



SECURITIES AND  
FUTURES COMMISSION  
證券及期貨事務監察委員會

## **Consultation Conclusions on the Draft Securities and Futures (Client Securities) Rules**

《證券及期貨(客戶證券)規則》  
草擬本的諮詢總結

Hong Kong  
July 2002

香港  
2002年7月

## Contents

	Page
<b>INTRODUCTION.....</b>	<b>1</b>
<b>PUBLIC CONSULTATION .....</b>	<b>1</b>
<b>A. Background .....</b>	<b>1</b>
<b>B. Consultation Process .....</b>	<b>2</b>
<b>CONSULTATION CONCLUSIONS.....</b>	<b>2</b>
Clarification of Scope of Application .....	2
Client Authority .....	3
Exemption for Professional Investors .....	3
Sundry amendments .....	4
<b>EFFECTIVE DATE AND TRANSITIONAL ARRANGEMENTS.....</b>	<b>4</b>

## **INTRODUCTION**

1. On 12 April 2001, the Securities and Futures Commission (the “SFC”) released a consultation document (“Consultation Document”) on the draft Securities and Futures (Client Securities) Rules (the “Draft Rules”).
2. The Draft Rules contained detailed requirements to regulate the receipt and holding of client securities with a view to protecting the interests of the investing public by requiring intermediaries and their associated entities (each, a “firm”) to segregate and hold such securities.
3. The consultation period lasted until 24 May 2001.
4. A summary of comments received on the Draft Rules (“Summary of Comments”) is attached as Appendix 1.
5. Taking into account the submissions received and following discussions with commentators, several revisions to the Draft Rules were considered appropriate.
6. These revisions have been adopted by the Commission and effected in the revised draft Rules (“Revised Draft Rules”) which are attached as Appendix 2. As the Revised Draft Rules remain subject to deliberation of the Legislative Council, they may not be in the final form. They are issued primarily to demonstrate how we have revised the rules in response to the market comments and not for the purpose of another round of consultation.
7. The purpose of this report is to provide interested persons with an analysis of the main comments raised during the consultation process and the rationale for the Commission’s conclusions. This report should be read in conjunction with the Securities and Futures Ordinance (the “SFO”), the Consultation Document, the Summary of Comments and the Revised Draft Rules.

## **PUBLIC CONSULTATION**

### **A. Background**

8. The Draft Rules were prepared to ensure that client securities received or held by intermediaries or their associated entities were properly segregated and that securities collateral could only be re-pledged in prescribed circumstances.

9. From a policy perspective, the Revised Draft Rules are intended primarily to:
  - (a) expand the scope of the requirements to apply to all intermediaries and their associated entities as currently the requirements are only contained in the Securities Ordinance applicable to securities dealers and securities margin financiers; and
  - (b) provide for withdrawal of client securities and securities collateral, e.g. in accordance with specific directions or general authority from clients.

**B. Consultation Process**

10. In addition to the public announcement inviting comments, the Consultation Document was distributed to all registered persons and various professional bodies. The Consultation Document was also published on the SFC website.
11. Sessions were held with trade associations, industry participants and with their legal advisers during the consultation period to discuss their comments.
12. 15 submissions were received from practitioners including fund management firms, international brokerage firms, legal firms, industry representative bodies and professional associations.
13. The overall tone of the comments was positive. Commentators generally welcomed the draft Rules. Comments varied considerably in range and depth, with some focusing on broad principles and others on points of detail and clarification.

**CONSULTATION CONCLUSIONS**

14. With the exception of a few minor amendments, the following changes are to be made to the Draft Rules originally set out in the Consultation Document:

Clarification of Scope of Application

15. Some commentators asked for clarification as to the scope of application of the Draft Rules to securities that are received by affiliates of intermediaries not in connection with the regulated activities conducted by the intermediaries and to intermediaries that hold client securities only by reason of their having power to operate the clients' accounts.

16. The Draft Rules have been revised to state expressly that -
- (a) they only apply to client securities and securities collateral received or held in Hong Kong by or on behalf of -
    - (i) an 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 such conduct of regulated activity; and
  - (b) they do not apply to client securities of an intermediary that are maintained in an account in the client's name and that the intermediary or associated entity "holds" solely because it has control over the account.

