

A Consultation Paper for the Proposed
Revised Code of Conduct for Persons Registered with
the Securities and Futures Commission

Consultation Conclusion Report

Hong Kong
February 2001

INTRODUCTION

1. On 27 September 2000, the Securities and Futures Commission released ‘A Consultation Paper for the Proposed Revised Code of Conduct for Persons Registered with the Securities and Futures Commission’ (“Consultation Paper”). The Consultation Paper contained proposed revisions to the 1994 Code of Conduct for Persons Registered with the Securities and Futures Commission, as amended (the “Code”).
2. As mentioned in the Consultation Paper, a joint exercise was conducted by the SFC and Hong Kong Exchanges and Clearing Limited (HKEx) to restructure the rules of the Exchanges and the clearing houses to become Code provisions (“Phase II Rule Amendments”).
3. On 13 October 2000, the SFC announced certain technical amendments to the Consultation Paper. These amendments related to client identity provisions (paragraph 5.4 of and Schedule 2 to the proposed revised Code). Neither the underlying provisions nor the amendments thereof were for public consultation.
4. The consultation period lasted until 27 October 2000. 27 submissions were received.¹
5. Taking account of the submissions received and discussions with commentators, some amendments to the original proposed revisions are considered appropriate. The revisions have been adopted by the Commission and will come into effect on 1 April 2001, except paragraphs 3.9, 5.1, 6.1-6.2 and paragraph 1A in Schedule 4 which will come into effect on 1 October 2001.
6. The purpose of this report is to provide interested persons with an analysis of the main comments raised during the consultation exercise and the rationale for the SFC’s conclusions. *This report should be read in conjunction with the Consultation Paper.*

PUBLIC CONSULTATION

Consultation process

7. In addition to the public announcement inviting comment, the Consultation Paper was distributed to all registered persons, various

¹ 15 submissions were received at the end of the consultation period. 12 additional submissions were received within 4 weeks after the close of the consultation period.

professional bodies and the Financial Services Bureau. The Consultation Paper was also published on the SFC website.

8. Discussion sessions were held with industry participants and their legal advisors during the consultation period to explain the proposed revisions to them, and to discuss their comments.
9. 27 submissions were received from practitioners, fund management firms, international brokerage firms, industry representative bodies, professional associations, legal firms, and financial services industry regulators. One of the submissions consisted of a survey by Hong Kong Securities Institute (which mainly represents the interests of securities dealers) of its members.
10. The overall tone of the comments was positive. Commentators generally welcomed the proposed revisions. Comments varied considerably in range and depth, with some focusing on the broad principles and others on points of detail and clarification.
11. The range of comments received on the proposals and the disparity of views reflected the similarities and differences between relatively small-scale local operations and international firms with a substantial local presence.
12. The submissions were carefully considered and amendments were made to the proposed revisions. These amendments were sent out to the main commentators for further comment. The amendments received a high level of acceptance and constituted the basis for the final version being put to the Commission.

Consultation conclusions

13. Except as otherwise stated in paragraphs 14 to 122 of this report and a few minor stylistic amendments, no changes² have been made to the original proposed revisions set out in the Consultation Paper.

SUMMARY OF COMMENTS AND SFC'S RESPONSES

General comments

14. Public comments. A few commentators remarked that, to maintain a level playing field, it should be made clear that the proposed revised Code applied to exempt persons. It was also pointed out that, in applying specific provisions of the proposed revised Code (e.g.,

² Except for the amendments announced by the SFC on 13 October 2000.

provisions relating to disclosure and fair treatment), regard should be given to the existence of Chinese Walls within the firm.

15. SFC's response. It is accepted that a level playing field be maintained for registered and exempt persons. It should, however, be noted that authorised institutions are already required by the Hong Kong Monetary Authority ("HKMA") to follow the Code. Moreover, concerns about equality of regulation are being addressed in the Securities and Futures Bill which provides that: (i) in future, only authorised institutions will be granted exempt status; (ii) exempt persons and registered persons will be subject to comparable conduct requirements; (iii) HKMA will be given disciplinary powers comparable to those of the SFC; and (iv) HKMA will supervise and regulate such exempt persons with respect to their "regulated activities" under a memorandum of understanding.
16. In relation to Chinese Walls, Commission staff have always respected the functional barriers maintained by a professional firm or a group of companies to prevent the flow of information that may be confidential and/or price sensitive between the different areas of operations. This policy will continue with respect to the administration of the final revised Code.

