

For discussion on
24 October 2002

Paper No. 32/02

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

Securities and Futures (Client Money) Rules

Members considered the draft Securities and Futures (Client Money) Rules at the Subcommittee meeting on 9 July 2002. In the light of the comments made by some Members and other necessary changes to better reflect policy intention and improve drafting, we submit at **Annex A** the **revised draft** of the Rules, with the proposed amendments marked up for easy reference. The reasons for the amendments are explained in the footnotes.

2. At **Annex B** is a note setting out our response to some other comments made by Members at the same meeting.

Securities and Futures Commission
Financial Services and the Treasury Bureau
11 October 2002

REVISED DRAFT

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

SECURITIES AND FUTURES (CLIENT MONEY) RULES

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SECURITIES AND FUTURES (CLIENT MONEY) RULES

(Made by the Securities and Futures Commission under section 149 of the Securities and Futures Ordinance (~~5 of 2002~~ Cap. 571¹))

1. ²Commencement

These Rules shall come into operation on the day appointed for the commencement of ~~on which Part VI of the Securities and Futures Ordinance (5 of 2002 Cap. 571) comes into operation.~~

2. Interpretation

In these Rules, unless the context otherwise requires –

“linked corporation” (相連法團————), 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” (獨立帳戶————) means a segregated account established and maintained under section 4(1) and (2);

“standing authority” (常設授權————) has the meaning assigned to it by section 8(1);

“unconscionable” (不合情理), in relation to a standing authority, means unconscionable having regard to the factors specified in section 6 of the Unconscionable Contracts Ordinance (Cap. 458), as if the standing authority in question were a contract under that Ordinance;³

¹ Minor drafting amendment.

² Drafting amendment to reflect the policy intention to commence concurrently these Rules and the Securities and Futures Ordinance as a whole.

³ This amendment should be read together with those made to clauses 4(5)(a), 5(2)(a) and 12(5). The drafting amendments were made in response to the comment of the LegCo Legal Adviser in his letter of 3 July 2002, to clarify the policy intent.

“written direction” (書面指示————) 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. –~~

- ~~(a) is received or held outside Hong Kong by the licensed corporation or an associated entity of the licensed corporation, while that client money remains outside Hong Kong; or~~
- ~~(b) has at any time been received or held in Hong Kong by the licensed corporation or an associated entity of the licensed corporation, once that client money is transferred outside Hong Kong in accordance with these Rules.⁴~~

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

⁴ Amendment made in response to the comment of some Members expressed at the meeting of 9 July 2002, to clarify that the Rules apply also to client money that was originally received or held outside Hong Kong by a licensed corporation or its associated entity but subsequently transferred to Hong Kong, and that the Rules cease to apply to client money once it is transferred outside Hong Kong in accordance with the Rules. We have explained in detail why client money received or held outside Hong Kong has to be excluded from the application of these Rules. Please refer to paragraphs 6 – 9 of Annex B to this paper.

- ~~(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.~~
- in a bank account established and maintained by a client of the licensed corporation in that client's name.⁵

4. Payment of client money into segregated accounts

(1) A licensed corporation or ~~any of its associated entities~~ an associated entity of a licensed corporation⁶ 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

⁵ The original clause 3(3)(b) is deleted in response to the comment of the LegCo Legal Adviser in his letter of 3 July 2002, on the rationale that the original clause 3(3)(a) already achieves the policy intent to exclude from application of the Rules, client money held in an account maintained in the name of the client, and to which the relevant licensed corporation has access through being a signatory or holding a power of attorney.

⁶ Minor drafting amendment.

- (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~~ an associated entity of a licensed corporation⁷ shall be dealt with in accordance with subsection (4) –

- (a) all amounts that are received from or on behalf of a client of the licensed corporation in respect of dealing in securities or futures contracts ~~on behalf of a client of the licensed corporation~~⁸
 - (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

⁷ Minor drafting amendment.

⁸ Minor drafting amendment.

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~~the 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~~an associated entity of a licensed corporation⁹ 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

⁹ Minor drafting amendment.

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

(5) A licensed corporation or ~~any of its associated entities~~ an associated entity of a licensed corporation¹⁰ 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~~¹¹; 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.

¹⁰ Minor drafting amendment.

¹¹ Please read footnote 3.

5. Payment of client money out of segregated accounts

(1) A licensed corporation or an associated entity of a licensed corporation¹² 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.

¹² Minor drafting amendment.

(2) A licensed corporation or ~~any of its associated entities~~ an associated entity of a licensed corporation¹³ 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~~¹⁴; or
- (b) the standing authority authorizes payment to an account in Hong Kong of –
 - (i) the licensed corporation or ~~the~~¹⁵ 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~~ 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.

