

# **LEGISLATIVE COUNCIL BRIEF**

## **Securities and Futures Ordinance (Cap. 571)**

### **SECURITIES AND FUTURES (CLIENT SECURITIES) RULES**

#### **INTRODUCTION**

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

#### **BACKGROUND**

##### **The SFO**

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

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

## **THE PROPOSALS**

### **Major policy considerations**

4. The Rules supplement Part VI of the SFO which mainly concerns the ongoing financial and operational requirements applicable to intermediaries and their associated entities<sup>1</sup>, including the requirements to ensure proper handling of client securities and collateral of intermediaries. The Rules prescribe the treatment of client securities and collateral of intermediaries received or held in Hong Kong by or on behalf of intermediaries or their associated entities. The requirements are mainly based on the existing sections 81, 81A and 121AB of the Securities Ordinance (Cap.333). In designing the requirements, the SFC is conscious of the need to strike an appropriate balance between providing investor protection and reducing compliance burden of its regulatees. New elements to address both have been introduced.

### **Major new elements**

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

6. The Rules also apply to associated entities of intermediaries, introduced as part of the package to impose direct regulation of such entities for closing an existing regulatory gap<sup>2</sup>. Essentially, this is designed to regulate the way nominee companies, operated by intermediaries within the same group, deal with client securities or securities collateral. The regulatory intention is for the associated entities to match the standards to be expected from the intermediaries, thereby according a greater degree of protection to investors.

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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.

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

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

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

## **The Rules**

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

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

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

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

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

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

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

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

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

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

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

### **Public consultation**

20. The SFC released a consultation document and an exposure draft of the Rules on 12 April 2001 for comment by the public. A total of 15 submissions were received. The SFC has considered all the comments received and revised the draft Rules as appropriate.

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

## **FINANCIAL AND STAFFING IMPLICATIONS**

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

## **COMMENCEMENT DATE**

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

## **PUBLICITY**

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

## **ENQUIRIES**

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

The Securities and Futures Commission  
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