

LEGISLATIVE COUNCIL BRIEF

Securities and Futures Ordinance (Cap. 571)

SECURITIES AND FUTURES (CLIENT SECURITIES) RULES

INTRODUCTION

Pursuant to section 148 of the Securities and Futures Ordinance (Cap. 571) (the SFO), the Securities and Futures Commission (the SFC) has made the Securities and Futures (Client Securities) Rules (the Rules) at the **Annex**.

BACKGROUND

The SFO

2. The SFO was enacted in March 2002. It consolidates and modernizes ten existing ordinances governing the securities and futures markets into a composite piece of legislation to keep the regulatory regime on a par with international standards and practices. For effective regulation, the SFO has already provided flexibility in addressing changing market practices and global conditions by empowering the Chief Executive in Council, the Financial Secretary, the Chief Justice and the SFC to prescribe detailed and technical requirements as necessary by way of subsidiary legislation, to supplement the regulatory framework laid down under the primary legislation.

3. On 22 February 2002, the House Committee of the Legislative Council established the Subcommittee on Draft Subsidiary Legislation to be made under the Securities and Futures Ordinance (the Subcommittee) to study the subsidiary legislation necessary for commencing the SFO. From March 2002 to October 2002, the Subcommittee held 12 meetings and considered a total of 37 sets of draft subsidiary legislation, including the *vires* to make them.

THE PROPOSALS

Major policy considerations

4. The Rules supplement Part VI of the SFO which mainly concerns the ongoing financial and operational requirements applicable to intermediaries and their associated entities¹, including the requirements to ensure proper handling of client securities and collateral of intermediaries. The Rules prescribe the treatment of client securities and collateral of intermediaries received or held in Hong Kong by or on behalf of intermediaries or their associated entities. The requirements are mainly based on the existing sections 81, 81A and 121AB of the Securities Ordinance (Cap.333). In designing the requirements, the SFC is conscious of the need to strike an appropriate balance between providing investor protection and reducing compliance burden of its regulatees. New elements to address both have been introduced.

Major new elements

5. The present requirements only apply to securities dealers, exempt dealers, and securities margin financiers as both the Commodities Trading Ordinance (Cap.250) and the Leveraged Foreign Exchange Trading Ordinance (Cap.451) are silent on the issue. The Rules now apply to client securities and securities collateral received or held by intermediaries licensed or registered for any type of regulated activity for enhanced investor protection.

6. The Rules also apply to associated entities of intermediaries, introduced as part of the package to impose direct regulation of such entities for closing an existing regulatory gap². Essentially, this is designed to regulate the way nominee companies, operated by intermediaries within the same group, deal with client securities or securities collateral. The regulatory intention is for the associated entities to match the standards to be expected from the intermediaries, thereby according a greater degree of protection to investors.

¹ An associated entity is a corporation that holds in Hong Kong client assets of an intermediary and has a controlling-entity relationship with the intermediary.

² To bring associated entities of intermediaries into the regulatory net for better investor protection, section 164 of the SFO prescribes the types of persons that are allowed to receive or hold in Hong Kong client assets; i.e. the intermediary, its associated entity and a person falling within the definition of “excluded person” which includes an authorized financial institution. The SFO then imposes direct regulation over an associated entity.

7. The Rules apply only to securities listed or traded on the Stock Exchange of Hong Kong (the SEHK) and collective investment schemes authorized by the SFC, that are received or held in Hong Kong. The SFC has not prescribed rules for securities received or held overseas in view of the enforcement difficulties and to do so might give clients a false sense of security that protection of client assets would be just as effective abroad as it would be in Hong Kong. Instead, the general requirements under the relevant Code of Conduct will require intermediaries to adequately safeguard client assets and make adequate risk disclosures so that clients can make informed decisions.

8. The Rules clarify the circumstances when intermediaries or associated entities can withdraw or dispose of client securities or securities collateral. For example, they provide for the right of disposal in accordance with the client's agreement in writing and for withdrawal in accordance with specific directions or a standing authority from clients.

9. The Rules make clear that it is permissible for client securities and securities collateral to be deposited in safe custody with another intermediary licensed or registered for dealing in securities, and for securities collateral to be registered in the name of the intermediary that holds or receives such securities collateral.