#### Client Authority

17. The Draft Rules required that the handling of client securities and securities collateral be in accordance with the Draft Rules, a client's authority or a direction from the client. "Client's authority" was defined in the Draft Rules and was required to be in writing, could only be valid for up to 12 months and might be renewed in writing or otherwise. Many commentators were concerned that administratively, it would be difficult to obtain affirmative renewals of client authority.
18. We appreciate these concerns and have accordingly modified the Draft Rules so that, subject to objection by the clients, the renewals may be by way of pre-expiry reminder notice and a post-expiry renewal confirmation from the intermediaries or associated entities and the authority would be renewed for up to another 12 months upon the same terms and conditions as the original authority. The Revised Draft Rules also allow for the intermediary or associated entity to specify for the renewal a period not exceeding 12 months, which should facilitate minimizing the administrative burden arising from the renewal process.

#### Exemption for Professional Investors

19. One commentator asked that clients who are professional investors be exempted from the Draft Rules and some asked for relaxation of the authority renewal requirement if the client is a professional investor.

20. We remain of the view that professional investors' securities should be protected in a similar manner as retail investors' securities. However, we accept that there may be a lesser need to subject authority given by professional investors to the renewal requirement and therefore have relaxed the requirement so that the client authority may be given without specifying a period in which it is valid or for a period of more than 12 months.

#### Outright transfer of legal title

21. A question was raised as to whether the Securities and Futures (Client Securities) Rules would apply to transactions such as equity repurchase transactions and whether securities collateral would include securities that were the subject of an outright legal transfer of ownership. Our view is that securities collateral should not ordinarily include securities that are the subject of an outright transfer. We have therefore added a carve-out in clause 3(3) so that client securities that are subject of a repurchase transaction would not be subject to the Securities and Futures (Client Securities) Rules.

#### Sundry amendments

22. We have -
- (a) clarified our intention that client direction is a special instruction for the firm to act in a certain manner in relation to a specific amount of client securities or securities collateral;
  - (b) required a written direction from a client to withdraw client securities or securities collateral (in order to provide a better audit trail); and
  - (c) specified that a client cannot give standing authority to transfer client securities or securities collateral to an account in Hong Kong of the intermediary, its associated entity or any of their corporate affiliates or result in such a person having the benefit or use of the client securities or securities collateral except as provided for in the Draft Rules.
23. In response to a market comment, we have revised the Draft Rules so as to apply them to securities traded as well as listed on the Stock Exchange of Hong Kong Limited.

#### **EFFECTIVE DATE AND TRANSITIONAL ARRANGEMENTS**

24. The Securities and Futures (Client Securities) Rules will become effective on the day appointed for the commencement of Part VI of the SFO.

## Draft Securities and Futures (Client Securities) Rules

### Summary of comments received and SFC's response

Item no.	Clause no.	Respondent	Respondent's comments	SFC's response
<i>General Comments</i>				
1.	-	Law Society of Hong Kong	The Draft Rules use various terms which are defined in the Securities & Futures Ordinance (the "Ordinance"), such as "client securities". For convenience, it would be helpful if the defined terms were set out in the Explanatory Notes or in an Introduction or Annex to the Rules.	<p>This is not considered necessary; subsidiary legislation should always be read in conjunction with the primary legislation.</p> <p>It is not necessary to define terms already defined in Part 1 of Schedule 1 to the Ordinance.</p>
2.	-	JF Asset Management Ltd	<p>The general comment on the Draft Rules is that they are drafted with a focus on the stock broking industry. It is suggested that the SFC should provide clarification regarding the application of the Rules to the asset management industry in Hong Kong.</p> <p>For example, where a fund manager does not normally hold client securities albeit that it has discretion from clients to operate their accounts and instruct clients' custodians for settlement purposes.</p>	<p>We propose to post answers to frequently asked questions to our website in due course. This is consistent with what we are currently doing when we introduce the revised financial resources rules and the Code of Conduct etc.</p> <p>The new clause 3(2) now makes it clear that these Rules do not apply to situations such as this one.</p>
3.	-	Linklaters & Alliance	<p>It is questioned whether the Rules should apply in respect of securities held for professional investors as this type of investors should not require the same protection as retail investors.</p> <p>For example, in the United Kingdom, both under the existing rules and the rules to be made under the Financial Services &amp; Markets Act, market counterparties and other non-private customers can opt-out of the client money rules (and often do so). Also, the more detailed requirements of the custody rules can be disapplied in respect of assets held for market counterparties.</p>	<p>We are of the view that the same principle should apply to protection of client securities, whether the clients are professional investors or otherwise. However, we agree that professional investors should be able to waive the annual renewal requirement for client's authority.</p> <p>It should be noted that the Rules only apply to clients and not to market counterparties and hence some of the concerns raised by the commentator are not relevant.</p>

