

Consultation Document
The Draft Securities and Futures (Client Securities) Rules (the “draft Rules”)

Introduction

1. Unlike the Securities Ordinance, the Securities and Futures Bill does not contain detailed requirements in relation to client securities; it merely gives the Commission the necessary rule-making power under clause 144 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 to the primary legislation.
2. When there are controls already built into the legislative system whereby any rules made by the Commission must be subject to negative vetting by the Legislative Council, to alleviate any remaining concern that rules made by the Commission may not be entirely appropriate for the intermediaries or their associated entities, the Commission 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 Resources 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 Securities Rules
12/F, Edinburgh Tower
The Landmark
15 Queen’s Road, Central
Hong Kong

or:

client_securities_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 the application insofar as it relates to client securities and client collateral of an exempt person or an associated entity that is an authorised financial institution.
6. To ensure that our regulatory thinking is generally in the right direction, the SFC has formulated the draft Rules after consulting selected brokerage firms and holding discussions with the Hong Kong Monetary Authority and its working group. We wish to acknowledge and thank them for their invaluable input.

Background

7. Copy of the draft Rules is attached for reference. In summary, the draft Rules require client securities and securities collateral received or held in Hong Kong to be treated by intermediaries and their associated entities in a certain way.
8. The draft Rules are derived from sections 81, 81A and 121AB of the Securities Ordinance.
9. At present, only the Securities Ordinance prescribes how client securities should be dealt with by securities dealers (including exempt dealers) and securities margin financiers. In June 2000, when the Securities (Margin Financing) (Amendment) Ordinance 2000 came into effect, these provisions were tightened. Securities dealers and securities margin financiers are only permitted to deal with client securities and securities collateral in the ways prescribed and this cannot be exceeded even with client's authority. There has been criticism from the market that these limitations are too strict, and that they hamper legitimate actions that the client may wish to take.
10. Both the Commodities Trading Ordinance and the Leveraged Foreign Exchange Trading Ordinance are silent on this issue. When it is not customary for futures dealers or leveraged foreign exchange traders to handle securities collateral in the course of their dealing or trading business, they can accept client securities in settlement of margin calls. Despite the absence of statutory protection, a recent survey conducted by the SFC indicates that this has not resulted in any abuse. In fact, most futures dealers or leveraged foreign exchange traders do not pledge securities collateral with banks for funding purposes.

New Policy Initiatives

11. Several major policy changes have been incorporated into the draft Rules:
 - (a) confining the application of the rules to local securities and collective investment schemes;
 - (b) extending the rules to apply to client securities and securities collateral received or held by all intermediaries and their associated entities;
 - (c) providing for the right of disposal to be incorporated in the client's agreement;
 - (d) providing for withdrawal of client securities and securities collateral, e.g., in accordance with specific or standing instructions from clients;
 - (e) allowing client securities and securities collateral to be deposited in safe custody with another intermediary licensed or exempt for dealing in securities and allowing securities collateral to be registered in the name of an intermediary; and
 - (f) continuing to allow intermediaries that are licensed or exempt for dealing in securities and securities margin financing to pledge securities collateral with banks etc. to raise funding.

Application of Rules - Securities Types

12. The draft Rules (see section 3) are drafted to only apply to securities listed on the Stock Exchange of Hong Kong Limited and collective investment schemes authorized by the SFC. The securities also have to be received or held by or on behalf of an intermediary or an associated entity.
13. The SFC has not prescribed rules for overseas securities. We believe this is not practical and may even 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. This is clearly not the case as the types of enforcement actions that can be taken may be limited where, e.g., an overseas custodian fails to fulfil its obligations for any reason.
14. However, the general requirements under the Code of Conduct For Persons Registered with Securities and Futures Commission will apply.

Intermediaries should therefore adequately safeguard client assets and make adequate risk disclosures so that clients can make informed decisions.