The Rules

10. Section 2 of the Rules contains interpretation provisions that apply throughout the Rules.

11. Section 3 defines the application of the Rules especially providing that the Rules only apply to securities listed or traded on the SEHK and collective investment schemes authorized by the SFC, and are received or held in Hong Kong by or on behalf of an intermediary or an associated entity.

12. Section 4 prescribes the requirements in respect of clients' written directions and standing authority including the renewal of such standing authority.

13. Section 5 requires intermediaries and associated entities to ensure that client securities or securities collateral received are deposited in safe custody in segregated accounts, or registered in the name of the relevant clients or associated entities or (in the case of securities collateral)

registered or deposited in accounts in the names of the relevant intermediaries.

14. Section 6 specifies the circumstances in which intermediaries or associated entities may withdraw or otherwise deal with client securities or securities collateral received or held on behalf of clients.

15. Sections 7, 8 and 9 prescribe other permissible forms of dealing with client securities or securities collateral received or held in relation to dealing in securities, providing securities margin financing and dealing in futures contracts respectively, provided there is clients' standing authority.

16. Section 10 requires intermediaries and associated entities to take reasonable steps to ensure that client securities and securities collateral are not deposited, transferred, lent, pledged, repledged or otherwise parted with except in the manner specified.

17. Section 11 provides for the approval by the SFC of custodians for safe custody of client securities and securities collateral.

18. Section 12 requires an intermediary and an associated entity to report non-compliance with certain provisions of the rules to the SFC.

19. Section 13 prescribes penalties for contraventions of certain provisions of the rules.

Public consultation

20. 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 15 submissions were received. The SFC has considered all the comments received and revised the draft Rules as appropriate.

21. A draft of the Rules was considered by the Subcommittee at its meeting held on 9 July 2002. Amendments were introduced in the light of the comments of some Members and to improve the drafting for better reflection of the policy intention. Members considered the revised draft of the Rules at the subcommittee meeting on 24 October. Members expressed no further concern.

FINANCIAL AND STAFFING IMPLICATIONS

22. There are no financial or staffing implications for the Government.

COMMENCEMENT DATE

23. The Rules will come into operation on the day appointed for the commencement of the SFO, together with other subsidiary legislation necessary for the commencement. We expect this to take place shortly, after completion of the negative vetting procedure through the Legislative Council and allowing the industry a reasonable period of time for making necessary adjustments with reference to the subsidiary legislation. We aim to announce the target commencement date by the end of 2002.

PUBLICITY

24. The Rules will be published in the Gazette on 6 December 2002. The SFC will issue a press release on the same day.

ENQUIRIES

25. For any enquiries on this brief, please contact Ms. Yvonne Mok of the Intermediaries and Investment Products Division of the SFC on 2842 7638 or Ms. Mary Ahern of the Legal Services Division of the SFC on 2283 6809.

The Securities and Futures Commission
6 December 2002

SECURITIES AND FUTURES (CLIENT SECURITIES) RULES

CONTENTS

Section		Page
PART 1		
PRELIMINARY		
1.	Commencement	1
2.	Interpretation	1
3.	Application	2
4.	Requirements in respect of a client's standing authority	3
PART 2		
TREATMENT OF CLIENT SECURITIES AND SECURITIES COLLATERAL		
Division 1 – General rules		
5.	Requirement for deposit or registration of client securities and securities collateral	5
6.	Dealings with client securities and securities collateral	6
Division 2 – Particular rules		
7.	Treatment of client securities and securities collateral by intermediaries licensed or registered for dealing in securities and their associated entities	8

8	Treatment of securities collateral by intermediaries licensed for securities margin financing and their associated entities	10
9.	Treatment of securities collateral by intermediaries licensed or registered for dealing in futures contracts and their associated entities	10

PART 3

MISCELLANEOUS

10.	Limitations on the treatment of client securities and securities collateral	11
11.	Approval of custodians for safe custody of client securities and securities collateral	11
12.	Reporting of non-compliance with certain provisions of the Rules	12
13.	Penalties	12

SECURITIES AND FUTURES (CLIENT SECURITIES) RULES

(Made by the Securities and Futures Commission under section 148
of the Securities and Futures Ordinance (Cap. 571))

PART 1

PRELIMINARY

1. Commencement

These Rules shall come into operation on the day appointed for the commencement of the Securities and Futures Ordinance (Cap. 571).