Item no.	Clause no.	Respondent	Respondent's comments	SFC's response
4.	-	Anonymity	<p>It is noted that the Rules apply to licensed corporations but not sole proprietors and partnerships conducting regulated activities.</p> <p>There should be a system or policy in place upon the Bill becoming effective to subject sole proprietors and partnerships to the Rules during the transitional period for the migration to the new licensing regime.</p>	Sections 27, 30 and 53(4) of Part III to Schedule 10 to the Ordinance already provide for partnerships and sole proprietorships to be treated as licensed corporations during the transition period, and that the provisions of the Ordinance shall apply to them.
5.	-	Law Society of Hong Kong, Linklaters & Alliance	<p>“Securities collateral” is defined to cover securities provided as security for the provision of financial accommodation, or to facilitate such provision. It has been assumed that this definition is not intended to apply to transactions such as equity repos, where a person might receive cash from a licensed corporation against the delivery of securities with a future obligation to purchase equivalent securities from the licensed corporation. In this case, the securities are sold outright to the licensed corporation, rather than being provided by way of collateral. Nor should securities be treated as client securities or as securities collateral where:</p> <ul style="list-style-type: none"> <li>(i) securities are delivered to a licensed corporation pursuant to a stock loan, against payment of cash collateral; or</li> <li>(ii) securities are transferred to a licensed corporation pursuant to an equity swap; or</li> <li>(iii) securities are provided to a licensed corporation under an ISDA Credit Support Annex (English law), which provides for outright transfer.</li> </ul>	Our view is that securities collateral should not ordinarily include securities that are the subject of an outright transfer. On this basis, we have disapplied client securities and securities collateral that are the subject of a repurchase transaction from the Rules (see the new clause 3(3)) to address the specific concern raised, based on similar US regulations.



Item no.	Clause no.	Respondent	Respondent's comments	SFC's response
6.	-	Albert Pun	<p>The Commission's policy that the Client Securities Rules would not apply to overseas securities is welcomed.</p> <p>In addition to that, if an intermediary has an overseas associated company which is a licensed broker-dealer and has overseas clients trading in Hong Kong securities, it is not clear whether this overseas broker-dealer is also subject to the Client Securities Rules.</p> <p>This should not be necessary as the overseas broker-dealer would be subject to its own client asset rules and it would retain a separate Hong Kong custodian for the securities held.</p>	<p>Noted.</p> <p>The Rules only apply to client assets received or held by licensed corporations and registered institutions. They should not apply to the overseas associated company in question.</p>
7.	-	Albert Pun	<p>Both section 81A of the Securities Ordinance and the draft Rules have failed to recognize the different nature upon which an intermediary holds client securities (i.e. securities of cash clients that have been fully paid) and securities collateral (i.e. securities of margin clients that have been pledged to an intermediary as collateral for a loan or credit facilities line).</p> <p>For client securities, the intermediary is by nature a bailee or custodian for cash clients, and terms of their holding should commensurate with a bailor-bailee relationship.</p> <p>Considering that custody of client securities involves a bailor-bailee relationship, it is reasonable to require the sort of client authority as defined in the client securities rules before they can be handled by an intermediary in those specified ways.</p> <p>For securities collateral, the relationship between margin clients and an intermediary is that of debtor-creditor relationship with the latter holding the securities collateral to secure repayment of the loan.</p>	<p>The suggested approach is based on the banking model; this is not considered suitable for the broking business. Given that the vast majority of brokers either deposit securities collateral at CCASS or pledge them with banks for financing, they should not have problems complying with the draft Rules. It is supported by the fact that no other commentators have made the same suggestion.</p>

Item no.	Clause no.	Respondent	Respondent's comments	SFC's response
			<p>Both section 81A and the draft Rules are formulated on the basis that all client securities should be held on bailor-bailee basis. This is not in line with international commercial practice.</p> <p>In fact, intermediaries are like banks which hold monies for clients. A bank's relationship with customers is one of debtor-creditor. As such, banks have flexibility in handling customers' monies but will be subject to a duty to repay customers upon demand.</p> <p>In this regard, banking regulators subject banks to a high standard of capital adequacy ratio to ensure that they are in a position to honour their obligations when required. Likewise, intermediaries should be regulated on a similar basis.</p>	<p>We will consider this separately in due course.</p>
<b><i>Specific Comments</i></b>				
8.	2	Lloyds TSB Pacific Ltd	<p>Under the "client's authority" definition (now deleted), the authority may be renewed "in writing or otherwise". It should be made clear that negative acceptance on the part of the client for renewal of the client's authority is permitted. This would be consistent with the Code of Conduct for Persons Registered with the SFC.</p> <p>On the other hand, some consider that allowing authority to be renewed otherwise than in writing will be likely to give rise to disputes between the brokers and the clients as to the fact or precise extent of the renewal of authority.</p>	<p>To address the market's concern, we have revised the draft Rules in the new clause 4 by allowing for either a renewal of that authority by the client affirmatively in writing or through a process whereby the intermediary or associated entity issues a pre-expiry reminder and a post-expiry confirmation, unless objected to by the client.</p>

