

LEGISLATIVE COUNCIL BRIEF

Securities and Futures Ordinance (Cap. 571)

SECURITIES AND FUTURES (CLIENT MONEY) RULES

INTRODUCTION

Pursuant to section 149 of the Securities and Futures Ordinance (Cap. 571) (the SFO), the Securities and Futures Commission (the SFC), has made the Securities and Futures (Client Money) 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 money. The Rules prescribe the treatment of client money received or held in Hong Kong by licensed corporations and their associated entities. The requirements are mainly based on the existing section 84 and Division 6 of Part XA of the Securities Ordinance, section 46 of the Commodities Trading Ordinance and section 23 of the Leveraged Foreign Exchange Trading Ordinance. 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 taking into account both needs have been introduced.

Major new elements

5. Major policy changes that have been incorporated into the Rules are :-

- (a) to apply the Rules to an associated entity of a licensed corporation except where it is an authorized financial institution, introduced as part of the package to impose direct regulation of such entity for closing an existing regulatory gap²;
- (b) to reduce the time limit within which client money received should be deposited in a segregated account to 1 business day, which is similar to that in most leading jurisdictions;
- (c) to exclude from the application of the Rules, client money received or held outside Hong Kong while such money

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.

remains there; or client money received or held in Hong Kong at any time but subsequently transferred outside of Hong Kong in accordance with the Rules. This is in recognition of the practical difficulty of and limited protection afforded by compliance with the segregation requirement in overseas countries particularly those with no trust law or where there is no presence of an authorized financial institution. Instead, licensed corporations are still required to ensure proper safeguarding of such client money to comply with the Code of Conduct and make proper risk disclosure to clients if their money is to be transferred out of Hong Kong; and

- (d) to permit withdrawal of client money in accordance with clients' standing authority, and in the light of the comments received during the market consultation, waiving the requirement to renew such standing authority annually, where the clients are professional investors, and also relaxing the renewal procedures for further reducing the compliance burden.

THE RULES

6. Clause 2 of the Rules contains interpretation provisions that apply throughout the Rules.

7. Clause 3 of the Rules defines the application of the Rules especially providing that the Rules do not apply to client money received or held outside Hong Kong while such money remains there; and that the Rules cease to apply to client money received or held in Hong Kong at any time but subsequently transferred outside of Hong Kong in accordance with the Rules.

8. Clause 4 of the Rules requires licensed corporations and their associated entities that receive or hold client money to establish and maintain segregated accounts in Hong Kong for deposit of such money within one business day of receipt.

9. Clause 5 of the Rules specifies the circumstances in which client money may be paid out of segregated accounts.

10. Clause 6 of the Rules prescribes the manner in which interest on client money held in segregated accounts is to be dealt with.

11. Clauses 7 and 8 of the Rules prescribe the requirements in respect of clients' written directions and standing authority including the renewal of such standing authority.

12. Clause 9 of the Rules puts beyond doubt that receiving a cheque for an amount of client money is regarded as receipt of client money upon receipt of the proceeds of that cheque.

13. Clause 10 of the Rules requires 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.

14. Clause 11 of the Rules requires licensed corporations and their associated entities to report to the SFC non-compliance with prescribed provisions of the Rules.

15. Clause 12 of the Rules prescribes penalties for contravention of prescribed provisions of the Rules.

Public consultation

16. 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.

17. 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 2002. Members expressed no further concern.

FINANCIAL AND STAFFING IMPLICATIONS

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

COMMENCEMENT DATE

19. 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

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

ENQUIRIES

21. For any enquiries on this brief, please contact Mr. Leo Lam of the Intermediaries and Investment Products Division of the SFC on 2842 7642 or Ms. Mary Ahern of the Legal Services Division of the SFC on 2283 6809.

The Securities and Futures Commission
6 December 2002

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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 (Cap. 571))

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 –

“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;

“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 –
- (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.
- (3) These Rules do not apply to client money of a licensed corporation that is in a bank account established and maintained by a client of the licensed corporation in that client's name.

4. Payment of client money into segregated accounts

(1) A licensed corporation or an associated entity of a licensed corporation 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 an associated entity of a licensed corporation 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 future contracts –
 - (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 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 an associated entity of a licensed corporation 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 an associated entity of a licensed corporation shall not pay any amount of client money of the licensed corporation under subsection (4)(d) if –

- (a) to do so would be unconscionable; or

- (b) the standing authority authorizes payment to an account in Hong Kong of the licensed corporation or 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 a 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 an associated entity of a licensed corporation 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 an associated entity of a licensed corporation shall not pay any amount of client money of the licensed corporation under subsection (1)(c) if –

- (a) to do so would be unconscionable; or
- (b) the standing authority authorizes payment to an account in Hong Kong of –
 - (i) the licensed corporation or 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 a 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 an associated entity of a licensed corporation 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 writing 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 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 that 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 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 corporation by a client of the licensed corporation 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 licensed corporation who gave it is not a professional investor; or
 - (ii) of any duration, if the client of the licensed corporation who gave it is a professional investor, at any one time, with the written consent of the client of the licensed corporation 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 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 period not exceeding 12 months specified by the licensed corporation or associated entity, if the client of the

licensed corporation is not a professional investor; or

(C) a period of any duration specified by the licensed corporation or associated entity, 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 deemed to have been renewed in accordance with subsection (3)(b), the licensed corporation 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 licensed corporation within 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 an associated entity of a licensed corporation 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) or (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.

(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.


Andrew Leung Tao SHENG
Chairman,
Securities and Futures Commission

2nd December, 2002

Explanatory Note

These Rules are made by the Securities and Futures Commission under section 149 of the Securities and Futures Ordinance (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. 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.