2. Interpretation

In these Rules, unless the context otherwise requires –

“agreement in writing” (書面協議) means a term in a client contract that is in writing;

“approved custodian” (核准保管人) means a company or overseas company approved by the Commission under section 11 as being suitable for the safe custody of client securities and securities collateral of an intermediary;

“asset management” (資產管理) has the meaning assigned to it by Part 2 of Schedule 5 to the Ordinance;

“client contract” (客戶合約) means any contract or arrangement between an intermediary and its client, which contains terms on which the intermediary is to provide services the provision of which constitutes a regulated activity;

“dealing in futures contracts” (期貨合約交易) has the meaning assigned to it by Part 2 of Schedule 5 to the Ordinance;

“dealing in securities” (證券交易) has the meaning assigned to it by Part 2 of Schedule 5 to the Ordinance;

“linked corporation” (相連法團), in relation to an associated entity of an intermediary, 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;

“standing authority” (常設授權) has the meaning assigned to it by section 4(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. Application

(1) Subject to subsection (2), these Rules apply to client securities and securities collateral of an intermediary that are –

- (a) either –
 - (i) listed or traded on a recognized stock market; or
 - (ii) interests in a collective investment scheme authorized by the Commission under section 104 of the Ordinance; and
- (b) received or held in Hong Kong by or on behalf of –
 - (i) the intermediary in the course of the conduct of any regulated activity for which the intermediary is licensed or registered; or
 - (ii) an associated entity of the intermediary in relation to the conduct of such regulated activity.

(2) These Rules do not apply to client securities of an intermediary that are in an account established and maintained by a client of the intermediary, in that client’s name, with a person other than the intermediary or an associated entity of the intermediary.

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

(1) For the purposes of section 6(1)(c), 7(2) or (3), 8(2) or 9(2), a standing authority is a written notice that –

- (a) is given to an intermediary or an associated entity of an intermediary by a client of the intermediary;
- (b) authorizes the intermediary or associated entity to deal with client securities or securities collateral from time to time received or 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 an intermediary or an associated entity of an intermediary by a client of the intermediary who is a professional investor.

(3) A standing authority which is not revoked prior to its expiry –

- (a) may be renewed for one or more further periods –
 - (i) not exceeding 12 months, if the client of the intermediary who gave it is not a professional investor; or
 - (ii) of any duration, if the client of the intermediary who gave it is a professional investor, at any one time, with the written consent of the client of the intermediary who gave it; or
- (b) shall be deemed to have been renewed if –
 - (i) at least 14 days prior to the expiry of the standing authority, the intermediary or associated entity to which it was given, gives a written notice to the client of the intermediary 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 stated in the standing authority;
 - (B) any period not exceeding 12 months specified by the intermediary or associated entity, if the client of the intermediary is not a professional investor; or
 - (C) a period of any duration specified by the intermediary or associated entity, if the client of the intermediary 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 deemed to have been renewed in accordance with subsection (3)(b), the intermediary or associated entity (as the case may be) shall give a written confirmation of the renewal of the standing authority to the client of the intermediary within one week after the date of expiry.

PART 2

TREATMENT OF CLIENT SECURITIES AND SECURITIES COLLATERAL

Division 1 – General rules

5. Requirement for deposit or registration of client securities and securities collateral

(1) Subject to section 6, an intermediary or an associated entity of an intermediary which receives any client securities of the intermediary shall ensure that, as soon as reasonably practicable, the client securities are –

- (a) deposited in safe custody in a segregated account which is designated as a trust account or client account and established and maintained in Hong Kong by the intermediary or associated entity for the purpose of holding client securities of the intermediary with –
 - (i) an authorized financial institution;
 - (ii) an approved custodian; or
 - (iii) another intermediary licensed for dealing in securities; or
- (b) registered in the name of –
 - (i) the client on whose behalf the client securities have been received; or
 - (ii) the associated entity.