Item no.	Clause no.	Respondent	Respondent's comments	SFC's response
9.		Anonymity	<p>The comment is made in respect of the “client's authority” definition (which has now been deleted). In view of the increasing popularity of on-line trading, it is recommended to include other electronic means of communication (e.g. e-mail) for such an authority.</p> <p>In addition, it is not clear if an authority signed by a client stating that it will remain valid unless otherwise instructed will meet the requirement of para. (c). If not, this will impose heavy administrative burden on the industry. It is, therefore, recommended that the said provisions be modified to allow more flexibility.</p>	<p>An authority in writing can be made in an electronic form provided compliance with the Electronic Transactions Ordinance.</p> <p>The example given by the commentator is not acceptable. Please see out response to comment 8. Administrative burden should have been substantially reduced by our allowing renewal in accordance with section 4(3). It is important for investor protection to remind investors of such authority on a yearly basis.</p>
10.	2	Law Society of Hong Kong, Linklaters & Alliance	<p>There is a definition of “segregated account”, which means an account designated as a trust account <u>or</u> a client account, which again appears confusing. This has now been deleted.</p> <p>Again, it may be helpful to spell out what is intended to be achieved: i.e. that the financial institution with which the segregated account is opened should treat the intermediary or associated entity as a trustee in respect of the account, and not apply any rights of consolidation or set-off, in respect of assets in that account for liabilities of the intermediary/associated entity to the financial institution.</p>	<p>The new clause 5(1)(a) and 5(2)(a) clarify the nature of the account and the requirement for separate accounts to be maintained for client securities and securities collateral.</p>
11.	3(a) (now the new clause 3(1)(a))	Lloyds TSB Pacific Ltd	<p>Clause 3(a) (now the new clause 3(1)(a)) only applies to securities which are either listed in a recognized stock market or are collective investment schemes, and are received or held in Hong Kong. We feel that the rules:</p> <p>(a) should apply to all securities (as defined in the Securities Ordinance); and</p> <p>(b) should apply to securities received or held by the intermediary whether in Hong Kong or elsewhere.</p>	<p>Para. 13 of the Consultative Document explains why we have opted for restricted application. We do not intend to expand the scope except in relation to securities traded on the SEHK (please see point 13).</p> <p>The Code of Conduct already requires licensed corporations to ensure that client assets are accounted for properly and promptly and are adequately safeguarded.</p>

Item no.	Clause no.	Respondent	Respondent's comments	SFC's response
			An intermediary should have the same duties of care in respect of all securities held for a client in connection with the firm's business in Hong Kong.	
12.		Lim Wah Sai	Presumably only the SEHK is currently the only recognized market under the Ordinance.	This is correct, recognized stock market is so defined in Schedule 1 of the Securities and Futures Ordinance.
13.		Anonymity	Clarification is required as to how the SFC intends for the draft Rules to apply to securities admitted to trading on the Stock Exchange only (but not listed).	The scope has been amended to cover securities traded or listed on the SEHK given that such securities are capable of being maintained with CCASS in the same way as securities listed on the SEHK.
14.	4 (now the new clause 5)	Hong Kong Trustees Association	Trustee companies in Hong Kong have been holding securities on behalf of their clients and trust funds for a number of years and the draft Rules would cause some substantial difficulties with regard to existing trust companies who provide custody services to a wide range of SFC registered intermediaries which may be in the forms of Mandatory Provident Funds, authorized collective investment schemes and other types of direct custody arrangements.	<p>The draft Rules are no different from the existing provisions in the SO which do not allow dealers to deposit client securities in safe custody with trust companies. Hence, this is not expected to suddenly cause substantial difficulties.</p> <p>We wish to clarify that the draft Rules do not apply to trust companies providing custody services to Mandatory Provident Funds and authorized collective investment schemes. The trust companies are only accountable to these Funds and schemes and not to any licensed corporation.</p>
15.		Lim Wah Sai	The existing rules permit the dealer to deposit client securities collateral under its name with an authorized institution (i.e. the bank). Clarification is sought as to whether the expansive definitions of client "securities" and "securities collateral" may include implicitly money.	No, this does not include money. Please see definitions of "client collateral", "client securities" and "client securities and collateral" and "other collateral" in Schedule 1 to the Ordinance.
16.		Albert Pun	Securities collateral refers to shares deposited under a share pledge. However, some financing arrangements involve an outright transfer of securities to the creditor to hold the same as the legal owner pending full repayment of the loan.	We take the view that securities collateral should not ordinarily include securities that are subject of an outright legal transfer of ownership.