Application of Rules - Intermediary Types

15. The present requirements apply to securities dealers, exempt dealers, and securities margin financiers. The draft Rules shall apply to all intermediaries. While the SFC does not expect intermediaries licensed or exempt for futures dealing or leveraged foreign exchange trading to generally handle client securities or securities collateral in their day-to-day operation, it is desirable to ensure that client securities or securities collateral where received or held by these intermediaries, or any other types of intermediaries, are subject to the draft Rules.
16. In addition, the draft Rules also apply to associated entities of intermediaries. “Associated Entity” is defined in Schedule 1 of the Securities and Futures Bill. Essentially, this is designed to regulate the way nominee companies, operated by securities dealers or within the same group, deal with client securities or securities collateral. At present, these nominee companies are not subject to any regulation and we have seen nominee companies pledging client securities to obtain funding for their own use. Industry has indicated that this is a regulatory gap which needs to be filled.

Right of disposal

17. Under section 6 of the draft Rules, an intermediary can secure a right of disposal of client securities or securities collateral by obtaining the client’s agreement. This right is more broadly drafted than existing legislation. It may be exercised in settlement of any liability owed by or on behalf of a client to the intermediary, the associated entity or a third person. Also, in line with current banking practice, we have removed the previous clause regarding the order in which different collateral can be liquidated. An intermediary can decide which client securities or securities collateral to dispose first.

Withdrawal of client securities or securities collateral

18. The existing rules have been criticised for not being explicit as to when client securities or securities collateral can be withdrawn. Section 5 of the draft Rules now makes clear that an intermediary or an associated entity of an intermediary can withdraw client securities or securities collateral when a client

- (a) places a sell order of specified securities;

- (b) gives an instruction to withdraw specified securities; or
 - (c) gives a standing instruction to deal with his securities in a certain manner, provided that
 - (i) this will not result in a transfer of such securities to the account of an officer or employee of the intermediary or associated entity (unless that officer or employee is the client); and
 - (ii) the instruction will not be unconscionable in the sense used in the Unconscionable Contracts Ordinance.
19. The SFC sees a need to allow clients to give standing instructions to the intermediaries (or associated entities) as to how they want their client securities or securities collateral to be dealt with. However, there is also a danger that some intermediaries may ask unsuspecting clients to sign authority which effectively deprives the clients of their statutory protection intended by the draft Rules. The current drafting is believed to provide flexibility when putting in the necessary safeguards against potential abuse.

General Rules vs. Particular Rules

20. General Rules provide for how clients' securities or securities collateral are to be generally safeguarded. Particular Rules allow for additional ways or means that clients' securities or securities collateral can be dealt with provided the client has given such authority.

General Rules (Division 1 of Part II, sections 4 - 6)

21. Under the General Rules, client securities or securities collateral must be
- (a) deposited in safe custody in a designated client or trust account with
 - (i) a bank;
 - (ii) an institution approved by the SFC for this purpose (currently limited to the Hong Kong Securities Clearing Company Limited); or
 - (iii) another intermediary licensed or exempt for dealing in securities;

OR

- (b) registered in the name of
 - (i) the client;
 - (ii) the associated entity; or
 - (iii) the intermediary (in the case of securities collateral only).
22. This is based on the existing provisions in the Securities Ordinance. It also clarifies the policy intent that where a securities dealer is not an exchange participant of the Stock Exchange of Hong Kong Limited, it can discharge its responsibilities by depositing client securities or securities collateral with another securities dealer (typically an exchange participant with access to CCASS) in a designated account.

Particular Rules (Division 2 of Part II, sections 7 - 9)

23. As with existing legislation, intermediaries licensed or exempt for dealing in securities and securities margin financing may, with client's authority, pledge securities collateral with banks (or in the case of securities margin financiers, also with intermediaries licensed or exempt for dealing in securities) to raise funding for themselves.
24. However, the market has commented that in the future, under the single license regime, intermediaries should have greater flexibility. Where an intermediary is licensed or exempt for dealing in securities and other regulated activities and provides financial accommodation to a client in the course of these other activities, a view has been taken that securities collateral provided by this client should not need to be designated for different purposes. Therefore, provided that the intermediary has obtained the necessary client's authority, it should be able to deal with that client's securities collateral etc. in accordance with section 7(2).