(2) Subject to section 6, an intermediary or an associated entity of an intermediary which receives any securities collateral of the intermediary shall ensure that, as soon as reasonably practicable, the securities collateral is –

- (a) deposited in safe custody in a segregated account which is designated as a trust account or client account and established and maintained in Hong Kong by the intermediary or associated entity for the purpose of holding securities collateral of the intermediary with –
 - (i) an authorized financial institution;
 - (ii) an approved custodian; or
 - (iii) another intermediary licensed for dealing in securities;

- (b) deposited in an account in the name of the intermediary or associated entity (as the case may be) with –
 - (i) an authorized financial institution;
 - (ii) an approved custodian; or
 - (iii) another intermediary licensed for dealing in securities; or
- (c) registered in the name of –
 - (i) the client on whose behalf the securities collateral has been received;
 - (ii) the intermediary; or
 - (iii) the associated entity.

6. Dealings with client securities and securities collateral

(1) An intermediary or an associated entity of an intermediary may deal with client securities or securities collateral of the intermediary that it receives or holds in accordance with –

- (a) an oral or written direction –
 - (i) to sell the client securities or securities collateral; or
 - (ii) to settle such a sale order;
- (b) a written direction to withdraw the client securities or securities collateral from an account referred to in section 5(1)(a) or (2)(a) or (b) or to deal with client securities or securities collateral that have been registered in accordance with section 5(1)(b) or (2)(c); or
- (c) a standing authority, except where this would –
 - (i) subject to subsection (2) or section 7, 8 or 9, result in a transfer of the client securities or securities collateral to an account in Hong Kong of –

- (A) the intermediary;
 - (B) the associated entity; or
 - (C) any corporation with which the intermediary is in a controlling entity relationship or in relation to which the associated entity is a linked corporation, other than an account referred to in section 5(1)(a) or (2)(a) or (b), or otherwise result in a person referred to in sub-subparagraph (A), (B) or (C) having the benefit or use of the client securities or securities collateral;
- (ii) result in a transfer of the client securities or securities collateral to any officer or employee of –
- (A) the intermediary;
 - (B) the associated entity; or
 - (C) any corporation with which the intermediary 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 in question; or
- (iii) be unconscionable.

(2) Without prejudice to subsection (1)(a), with an agreement in writing with the client on whose behalf client securities have been received or are held, an intermediary licensed or registered for asset management may withdraw any of the client securities from an account referred to in section 5(1)(a) or deal with client securities that have been registered in accordance with section 5(1)(b) –

- (a) to sell them; or

(b) to settle a sale order,
on behalf of the client.

(3) Without prejudice to subsections (1) and (2), with an agreement in writing with the client on whose behalf client securities or securities collateral have been received or are held, an intermediary may –

- (a) dispose; or
- (b) initiate a disposal by an associated entity of the intermediary,

of any of the client securities or securities collateral in settlement of any liability owed by or on behalf of the client to –

- (c) the intermediary;
- (d) the associated entity; or
- (e) a third person.

(4) In subsection (1), a direction is a direction from a client that –

- (a) relates to specified client securities or securities collateral;
- (b) is given to the intermediary or associated entity in question by the client of the intermediary on whose behalf the client securities or securities collateral were received or are being held;
- (c) directs the intermediary or associated entity to deal with the client securities or securities collateral in a particular manner; and
- (d) ceases to have effect after the client securities or securities collateral to which it relates have been dealt with by the intermediary or associated entity in the manner directed.

Division 2 – Particular rules

7. Treatment of client securities and securities collateral by intermediaries licensed or

**registered for dealing in securities and
their associated entities**

(1) This section applies to –

- (a) an intermediary licensed or registered for dealing in securities; and
- (b) an associated entity of such intermediary.

(2) With a standing authority, an intermediary or an associated entity to whom this section applies may –

- (a) apply any of the client securities or securities collateral in question pursuant to a securities borrowing and lending agreement;
- (b) deposit any of the securities collateral in question with an authorized financial institution as collateral for financial accommodation provided to the intermediary; or
- (c) deposit any of the securities collateral in question with –
 - (i) a recognized clearing house; or
 - (ii) another intermediary licensed or registered for dealing in securities,as collateral for the discharge and satisfaction of the intermediary's settlement obligations and liabilities.