Item no.	Clause no.	Respondent	Respondent's comments	SFC's response
17.		Anonymity	The time limit for treating client securities or securities collateral as specified in the draft Rules is "as soon as practicable" after any securities or securities collateral are/is received. To avoid inadvertent contravention of these requirements, the SFC should consider setting out its expectation of the timing of compliance and specifying any particular scenario to illustrate such expectation where necessary.	When it is desirable to require deposits into segregated accounts to be made within 1 business day of the date of receipt, this may not always be possible, as the result of normal business operations and temporary lags that occur between the time when a security is required to be deposited and the time that it is so deposited. On balance, we maintain the view that we should retain the same flexibility as in section 81A of the Securities Ordinance by requiring compliance as soon as practicable.
18.	5 (now the new clause 6)	Anonymity	<p>This provides that an intermediary may withdraw client securities or securities collateral in accordance with the client's authority except where this would be unconscionable in the sense used in the Unconscionable Contracts Ordinance ("UCO") in clause 5(c)(ii) (now the new clause 6(1)(c)(iii)). As it is difficult for market practitioners to determine as to what would be unconscionable in the sense as used in the UCO, it is suggested that the Rules clarify this by highlighting any particular sections in the Ordinance, which should be taken into account by market practitioners.</p> <p>Clause 5(c) (now the new clause 6(1)(c)(ii) and (iii)) provides that client's authority is required in respect of the withdrawal by the intermediary of client securities or securities collateral received by the intermediary. The SFC should clarify as to whether an intermediary who acts as a custodian for client securities would be required to seek renewal of this authority annually.</p>	<p>Although the UCO is merely 8 sections long, we now specifically refer to section 6 of the UCO (which sets out the criteria that a court will look at when determining if a contract is unconscionable).</p> <p>The draft Rules are clear that all intermediaries, including those acting as custodians for client securities, are required to seek renewal of this authority annually.</p>
19.		Lloyds TSB Pacific Ltd	It is not clear whether clause 5(c)(ii) (now the new clause 6(1)(c)(iii)) is necessary as the statutory provisions of the UCO are likely to apply whether or not this is explicitly stated in the Draft Rules.	We concur that the UCO is likely to apply in most circumstances but wish to ensure that if a client's authority were not given as part of a contract for some reason, the disciplines of the UCO would still apply to it. In any event, it should be a useful reminder to intermediaries and associated entities of the existence of the UCO and so prevent inadvertent breach of its provisions.

Item no.	Clause no.	Respondent	Respondent's comments	SFC's response
20.		Law Society of Hong Kong, Linklaters & Alliance	<p>This provides for the circumstances in which client securities may be withdrawn from a segregated account. If an intermediary is acting as a discretionary investment manager for the client, including providing custody of the client's portfolio, it appears that the intermediary can only transfer securities to settle sales from the client's portfolio if it obtains written authority every 12 months (in addition to the annual renewal required in respect of its discretionary authority by the SFC Code of Conduct).</p> <p>There is no exemption in respect of professional investors, although the need for annual renewal of discretionary authority under the Code of Conduct is disapplied in respect of professional investors.</p>	<p>Where the intermediary is to sell client securities under clause 5(1)(a) (now the new clause 6(1)(a)), it will not need to obtain written authority every 12 months.</p> <p>We have added the new clause 6(2) to make allowance for sales transactions generated internally in case of an asset manager.</p> <p>The Revised Draft Rules waive the annual renewal for professional investors.</p>
21.		Albert Pun	<p>Client authority defined in clause 1 is more restrictive than actual practice.</p> <p>It should not be necessary to restrict client's authority in the proposed manner with respect to their instructions to withdraw securities. There is not any inherent conflict or client detriment in the matter. Moreover, clause 5(c)(i) and (ii) (now the new clause 6(1)(c)(ii) and (iii)) already prohibits unconscionable withdrawals or withdrawal involving a transfer of the securities to an intermediary's employee or officer.</p> <p>Also, client's standing authority to withdraw their shares should not be restricted in the defined manner. It seems to serve little purpose and is unduly cumbersome on clients.</p>	<p>The client authority defined in the old clause 1 is not substantially different from that provided under section 81, 81A or 121AB of the Securities Ordinance. Hence, we do not agree that this is a more stringent requirement.</p> <p>The above notwithstanding, we now allow negative acceptance of renewal of authority and waive annual renewal by professional investors (now the new clause 4).</p>