Specific comments

Explanatory notes

17. The proposed revisions. The proposed revised explanatory notes emphasized the importance of compliance with both the General Principles and the letter of the proposed revised Code and clarified that breaches of either would be taken equally seriously.
18. Public comments. A number of commentators were concerned that, owing in part to the generality of the General Principles, the SFC might seek to outlaw a market practice (which was not otherwise illegal or an infringement on the relevant codes or guidelines) retrospectively by resorting to disciplinary action based on its subjective interpretation of the General Principles. In addition, one commentator queried whether the new reference to the "letter of the Code" implied that there was a shift in SFC's emphasis. Requests were also made for examples of procedures and techniques to be included in the Code to facilitate compliance and for clearer guidance on SFC's enforcement approach.
19. SFC's response. These issues have been carefully considered. As financial markets evolve rapidly and are becoming increasingly complex, it is essential that the SFC be able to rely on general conduct of business principles (most of which are recognized by the International

Organization of Securities Commissions (“IOSCO”)) in considering the fitness and properness of a registered person.

20. Under current law and the Securities and Futures Bill, the SFC can only exercise its disciplinary powers when specific statutory thresholds are satisfied (i.e., in cases involving misconduct or where a registered person’s fitness or properness is impugned). Avenues of redress such as judicial review and complaints to the Ombudsman are available to registered persons under the general law. There is also a right of appeal to the Securities and Futures Appeals Panel. Moreover, SFC’s work is subject to the review of the Process Review Panel and a number of additional checks and balances in respect of SFC’s powers have also been incorporated in the Securities and Futures Bill.
21. It is accepted that the statement “the Commission takes a breach of the general principles as seriously as a breach of the letter of the Code” might give the impression that there is a shift in the SFC’s enforcement emphasis. Accordingly, the relevant provisions have been amended to clarify that the SFC ‘will have regard to’ the General Principles and the letter of the Code in considering whether a registered person is ‘fit and proper’.
22. In respect of compliance guidance, given the significant differences that exist in the organisational and legal structures as well as the scope and nature of business activities among the firms, it would be impractical, if not impossible, to design a set of “one size fits all” guidelines for all the registered persons under the jurisdiction of the Commission. The final revised Code is intended to be a framework within which registered persons should structure their internal procedures according to individual circumstances, including size.

General principle: responsibility of senior management

23. The proposed revisions. In addition to the seven Conduct of Business Principles developed by IOSCO, the Consultation Paper included a General Principle relating to the responsibility of senior management. It was also proposed that a new paragraph 14 (responsibility of senior management) be added to the Code to provide that senior management should, amongst other things, understand their responsibilities and manage risks properly.
24. Public comments. Many comments were made about the responsibility proposed to be borne by senior management. Commentators raised the following issues: (a) the term “senior management” was not defined; (b) senior management who were responsible for only one part of the business of the firm might be unfairly held responsible for activities that

took place in other functions; and (c) senior management might be held liable in cases involving uncontrollable circumstances, such as system failures and actions of third parties.

25. SFC's response. The SFC accepts these suggestions. It is now clarified in a new definition for "senior management" that who constitutes senior management will be determined by reference to the actual or apparent authority of the persons over the relevant business operations. Within this context, senior management remains accountable. However, in considering the fitness and properness of the registered person and senior management, Commission staff will take into account the existence of adequate and reasonable safeguards already in place (or the lack thereof) to guard against system failures and fraudulent actions of third parties.

Interpretation and application (paragraph 1)

26. The proposed revisions. Managers of *authorized* unit trusts and mutual funds, although not subject to the Code or the proposed revised Code, were reminded to comply with the Fund Manager Code of Conduct issued by the SFC.
27. Public comments. A couple of commentators conducting discretionary fund management argued that, owing to the nature of their business, various provisions in the proposed revised Code should not apply in relation to discretionary funds (e.g., various information to be furnished to clients, prompt confirmation, timely and accurate reporting... etc).
28. SFC's response. The SFC accepts these comments. The final revised Code will *not* apply to a registered person acting in the capacity of a management company in relation to the discretionary management of collective investments, including unit trusts and mutual funds (whether *authorised* or *unauthorised*), and pension and provident funds. Such registered persons are already (and will continue to be) subject to the Fund Manager Code of Conduct and there is no regulatory gap.