¹³ Minor drafting amendment.

¹⁴ Please read footnote 3.

¹⁵ Minor drafting amendment.

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~~ an associated entity of a licensed corporation¹⁶ 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 in writing¹⁷ 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~~ that¹⁸ section;
- (b) is given to the licensed corporation or an associated entity of the licensed corporation by the client of the licensed corporation –

¹⁶ Minor drafting amendment.

¹⁷ Amendment made in response to the comment of some Members expressed at the meeting of 9 July 2002, to require the agreement to be effected in writing.

¹⁸ Minor drafting amendment.

- (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~~¹⁹ a 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 an associated entity of a licensed corporation²⁰ by a client of the licensed corporation who is a professional investor.

¹⁹ Minor drafting amendment.

²⁰ Minor drafting amendment.

(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~~²¹–

- (c) ~~at~~with the written ~~request~~consent of the client of the licensed corporation who gave it; ~~or~~
- (d) ~~by means of the following procedure~~if –
 - (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 specified by the licensed corporation or associated entity²², if the client of the licensed corporation is not a professional investor; or

²¹ Drafting amendment made in response to the comment of the LegCo Legal Adviser in his letter of 3 July 2002, to clarify the policy intent.

²² Minor drafting amendment.

- (C) a period of any duration specified by the licensed corporation or associated entity²³, 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~~²⁴ 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~~²⁵ one 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~~ an associated entity of a licensed corporation²⁶ 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.

²³ Minor drafting amendment.

²⁴ Minor drafting amendment.

²⁵ Minor drafting amendment.

²⁶ Minor drafting amendment.

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~~ or ²⁷(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.

²⁷ Minor drafting amendment.

(5) In deciding whether or not a payment of client money under section 4(5)(a) or 5(2)(a) would be unconscionable, the court shall have regard to the factors specified in section 6 of the Unconscionable Contracts Ordinance (Cap. 458), as if the standing authority in question were a contract under that Ordinance.²⁸

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~~ Cap. 571). 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.

²⁸ Please read footnote 3.

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.

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

Securities and Futures (Client Money) Rules

This paper seeks to respond to the comments of some Members made at the Subcommittee meeting on 9 July 2002 when the draft Securities and Futures (Client Money) Rules (the “draft Rules”) were considered.

Time limit for segregating client money in other jurisdictions

2. Members have asked us to provide more information on the time limit for segregating client money in other jurisdictions, and to see if the “one business day” limit proposed by the Securities and Futures Commission (the “SFC”) is comparable to international practices.

3. The SFC’s research shows that licensees in the United Kingdom, Australia and Singapore are required to segregate client money within one business day of receipt. The United States’ regime is very different from the above countries and Hong Kong in that client money is not held on trust basis¹. Therefore, their requirements are not strictly comparable with the requirements prescribed in the draft Rules. The requirements in these countries are summarised in the **Attachment** for Members’ reference.

4. The time limit of one business day for segregating client money under the draft Rules is in line with international practices. In addition, leveraged foreign exchange traders licensed by the SFC have always been required to segregate client money within one business day of receipt under the Leveraged Foreign Exchange Trading Ordinance since its enactment in 1994. The SFC maintains that the proposed time limit is practicable and is an important measure for investor protection.

¹ Net amounts payable to all clients are required to be placed in a reserve bank account held for the sole benefit of the clients.

Situations where client money is considered “received or held” by licensed corporations

5. The SFC agrees with the comment of some Members that receipt of certain instruments, such as deposit slips or cheques, would not necessarily mean receipt of “good money”. The SFC takes the view that “client money” under the draft Rules refers to “good money”, i.e. not the instruments supposed to effect, or represent payment of, client money to the relevant licensed corporations. References like “client money of licensed corporation that is received or held” should be accordingly construed. Clause 9, which is included for avoidance of doubt, reflects such policy intention.

Rationale for excluding client money that is received or held outside Hong Kong from application of the Rules

6. Some Members were concerned that investors would not be afforded proper protection if client money that is received or held outside Hong Kong is excluded from application of the draft Rules. We would like to stress that the above policy is premised on the practical difficulty of complying with the money segregation requirements in the circumstances. More detailed considerations are set out below.

7. Consideration has been given to the fact that there may not be an authorized financial institution in the relevant jurisdiction outside Hong Kong for opening a segregated account in accordance with the requirement of the draft Rules. Moreover, in jurisdictions where there is no trust law, it may not be meaningful to open segregated accounts with local banks as the protection intended, which relies on trust law principles, may not be available. Besides, the protection afforded by section 149(3) of the Securities and Futures Ordinance (i.e. client money shall not be liable to be taken in execution against the licensed corporation or its associated entity under the order or process of a court) would not apply outside Hong Kong. Given the limitations, applying the Rules to client money held outside Hong Kong may give a false sense of security to investors that their money will enjoy the same level of protection as held in Hong Kong.

