cash collateral is different from that of trust money (e.g. whether there is any legal implication if cash collateral is required to be paid into a trust account as required for client money), it may not be appropriate to apply the Rules to cash collateral. Standard practices and transactions were highlighted for the Commission's consideration as examples of why the Rules should not extend to cash collateral. For example, for transactions such as stock loans and derivatives, it is usual for cash collateral to be taken by way of outright transfer, so that the transferee is free to use the money for its own purposes and simply owes a debt for the amount of the collateral to the transferor. It was further pointed out that client agreements will often contain provisions enabling a licensed person to apply cash (particularly cash collateral) of a client, in settlement of amounts owing to the licensed person or its affiliates by the client, howsoever the debt from the client has arisen. Licensed corporations or its associated entities may receive cash collateral pursuant to financial transactions such as a swap. One commentator considered the these entities should have rights to apply the cash collateral in accordance with an agreement signed between the client and the company.	See our response to comment 28.

74			[L&A] If the cash collateral is held on trust for the client, a client's trustee in bankruptcy or liquidator may be entitled to require repayment of the collateral notwithstanding that the client still had actual or contingent obligations to the licensed corporation in respect of which the collateral had been provided, unless the Client Money Rules specifically protect the licensed corporation from having to pay out the collateral in these circumstances.	In the event of a client bankruptcy, the liquidator would be entitled under the Bankruptcy Ordinance to identify and seize all assets of the bankrupt client and conduct an orderly liquidation. Whether the licensed corporation is legally entitled to the cash collateral would be determined by the liquidator based on a number of considerations including the contractual terms of the underlying transaction between the client and the licensed corporation, the nature of the debt, and priority of the creditor. The Commission is not in a position to exempt client assets from the potential reach of the liquidator nor is it the intention of these Rules to do so.

List of Respondents

Date Received	Respondent
24 May 2001	Hong Kong Stockbrokers Association (HKSbA)
24 May 2001	- (commentator has reserved anonymity)
24 May 2001	Hong Kong Trustees Association (HKTA)
24 May 2001	JF Asset Management Ltd (JFAM)
24 May 2001	Albert Pun (AP)
24 May 2001	Law Society of Hong Kong (LSHK)
24 May 2001	Linklaters & Alliance representing (L&A) - Credit Suisse First Boston (Hong Kong) Ltd - Deutsche Securities Asia Ltd - Dresdner Kleinwort Wasserstein - Goldman Sachs (Asia) L.L.C. - J.P. Morgan - Merrill Lynch (Asia Pacific) Ltd - Morgan Stanley Dean Witter Asia Ltd - Salmon Smith Barney Hong Kong Ltd - UBS Warburg
24 May 2001	Lloyds TSB Pacific Ltd (LTP)
24 May 2001	Lim Wah Sai (Lim)
24 May 2001	Institute of Securities Dealers Ltd (ISD)
25 May 2001	BNP Paribus Peregrine Securities Ltd (BNP)
25 May 2001	- (commentator has reserved anonymity and contents of submission)
30 May 2001	- (commentator has reserved anonymity and contents of submission)

31 May 2001	Fimat Futures (Hong Kong) Ltd (FFHK)
13 June 2001	- (commentator has reserved anonymity)
26 June 2001	- (commentator has reserved anonymity and contents of submission)
Respondent with no specific comments on the draft Rules	
31 May 2001	Prudential Assurance Company Ltd

Derivation table of provisions of the Draft Rules released for public consultation and the Draft Rules now being placed before the Subcommittee

Section of the Draft Rules released for public consultation	Heading	Section of the Draft Rules now being placed before the Subcommittee
1	Commencement	1
2	Interpretation	2
2(1)	"client contract"	Deleted
	"client authority"	Renamed as "standing authority" and details of definition now incorporated in new s.8
2(2)		Deleted
3	Payment of client money into segregated accounts	
3(1)		4(1)&(2)
3(2)(a) to (d)		4(3)
3(2)(e)		Incorporated in new s.6(1)
3(3)		4(4)&(5)(a)
3(4)		4(5)(b)&(6)
3(5)		Deleted
4	Payment of client money out of segregated accounts	5
4(1)		5(1)(a) to (d), (e)(i)
4(2)		Deleted

5	Payment of interest on client money held in segregated accounts	Deleted
6	Notification where client money becomes subject to exchange control	Deleted
7	Reporting of non-compliance with certain provisions of the Rules	10
8	Penalties	12
8(1)(a)		12(1)
8(1)(b)		12(2)
8(2)(a)		12(3)
8(2)(b)		12(4)
	Brief description of new sections in the Draft Rules now placed before the Subcommittee	**Section of the Draft Rules now being placed before the Subcommittee**
	Definition of "linked corporation"	2
	Definition of "segregated account"	2
	Definition of "standing authority"	2
	Definition of "written direction"	2
	Application	3
	Exclusion of amounts already excluded under s.4(3)(a), (b) and (c) from the coverage of s.4(3)(d)	4(3)(d)(i) to (iii)
	Payment of client money out of segregated account to associated entity for money owed by client to associated entity	5(1)(e)(ii)
	Restrictions on payment of client money out of segregated account according to clients' standing authority	5(2)

	Restrictions on payment of client money out of segregated account according to clients' written directions	5(3)
	Treatment of interest on client money held in segregated accounts	6
	Requirements in respect of a client's written direction	7
	Requirements in respect of a client's standing authority	8
	Receipt of cheques for client money	9
	Requirement to pay money other than client money out of segregated accounts	10