Honesty and fairness (paragraph 2)

Advertising

29. The proposed revisions. The proposed new provision stated that a registered person should ensure that invitations and advertisements do not contain any information that is false, biased, misleading or deceptive.

30. Public comments. Commentators opposed the use of the word “biased”, principally arguing that advertisements were inevitably biased.
31. SFC’s response. This suggestion is accepted and the word “biased” has been replaced by “disparaging” in the final revised Code.

Anti-bribery guidelines

32. The proposed revisions. The proposed revised Code stressed the importance of compliance with the Prevention of Bribery Ordinance (Cap. 201) and related guidance issued by the Independent Commission Against Corruption.
33. Public comments. Commentators argued that the summary of the Prevention of Bribery Ordinance (Cap. 201) was unnecessary and inaccurate, and suggested its deletion.
34. SFC’s response. It is believed that a brief summary of the Ordinance would provide helpful guidance to practitioners. Amendments have, however, been made to the relevant wording to take account of the comments.

Diligence (paragraph 3)

Advice to clients: due skill, care and diligence

35. The proposed revisions. The proposed revised Code stated that a registered person should “disclose material facts” to a client when providing advice to a client.
36. Public comments. Some commentators argued that the requirement to disclose all material facts to a client was unnecessary as it is part of the duty of acting diligently in relation to client matters. Questions were also raised as to the type of information that constituted a “material fact”.
37. SFC’s response. These comments are accepted and the obligation has been rephrased as one to “act diligently and carefully in providing the advice” to clients. It is believed that the amended provision adequately addresses the perceived problems of inadequate disclosure.

No withholding of orders for convenience; Collection of margins; Separate accounts; Derivative position and reporting limits

38. The proposed revisions. The proposed revised Code expected a registered person to: refrain from withholding orders; promptly collect

all margins; maintain separate accounts (per client) for dealings in securities and futures contracts, and for transactions concluded on a cash vis-à-vis a margin basis; and inform clients of any applicable derivative position and reporting limits. These provisions were derived, in part, from the relevant Ordinances and rules of the Exchanges.

39. Public comments and proposed response.
40. *No withholding of orders for convenience.* It was argued that this provision should only apply to market orders and limit orders which could (potentially) be immediately executed in the market at the relevant prices, and not to other orders such as careful discretion orders (which by their terms were to be withheld).
41. This point is accepted. The relevant provision has been amended to provide that only market orders and limit orders are subject to this requirement.
42. *Collection of margins.* It was argued that a firm should have the right but not the obligation to protect its position by calling margin or obtaining collateral.
43. It remains the SFC's view that this is an important area to be covered. The SFC wishes to promote prudent risk management, which would generally encompass the prompt collection of margins.
44. *Separate accounts.* One commentator queried whether this provision prohibited the maintenance of omnibus accounts by a registered person.
45. The answer is that the duty to maintain separate accounts applies in relation to each "client" and does not impact on the ability of a registered person to operate omnibus accounts.
46. *Derivative position and reporting limits.* Questions were raised as to the ultimate responsibility for complying with position and reporting limits.
47. The SFC wishes to point out that, pursuant to the relevant Ordinances and subsidiary legislation, a person (whether a registered person or a client) is obliged to comply with the applicable limits in relation to its own account. To take into account public comments, the original proposals have been amended to clarify that in relation to a client's dealings, a registered person should "inform" a client of the applicable limits and "monitor" the client's positions "maintained with the registered person" (as opposed to merely bringing the limits "to the attention of clients").