Item no.	Clause no.	Respondent	Respondent's comments	SFC's response
22.	6	Anonymity	<p>There are some concerns with the drafting of the first paragraph of clause 6 (now the new clause 6(3)). It may be better for it to read as follows:</p> <p>"With the client's agreement, an intermediary may...".</p> <p>Also, the wording as currently drafted in the consultation document raises some doubts on the operation of the bank's lien and right of sale, which is usually set out in the client documentation entered into between a bank and the client. Such documentation usually provides for the bank to have the right to dispose of any of the client's assets which the client has placed with the bank, in settlement of a liability due from the client to the bank.</p>	<p>The elaboration in clause 6 (now the new clause 6(3)) is intended to identify more precisely the link between a client's authority and the securities or securities collateral of that client to which the authority relates. However, we have adjusted the definition of "agreement in writing" to enable the clause to read more naturally without changing the substance.</p> <p>The clause should not have the suggested effect as any client's assets deposited with the bank in another capacity will not be subject to these Rules in the first place.</p>
23.		Albert Pun	<p>Considering that an intermediary's enforcement right takes many forms including lien, consolidation and set off, foreclosure, power of sale and so on, it would be helpful if the Commission can clarify whether the word "disposal" in this clause means "handling" generally or it means "selling" in specific.</p> <p>In case of the latter, it would be too restrictive in view of actual commercial practice and would need to be amended to allow for the legitimate exercise of other enforcement rights.</p>	<p>The regulatory intent is primarily to mean "selling" though it would automatically allow any act that amounts to less than outright sale since disposal is a broad term.</p>

Item no.	Clause no.	Respondent	Respondent's comments	SFC's response
24.	7	Albert Pun	It should not be necessary to limit client's standing authority to a maximum of 12 months and require them to renew their authority annually. But for those margin clients who no longer use the margin line extended and have no outstanding margin loans, it may be reasonable to require an annual authorization from them before an intermediary can handle their securities. So, the proposed renewal should only be confined to margin clients with no outstanding indebtedness with the intermediary.	We believe that the new clause 4 already makes the renewal requirement much easier to comply with.
25.		Hong Kong Trustees Association	Clause 7(2) contains the opening words "with the client's authority of the client from whom...". Perhaps, this should read "with the authority of the client from whom..."	We have revised the draft Rules as suggested with consequential changes to the previously defined term "client's authority" to which reference was necessary in the original formulation of clause 7(2) and elsewhere.
26.		Law Society of Hong Kong, Linklaters & Alliance	To utilise client securities or securities collateral in the way set out in clause 7 it is necessary to obtain written authority from the client, which requires annual renewal. SFC should consider an exemption in respect of persons who are professional investors for the purposes of the Securities and Futures Ordinance and/or the SFC Code of Conduct. The same comment applies in respect of clauses 8 and 9.	We have waived annual renewal by professional investors in the new clause 4.
27.	8	Marcus Hung	<p>Re-pledging of securities collateral can be dangerous even with client's authority.</p> <p>A broker should only be allowed to exercise his right under the client's authority to deposit the client's securities with a bank as collateral for funding purpose when that client owes him money.</p> <p>This would help retail investors to restore confidence on brokerage firms so as to enable the latter to improve their competitiveness with banks.</p>	<p>This of course is ideal for investor protection but may not be practical as advised by the industry as it is administratively burdensome and costly to track movement of collateral on a client-by-client basis and to effect frequent transfer securities to and from banks.</p> <p>We recognize the need to address this in the long-term and plan to address this separately in due course.</p>