8. It is also necessary to strike a balance between investor protection and compliance cost. Hong Kong is an international financial centre and many licensed corporations are active in overseas markets such as Korea and Taiwan, where there are local requirements concerning client money received or held therein. Those requirements may or may not be compatible with those prescribed in the draft Rules. On balance, it seems more appropriate not to

apply the Rules in such circumstances, and let the relevant clients be aware of the risks involved through stipulating in the Code of Conduct the requirement for a licensed corporation to make suitable risk disclosure to its clients.

9. Regarding the concern that client protection may be lost once the relevant client money is transferred out of Hong Kong, it is submitted that clauses 4(4) and 5(1) of the draft Rules require a licensed corporation or an associated entity of a licensed corporation to act in accordance with clients' written direction or written standing authority. Hence, the licensed corporation or associated entity cannot transfer client money overseas without having first received such a direction or authority. There are also specific requirements governing the validity period and renewal procedures of client's standing authority. The SFC maintains that the draft Rules already have sufficient safeguards to protect clients' interests. The SFC will further strengthen investor education by promoting investors' alertness of protecting their own interest. In addition, the SFC will stipulate in the Code of Conduct the requirement for a licensed corporation to make proper risk disclosure to its clients if their money is to be transferred out of Hong Kong.

Requirements under the Banking Ordinance to report non-compliance

10. Members asked if the Banking Ordinance ("BO") imposes requirements to report non-compliance with prescribed requirements similar to those set out in the draft Rules. The Hong Kong Monetary Authority advises that there are similar requirements under the BO and corresponding consequences for failure to comply. Some examples are given below -

- (a) sections 99 and 103 of the BO stipulate that where an Authorized Institution (AI) contravenes the minimum capital adequacy ratio or the minimum liquidity ratio, it shall "forthwith notify the Monetary Authority of that contravention," and provide such particulars as may be required. If an AI fails to make such notification, every director, chief executive and manager of the AI commit an offence. On conviction upon indictment, the said individual is liable to a fine at tier 8 (currently \$1,000,000) and to imprisonment for 5 years and, in the case of a continuing offence, to a further daily fine at tier 3 (currently \$20,000);
- (b) section 67 of the BO requires any AI that is likely to become unable to meet its obligations or about to suspend payment to forthwith report all relevant facts, circumstances and information to the Monetary Authority. If the AI fails without reasonable excuse

to so report, every director, chief executive and manager commit an offence. On conviction upon indictment, the said individual is liable to a fine at tier 7 (currently \$400,000) and to imprisonment for 2 years and, in the case of a continuing offence, to a further daily fine at tier 3; and

- (c) section 70(5) of the BO requires a person who is aware of the fact that he has become a minority shareholder controller of an AI incorporated in Hong Kong to report to the Monetary Authority that he has become such a controller, within 14 days of his becoming aware of the fact. A person who fails to so report commits an offence. On conviction upon indictment, the person is liable to a fine at tier 7 and to imprisonment for 2 years and, in the case of a continuing offence, to a further daily fine at tier 2 (currently \$10,000).

Summary of Time Limit for Segregating Client Money in other jurisdictions

United Kingdom

Under rule 9.3.44 of the Conduct of Business Source Book made under the Financial Services and Markets Act 2000, a firm authorised to carry out regulated activities must pay client money as soon as possible, and in any event no later than the next business day after receipt, into a client bank account.

Australia

Under section 981B of the Corporations Act 2001, a financial services licensee must ensure that client money is paid into a designated account with an Australian authorised deposit-taking institution *on the day it is received by the licensee or on the next business day*.

Singapore

Under section 58 of the Securities Industry Act, a dealer must pay or deposit any moneys or property held by him on trust for a client into a trust account *not later than the next bank business day following the day on which the dealer has received the moneys or property*.

United States

The regime in respect of treatment of client money in the United States is very different from those in the UK, Australia, Singapore and Hong Kong. Under rule 15c3-3 promulgated under the Securities Exchange Act of 1934, a broker-dealer is required to maintain at all times in a reserve bank account, held for the sole benefit of the clients of the broker-dealer, cash and/or qualified securities in an amount not less than the amount by which the aggregate amount of its liabilities to all its clients exceeds the aggregate amount owed by all its clients. The amount to be maintained should be calculated on a weekly basis. The broker-dealer is required to deposit the amount into the reserve bank account no later than 1 hour after the opening of banking business on the second following business day.