Order recording

48. The proposed revisions. The proposed revised Code required all registered persons to record and immediately time stamp both agency and internally generated orders; and install a telephone recording system to record client orders received through the telephone and keep such recordings for at least six months.
49. Public comments. Some commentators felt that it was impractical to “immediately” time-stamp orders. Requests were also made for the SFC to clarify whether time records in automated trading systems satisfied the proposed requirement.
50. Regarding the taping of telephonic orders, commentators raised the following points: (a) the six month telephone record retention requirement was considered excessive, burdensome, and out of line with international practice; and (b) the permitted use of mobile phones under the proposed revised Code appeared different from HKFE’s provision. It was also queried whether order sheets for details of orders accepted by mobile phones should be maintained for 6 months.
51. A few commentators (one of which represented certain securities dealers) suggested that taping should not be mandatory. On the other hand, one organization felt strongly that, in addition to the taping of orders, recording of telephonic trade confirmations should also be required to facilitate the resolution of trade disputes.
52. SFC’s response. All the comments have been carefully considered. It is acknowledged that the proposed requirements would increase the compliance costs of practitioners. This was considered in preparing the original proposals, and the SFC remains of the view that an improved standard of record keeping is essential to make Hong Kong’s regulatory regime more compatible with international standards.
53. In order to address the comments received, two amendments to the original proposals have been made. First, the time period for telephone record retention has been reduced from 6 months to 3 months. Second, the use of mobile phones both *within* and outside the office is permitted provided that specific order recording procedures (contained in the Note to paragraph 3.9 of the final revised Code) are complied with.
54. It should also be noted that: (a) time records in automated trading systems are acceptable; (b) the provision for the use of mobile phone under the final revised Code applies to *all* registered persons (as opposed to the HKFE provision that applies only to HKFE exchange participants); (c) order sheets for trades accepted by mobile phones are

subject to the retention requirement applicable to tape recordings; (d) the proposed order recording requirement applies to client orders placed by telephone directly with the SEHK Trading Hall; and (e) the recording requirement for telephonic trade confirmations has been added to Schedule 4 to the final revised Code.

Best interests of clients

55. The proposed revisions. It was proposed that a registered person should act in the best interests of its clients. This would also entail that the clients' best interests be taken into account when a registered person recommends the services of another person to clients.
56. Public comments. Several commentators noted the following concerns in relation to this proposal: (a) the "best interests" standard was subjective; and (b) the application of this standard in instances where services of *another* person were recommended to clients would likely cause a proliferation of disputes.
57. SFC's response. The SFC remains of the view that a registered person should act in the "best interests" of a client. The proposed standard is being introduced to help guide conduct and protect clients in Hong Kong.
58. It is, however, acknowledged that the application of this standard in all instances where services of others are recommended may be counterproductive. The relevant provision has been amended such that the proposed standard applies only where services of an *affiliated* person are involved.

Information about clients (paragraph 5)

59. The proposed revisions. The proposed revised Code stated that where account opening does not involve a face-to-face meeting, client identity should be ascertained in a satisfactory manner. In addition, when the account opening documents were not executed in the presence of an employee of the registered person, the Client Agreement should generally be certified by a professional person.
60. Public comments. Commentators welcomed SFC's proposed relaxation in the account opening procedures – which would no longer be limited to a face-to-face approach (but could be done through mail or on the Internet).
61. Many commentators, however, opposed the certification requirement, citing the following main concerns: (a) the certification process was

burdensome and costly; and (b) various professionals would likely be reluctant to certify the documentation owing to potential liability.

62. Requests were also made to clarify the following issues: (a) whether the registered person would be responsible to independently verify the professional qualification of the person making the certification; (b) whether certification would still be required where a client was introduced to the Hong Kong registered person by an overseas affiliate; (c) the acceptability of electronic certification technology; and (d) the definition of the term “banker”. One professional body suggested that its members be considered professionals qualified to provide certification.
63. SFC’s response. Whilst it is not the SFC’s intention that procedures be put in place to prove beyond reasonable doubt that the information provided by the prospective client is correct, the SFC is looking for some reasonable effort by the registered person to confirm the identity of the client in order to comply with standards expected by the International Financial Action Task Force and IOSCO to thwart attempts at money laundering.
64. To take into account public comments and to facilitate compliance with the certification requirement, however, the relevant provision has been amended to clarify that certification should relate *only* to the signing of the Client Agreement and the sighting of identity documents. In addition, the categories of persons qualified to provide certification services have been expanded to include: other registered persons, affiliates of a registered person, Justices of the Peace, bank branch managers (in place of bankers), and lawyers (in place of solicitors). Moreover, certification services that are recognized by the Electronic Transactions Ordinance (Cap. 553), such as those available from the Hongkong Post, may be employed.
65. It is not intended that the registered person be responsible for independently verifying the professional qualification of the person making the certification.