Item no.	Clause no.	Respondent	Respondent's comments	SFC's response
28.	9	Anonymity	With regard to clauses 8 and 9 , the use of client securities as collateral has given rise to tracing difficulties in the liquidations of both CA Pacific Securities Ltd and Forlux Securities Ltd. Requirements as to the keeping of records should be imposed in respect of the use of client securities as collateral so that it is clear whose securities are being used at any particular time.	There is a fundamental problem in accounting for securities collateral on a client-by-client basis when all the securities collateral is allowed to be pooled (please see point 27 above).
29.	11 (the new clause 12)	Anonymity	<p>Clause 11 (now the new clause 12) requires that non-compliance with any of the provisions of Part II or clause 10(1) must be notified to the SFC within 1 business day. This deadline is quite short and it may be difficult for market practitioners to comply within such a short period of time. It is suggested to extend to 3 business days.</p> <p>In addition, for registered institutions, it would be preferable for such entities to notify their lead regulator, the Hong Kong Monetary Authority.</p>	<p>We have kept the 1-day notice period because non-compliance may seriously undermine investor protection.</p> <p>We will be sharing relevant information with the HKMA under our Memorandum of Understanding.</p>
30.		Albert Pun	<p>Since non-compliance with rules may amount to an offence, the criminalisation of non-reporting of an offence must be very carefully scrutinized. That seems repugnant to the common law practice of privilege against self-discrimination.</p> <p>Such arrangement is very unusual in international practice. When endorsed by legislature, it is very important that such arrangement is carefully orchestrated to ensure that the criminalisation of non-reporting of an offence is just, fair and appropriate for the circumstances.</p>	This has been subject to considerable amount of scrutiny at the Ordinance level. The concern should be adequately addressed by section 166 of the Ordinance on use of incriminating evidence in proceedings.

Item no.	Clause no.	Respondent	Respondent's comments	SFC's response
31.	12 (now the new clause 13)	Anonymity	<p>There are concerns as to the meaning of the words "reasonable excuse". It is unclear as to what type of situations would be covered by the concept of "reasonable excuse" which are executed but there are problems with verification. For example, a situation may arise where a client has opened an account with the bank and placed securities with the bank as custodian. If the client becomes involved in litigation as a result of which a court order is issued on the bank requiring that the bank transfers to his creditors the securities which it holds as a custodian, the bank will be faced with a situation where a transfer of shares pursuant to the court order will be in breach of clause 6 of the draft Rules. Clause 12(1)(a) (now the new clause 13(1)(a)) should be expanded to include protection for any intermediary or associated entity which is merely complying with any legal or regulatory requirements in transferring, disposing of, or withdrawal of client securities. In addition, it would be preferable for there to be some explanatory note on what constitutes "reasonable excuse".</p>	<p>"Reasonable excuse" is a concept commonly used in the laws of Hong Kong. It is used frequently in the Ordinance (and in current securities law e.g. section 33(12) of the SFC Ordinance Cap.24). It will be for the courts to decide what is reasonable in each case.</p> <p>The example given obviously amounts to a reasonable excuse and it should not be necessary to state the obvious as suggested.</p>
32.		Anonymity	<p>It is as a matter of general principle not desirable that the criminal offences and penalties should be created by rules themselves which are made by the SFC and only subject to negative vetting.</p> <p>It is also unclear what the status of the Rules is, for example, as regards the legal effect of any pledge or deposit of client securities as collateral in breach of the Rules.</p>	<p>This has already been provided for in the Ordinance. In addition, the Legislative Council will be vetting the rules once gazetted.</p> <p>It is also worthy of note that section 73(2), LFETO already allows the Commission to specify offences in rules made under the LFETO.</p>

## List of Respondents

Date Received	Respondent
24 May 2001	Hong Kong Stockbrokers Association (HKSbA)
24 May 2001	- (commentator has reserved anonymity)
24 May 2001	Hong Kong Trustees Association
24 May 2001	JF Asset Management Ltd
24 May 2001	Albert Pun
24 May 2001	Law Society of Hong Kong
24 May 2001	Linklaters & Alliance representing (Linklaters & Alliance) - Credit Suisse First Boston (Hong Kong) Ltd - Deutsche Securities Asia Ltd - Dresdner Kleinwort Wasserstein - Goldman Sachs (Asia) L.L.C. - J.P. Morgan - Merrill Lynch (Asia Pacific) Ltd - Morgan Stanley Dean Witter Asia Ltd - Salmon Smith Barney Hong Kong Ltd - UBS Warburg
24 May 2001	Lloyds TSB Pacific Ltd
24 May 2001	Lim Wah Sai
25 May 2001	- (commentator reserved anonymity)
31 May 2001	Marcus Hung
13 June 2001	- (commentator has reserved anonymity)
26 June 2001	- (commentator reserved anonymity)
<i>Respondent with no specific comments on the Draft Rules</i>	
24 May 2001	Institute of Securities Dealers Ltd
31 May 2001	Prudential Assurance Company Ltd

