

## 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 entities<sup>1</sup>, 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 gap<sup>2</sup>;
- (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

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<sup>1</sup> 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.

<sup>2</sup> 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