Client agreement and risk disclosures (paragraph 6, Schedules 1-3)

66. The proposed revisions. It was considered desirable to clarify the existing requirements on client agreements by stating in the proposed revised Code that: (i) the client should be able to specify the language (that is, English or Chinese) used for the Client Agreement,³ any other

³ Including the applicable risk disclosures, staff declaration, and client acknowledgement, as specified in Schedules 1, 3, and 4 to the proposed revised Code.

risk disclosure, authority, or supporting document or agreement; and (ii) the registered person should explain these documents to the client. The proposed revised Code also specified certain minimum content requirements for Client Agreements.

67. Public comments. There were many comments relating to the proposed revisions. Comments focused on the following areas: (a) the proposed Client Agreement appeared too lengthy; (b) the requirements for providing explanations, staff declarations, and client acknowledgements and quoting the SFC “CE” number were over burdensome; (c) the annual renewal of hold mail arrangements would be impractical; (d) there was some confusion as to whether the requirements for renewal of client authority under the proposed revised Code were the same as those pursuant to section(s) 81, 81A or 121AB of the Securities Ordinance (Cap. 333);⁴ and (e) where an English Client Agreement was translated into Chinese, it was not clear which version would prevail in the event of any inconsistency.
68. Questions were also raised regarding the application of the Client Agreement requirements to a one time sale of securities in connection with an initial public offering.
69. SFC’s response. It is acknowledged that the proposed requirements would increase the compliance workload of market participants, but it should be noted that the relevant provisions were formulated with fiduciary duties in mind.
70. With respect to the contractual provisions for the Client Agreement, since the proposed revisions represent primarily incorporation of requirements already contained in the rules of the Exchanges, it is believed that the original proposals should generally be preserved.
71. With respect to the requirements for risk disclosures, explaining the Client Agreement, and obtaining various client authorities, it is recognised that a proper balance should indeed be struck between the benefits to the clients and costs to the registered persons involved with the various proposals. With the benefit of public comments and feedback from practitioners, SFC’s approach in these matters has been restated.
72. First, a more concise risk disclosure has been included in the final revised Code to replace the original draft.

⁴ Sections 81, 81A and 121AB of the Securities Ordinance (Cap. 333) restrict the disposition of securities and securities collateral by a dealer and a registered financier *except* under limited instances and where written authority of the client is obtained.

73. Secondly, the obligation to “explain” all client account documents to a client has been modified as one of drawing the relevant risks to the client’s attention. It has also been clarified that where the account opening process is not face-to-face, the covering correspondence should direct the client’s attention to the risk disclosure statements. In this regard, guidance on certain key items that should be drawn to the attention of the client has been incorporated into the (modified) staff declaration and client acknowledgement contained in Schedule 1 to the final revised Code.
74. Thirdly, the provision for annual renewal of hold mail arrangements has been amended to clarify that it would be acceptable if the registered person notifies the client (prior to the expiry date of the arrangement) that the hold mail arrangement is automatically renewed unless it is revoked by the client in writing.
75. It should be noted that under both the proposed (and final) revised Code and section(s) 81, 81A or 121AB of the Securities Ordinance (Cap. 333), the same written confirmation of client authority by the client on annual basis is required.
76. In relation to the choice of language, where an English Client Agreement is translated into Chinese (or vice versa), a registered person may specify that one particular version would prevail in the event of any inconsistency. The enforcement of the Client Agreement would, of course, be subject to any applicable law, including the Unconscionable Contracts Ordinance (Cap. 458).
77. In response to the queries raised on the one-off disposal of securities, a new provision has been added to the final revised Code (paragraph 6.4 (limited provision of services)) to clarify that where limited services are provided, the Client Agreement could be limited accordingly and would only need to contain provisions stated in paragraph 6.2(a), (b), (d) and (e) (relating primarily to the identity of the client, the identity and registration status of the registered person, the services available and provided, and the remuneration involved).
78. Finally, although registered persons are not required under the final revised Code to re-execute Client Agreements with existing clients, registered persons may do so if they wish.