**Derivation Table**

Clause/Schedule in the Securities and Futures Bill	Section/Schedule in the Securities and Futures Ordinance
Clause 27, Part 1 of Schedule 9	Section 27, Part 1 of Schedule 10
Clause 30, Part 1 of Schedule 9	Section 30, Part 1 of Schedule 10

**REVISED DRAFT****SECURITIES AND FUTURES (CLIENT SECURITIES) RULES****CONTENTS**

Section		Page
---------	--	------

**PART I****PRELIMINARY**

1.	Commencement	1
2.	Interpretation	1
3.	Application	2
4.	Requirements in respect of a client's standing authority	3

**PART II****TREATMENT OF CLIENT SECURITIES AND  
SECURITIES COLLATERAL****Division 1 – General rules**

5.	Requirement for registration or deposit 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	9
----	---	---

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

### PART III

#### 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	12
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 (5 of 2002))

## PART I

### PRELIMINARY

#### 1. Commencement

These Rules shall come into operation on the day on which Part VI of the Ordinance (5 of 2002) comes into operation.

#### 2. Interpretation

In these Rules, unless the context otherwise requires –

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

“approved custodian” ( ) 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” ( ) has the meaning assigned to it by Part 2 of Schedule 5 to the Ordinance;

“client contract” ( ) 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” ( ) has the meaning assigned to it by Part 2 of Schedule 5 to the Ordinance;

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

“linked corporation” ( ) 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;

“repurchase transaction” ( ) means a sale of securities whereby the seller is obliged to repurchase from the purchaser, or the purchaser is obliged to resell to the seller, securities of the same description at a pre-determined price and date;

“standing authority” ( ) has the meaning assigned to it by section 4(1).

### 3. **Application**

(1) Subject to subsections (2) and (3), 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) 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 –

- (a) maintained in an account in the name of a client of the intermediary; and



- (b) held by the intermediary or an associated entity of the intermediary solely as a result of that intermediary or associated entity –
  - (i) being in a position to transfer the client securities to itself; or
  - (ii) otherwise having control of or power over the client securities.

(3) These Rules do not apply to client securities or securities collateral of an intermediary that are the subject of a repurchase transaction.

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

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

- (a) is given by a client to an intermediary or associated entity of an 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 associated entity by a client of the intermediary who is a professional investor.

(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 intermediary who gave it is not a professional investor; or

- (b) of any duration, if the client of the intermediary who gave it is a professional investor,

at any one time, in any of the following ways –

- (c) at the written request of the client of the intermediary who gave it; or

- (d) by means of the following procedure –

- (i) at least 14 days prior to the expiry of the standing authority, the intermediary or the 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 specified period not exceeding 12 months, if the client of the intermediary is not a professional investor; or

- (C) a period of any duration, 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 renewed in accordance with subsection (3)(d), the intermediary or the 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 1 week after the date of expiry.

PART II  
TREATMENT OF CLIENT SECURITIES AND  
SECURITIES COLLATERAL

**Division 1 – General rules**

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

(1) Subject to section 6, an intermediary or any of its associated entities 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 by the intermediary or associated entity in Hong Kong 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 any of its associated entities 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 by the intermediary or

associated entity in Hong Kong 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), 5(2)(a) or 5(2)(b) or to deal with client securities

or securities collateral that have been registered in accordance with section 5(1)(b) or 5(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), 5(2)(a) or 5(2)(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 in the sense used in section 6 of the Unconscionable Contracts Ordinance (Cap.

458), as if the standing authority in question were a contract under that Ordinance.

(2) Without prejudice to subsection (1)(a), with the agreement in writing of 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 the agreement in writing of 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 any of its associated entities,

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 any of its associated entities may apply or deposit any securities collateral 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 referred to in subsection (1) may deposit any of the securities collateral 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.

### PART III

#### 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 II.

(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 II.

### **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.

### **13. Penalties**

(1) An intermediary or an associated entity which contravenes section 4(4) or 12 –

- (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 which contravenes section 5 or 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;
- (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

2002

### **Explanatory Note**

These Rules are made by the Securities and Futures Commission under section 148 of the Securities and Futures Ordinance (5 of 2002). 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.