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SECURITIES AND FUTURES (CLIENT SECURITIES) RULES

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PART I

PRELIMINARY

No		Page
1.	Commencement	1
2.	Interpretation	1
3.	Application	3

PART II

TREATMENT OF CLIENT SECURITIES

Division 1 - General Rules

4.	Requirement for registration or deposit of client securities and securities collateral	5
5.	Withdrawal of client securities and securities collateral	7
6.	Right of disposal of client securities and securities collateral	9

Division 2 - Particular Rules

7.	Treatment of client securities and securities collateral by intermediaries licensed or exempt for dealing in securities and their associated entities	10
8.	Treatment of securities collateral by intermediaries licensed for securities margin financing and their associated entities	12
9.	Treatment of securities collateral by intermediaries licensed or exempt for dealing in futures contracts and their associated entities	13

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PART III

MISCELLANEOUS

	Page
10. Limitations on the treatment of client securities and securities collateral	14
11. Reporting of non-compliance with Rules	15
12. Penalties	16

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SECURITIES AND FUTURES (CLIENT SECURITIES) RULES

(Made by the Securities and Futures Commission under
section 144(1) of the Securities and Futures
Ordinance (of 2001))

PART I

PRELIMINARY

1. Commencement

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

2. Interpretation

In these Rules, unless the context otherwise requires -
"approved institution" (核准機構) means an
institution approved by the Commission by written
notice as providing satisfactory facilities for the
safe custody of client securities and securities
collateral;

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

(a) an intermediary to which these Rules apply and its client, containing terms on which the intermediary is to provide services the provision of which constitutes a regulated activity;

(b) an associated entity to which these Rules apply and the client of an intermediary with which the associated entity is in a controlling entity relationship, which contains terms regarding the treatment of client securities or securities collateral;

"client's agreement" (客戶協議) means a written client contract in which a client is notified of the right of an intermediary, or an associated entity of the intermediary, to which these Rules apply, to dispose of client securities or securities collateral in accordance with section 6;

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"client's authority" (客戶授權) means the authority given in writing by a client to an intermediary, or an associated entity of the intermediary, to which these Rules apply, concerning the treatment of client securities or securities collateral 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;

"segregated account" (獨立帳戶) means an account designated as a trust account or a client account.

3. Application

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These Rules apply to client securities and securities collateral that are -

(a) either -

(i) listed on a recognized stock market; or

(ii) collective investment schemes authorized by the Commission under section 103 of the Ordinance; and

(b) received or held in Hong Kong by or on behalf of -

(i) an intermediary; or

(ii) an associated entity of the intermediary.

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PART II

TREATMENT OF CLIENT SECURITIES

Division 1 - General rules

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

(1) Subject to sections 5 and 6, and Division 2 as applicable, as soon as practicable after any client securities are received, an intermediary or an associated entity of the intermediary must ensure that they are -

(a) deposited in safe custody in a segregated account with -

- (i) an authorized financial institution;
 - (ii) an approved institution; or
 - (iii) another intermediary that is licensed for dealing in securities;
- or

(b) registered in the name of -

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- (i) the client from whom or on whose behalf the client securities have been received; or
- (ii) the associated entity.

(2) Subject to sections 5 and 6, and Division 2 as applicable, as soon as practicable after any securities collateral is received, an intermediary or an associated entity of the intermediary must ensure that it is -

- (a) deposited in safe custody in a segregated account with -

- (i) an authorized financial institution;
- (ii) an approved institution; or
- (iii) another intermediary that is licensed for dealing in securities;

- (b) deposited in an account in its own name with -

- (i) an authorized financial institution;
- (ii) an approved institution; or

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(iii) another intermediary that is licensed for dealing in securities; or

(c) registered in the name of -

(i) the client from whom or on whose behalf the securities collateral has been received;

(ii) the intermediary; or

(iii) the associated entity.