(3) Where an intermediary to which this section applies –

- (a) provides financial accommodation to a client of the intermediary in the course of dealing in securities; and
- (b) also provides financial accommodation to the client in the course of any other regulated activity for which the intermediary is licensed or registered,

the intermediary or an associated entity of the intermediary may apply or deposit any of the securities collateral in question in accordance with subsection (2) with a standing authority.

8. Treatment of securities collateral by intermediaries licensed for securities margin financing and their associated entities

(1) This section applies to –

- (a) an intermediary licensed for securities margin financing; and
- (b) an associated entity of such intermediary.

(2) With a standing authority, an intermediary or an associated entity to which this section applies may deposit any of the securities collateral in question with –

- (a) an authorized financial institution; or
- (b) an intermediary licensed for dealing in securities,

as collateral for financial accommodation provided to the intermediary.

9. Treatment of securities collateral by intermediaries licensed or registered for dealing in futures contracts and their associated entities

(1) This section applies to –

- (a) an intermediary licensed or registered for dealing in futures contracts; and
- (b) an associated entity of such intermediary.

(2) Without prejudice to section 7(3), with a standing authority, an intermediary or an associated entity to which this section applies may deposit any of the securities collateral in question with –

- (a) a recognized clearing house; or
- (b) another intermediary licensed or registered for dealing in futures contracts,

as collateral for the discharge and satisfaction of the intermediary's settlement obligations and liabilities.

MISCELLANEOUS

10. Limitations on the treatment of client securities and securities collateral

(1) An intermediary or an associated entity of an intermediary must take reasonable steps to ensure that client securities and securities collateral of the intermediary are not –

- (a) deposited;
- (b) transferred;
- (c) lent;
- (d) pledged;
- (e) repledged; or
- (f) otherwise dealt with,

except as provided in Part 2.

(2) Subsection (1) does not require the intermediary or associated entity in question to ensure that the client securities or securities collateral in question are not –

- (a) deposited;
- (b) transferred;
- (c) lent;
- (d) pledged;
- (e) repledged; or
- (f) otherwise dealt with,

by a person to whom the intermediary or associated entity has lent or with whom the intermediary or associated entity has deposited any of the client securities or securities collateral in accordance with Part 2.

11. Approval of custodians for safe custody of client securities and securities collateral

The Commission may approve, by notice in writing and subject to such conditions as the Commission considers appropriate, any company or overseas

company as being suitable for the safe custody of client securities and securities collateral of an intermediary.

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

If an intermediary or an associated entity of an intermediary to which section 4(4), 5 or 10(1) applies becomes aware that it does not comply with such section, it shall give written notice of that fact to the Commission within one business day thereafter.

13. Penalties

(1) An intermediary, or an associated entity of an intermediary, which, without reasonable excuse, contravenes section 4(4) or 12 commits an offence and is liable on conviction to a fine at level 3.

(2) An intermediary, or an associated entity of an intermediary, which, with intent to defraud, contravenes section 4(4) or 12 commits an offence and is liable on conviction to a fine at level 6.

(3) An intermediary, or an associated entity of an intermediary, which, without reasonable excuse, contravenes section 5 or 10(1) commits an offence and is liable –

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

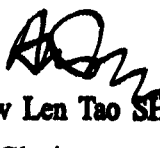
(b) on summary conviction to a fine at level 6 and to imprisonment for 6 months;

(4) An intermediary, or an associated entity of an intermediary, which, with intent to defraud, contravenes section 5 or 10(1) 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.

(5) In deciding whether or not any dealing with client securities or securities collateral under section 6(1)(c) is 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.


Andrew Len Tao SHENG
Chairman,
Securities and Futures Commission

2nd December, 2002

Explanatory Note

These Rules are made by the Securities and Futures Commission under section 148 of the Securities and Futures Ordinance (Cap. 571). They prescribe the manner in which intermediaries and their associated entities shall treat and deal with client securities and securities collateral received or held in Hong Kong. Different provisions are included for different intermediaries, and their respective associated entities, depending upon the type of regulated activity for which an intermediary is licensed or registered.