5. Withdrawal of client securities and securities collateral

Subject to section 6, and Division 2 as applicable, an intermediary or an associated entity of the intermediary may withdraw client securities or securities collateral in accordance with -

(a) an oral or written direction from the client from whom or on whose behalf the client securities or securities collateral have been received -

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- (i) to sell specified client securities or securities collateral; or
 - (ii) to settle such a sale order;

- (b) an oral or written direction from the client from whom or on whose behalf the client securities or securities collateral have been received to withdraw specified client securities or securities collateral; or

- (c) the client's authority of the client from whom or on whose behalf the client securities or securities collateral have been received, except where this would -
 - (i) result in a transfer of the client securities or securities collateral to the account of any officer or employee of the intermediary or the associated entity, unless that officer or employee is the client; or
 - (ii) be unconscionable in the sense used in the Unconscionable

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Contracts Ordinance (Cap. 458),
as if the client's authority
were a contract under that
Ordinance.

6. Right of disposal of client securities and securities collateral

With the client's agreement of the client from whom
or on whose behalf client securities or securities
collateral have been received, 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

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(e) a third person.

Division 2 - Particular rules

7. Treatment of client securities and securities collateral by intermediaries licensed or exempt for dealing in securities and their associated entities

(1) This section applies to -

(a) an intermediary licensed or exempt for dealing in securities; and

(b) an associated entity of the intermediary.

(2) With the client's authority of the client from whom or on whose behalf client securities or securities collateral have been received, an intermediary or an associated entity referred to in subsection (1) may -

(a) apply any of the client securities or securities collateral pursuant to a securities borrowing and lending agreement;

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(b) deposit any of the securities collateral with an authorized financial institution as collateral for financial accommodation provided to the intermediary; or

(c) deposit any of the securities collateral with -

(i) a recognized clearing house; or

(ii) a different intermediary licensed for dealing in securities,

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

(3) Where an intermediary referred to in subsection (1) provides financial accommodation to a client in the course of -

(a) dealing in securities; and

(b) any other regulated activity for which the intermediary is licensed or exempt,

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the intermediary or an associated entity of the intermediary may apply or deposit any securities collateral in accordance with subsection (2) with the client's authority of the client from whom or on whose behalf the securities collateral has been received.

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 the intermediary.

(2) With the client's authority of the client from whom or on whose behalf securities collateral has been received, an intermediary or an associated entity referred to in subsection (1) may deposit any of the securities collateral with -

(a) an authorized financial institution; or

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- (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 exempt for dealing in futures contracts and their associated entities

- (1) This section applies to -

- (a) an intermediary licensed or exempt for dealing in futures contracts; and

- (b) an associated entity of the intermediary.

(2) Subject to section 7(3), with the client's authority of the client from whom or on whose behalf securities collateral has been received, an intermediary or an associated entity referred to in subsection (1) may deposit any of the securities collateral with -

- (a) a recognized clearing house; or

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(b) another intermediary licensed for dealing
in futures contracts,

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

PART III

MISCELLANEOUS

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

(1) An intermediary or an associated entity to
which these Rules apply must take reasonable steps to
ensure that client securities and securities collateral
are not -

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

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except as provided in Part II.

(2) For the avoidance of doubt, subsection (1) does not require the intermediary or associated entity to ensure that the client securities or securities collateral are not -

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

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

11. Reporting of non-compliance with Rules

An intermediary or an associated entity which becomes aware that it is not in compliance with any of the provisions in Part II or section 10(1) must notify the Commission within one business day.

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12. Penalties

(1) An intermediary or an associated entity that contravenes section 4 or 11 -

(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.

(2) An intermediary or an associated entity that contravenes section 10(1) -

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

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

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

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

- (i) on conviction on indictment to a
fine of \$1,000,000 and to
imprisonment for 7 years; or
- (ii) on summary conviction to a fine
of \$500,000 and to imprisonment
for 1 year.

Chairman,
Securities and Futures
Commission

2001

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Explanatory Note

These Rules are made by the Securities and Futures Commission under section 144(1) of the Securities and Futures Ordinance (of 2001). They prescribe the manner in which intermediaries and their associated entities must treat client securities and securities collateral received or held in Hong Kong. Different requirements are prescribed for different intermediaries, and their respective associated entities, depending upon the type of regulated activity for which an intermediary is licensed.