Discretionary accounts (paragraph 7)

Authorization and operation of a discretionary account

79. The proposed revisions. To minimize the potential abuse of discretionary power granted by a client to a registered person or an account executive, the proposed revised Code provided that: (i) the terms of the authorization should be explained to the client and it should be confirmed on at least an annual basis that the client does not wish to revoke such authority; (ii) discretionary accounts should be designated as such in the books and records of the registered person; and (iii) senior management should approve the opening of discretionary accounts.
80. Public comments. Commentators argued that the annual confirmation requirement was administratively burdensome. Questions were raised as to: (a) whether an employee of a registered person who was not registered with the SFC could effect transactions for discretionary clients; and (b) the rationale for requiring designation in the books and senior management approval.
81. SFC's response. As in the case of hold mail arrangements, to take into account public comments, the relevant provision has been amended to clarify that it would be considered acceptable practice if the registered person notifies the client (prior to the expiry date of the discretionary account arrangement) that the arrangement is automatically renewed unless it is revoked by the client in writing. It has also been clarified that only an employee who is a registered person may effect transactions for a discretionary client.
82. In addition, it is accepted that designation of discretionary accounts in a registered person's books is not necessary. That requirement has now been removed.
83. For reasons stated in the Consultation Paper, the SFC remains of the view that senior management approval is necessary to protect the registered person from allegations of unauthorised trading.
84. Finally, it should be noted that new requirements have been included in the final revised Code which provide that, if an authority is granted to an employee or agent of the registered person, the authority should state that the person is an employee or agent of the registered person. On the other hand, if an authority is granted to a person who is not an employee or agent of the registered person, the authority should state that the person is not an employee or agent of the registered person. These are intended to minimize abuses and disputes.

Information for clients (paragraph 8)

Information about the firm: in general

85. The proposed revisions. To minimize the potential for misleading or confusing clients, the proposed revised Code emphasized that, when employees put on “ multiple hats” , the registered person should ensure that such employees clearly identify the specific company on whose behalf and the capacity in which they are acting.
86. Public comments. A few commentators remarked that the identification requirement would be difficult to implement in practice within a large organization.
87. SFC’s response. This comment was accepted and the original approach has been modified. Under the final revisions, where an employee acts for more than one company within one financial services group, the registered person should ensure that there is “no reasonable basis for confusion on the part of the client” as to the company for which such employee is acting. The strict requirement for clear identification (including identification of the specific capacity under which an employee acts) has been removed.

Prompt confirmation

88. The proposed revisions. There is a general requirement under the Code that trade confirmations should be provided to the client promptly. The proposed revised Code elaborated on the specific requirements for the contents and timing of confirmations relating to options contracts.
89. Public comments. Commentators noted that the general prompt confirmation requirement should not apply to discretionary accounts. One commentator also objected to the “one business day” time limit proposed for options confirmations.
90. SFC’s response. These suggestions are accepted. It has been made clear in the amended provisions that paragraph 8.2(a) (general requirement for prompt confirmation) does not apply in relation to discretionary accounts. In addition, options confirmations are to be furnished to clients “promptly” (as opposed to within “one business day”).

Timely and accurate reporting.

91. The proposed revisions. The Consultation Paper suggested that statements of accounts should be furnished to clients on a *monthly* basis (as opposed to a quarterly basis under the Code), except in respect of dormant accounts. It was also proposed that the content requirements of statements of accounts and contract notes be elaborated.
92. Public comments. A few commentators disagreed with the proposal for monthly statements, stating that the procedure is burdensome. Questions were also raised as to the need to issue “contract notes” in respect of stock lending and borrowing transactions, and the reasoning for identifying an account other than a margin account as a “cash account”.
93. SFC’s response. The majority of these comments are accepted. The requirement to issue contract notes in relation to short selling, and stock lending and borrowing has been modified so that it applies only to registered persons which are SEHK exchange participants. In addition, to facilitate compliance, the obligation to identify a “cash” account has been amended as one to identify a “margin” account.
94. The SFC remains of the view that monthly statements should be provided to keep clients informed.

Information about the firm: financials

95. The proposed revisions. It was suggested that a registered person’s latest ‘ audited balance sheet and profit and loss account’ (as opposed to ‘the most recent accounts’ stated in the Code) be delivered to a client upon the latter’s request.
96. Public comments. There were concerns that the subject financial statements might contain price sensitive and confidential information and should not be disclosed.
97. SFC’s response. The SFC does not intend this provision to result in the disclosure of truly price sensitive and confidential information by a registered person.
98. It is, however, considered appropriate to **reinstate** the Code requirement that a registered person should disclose any material adverse changes in its financial condition to a client (when a client requests the registered person to disclose its financial conditions).

Client priority (paragraph 9)

Non-public, material information

99. The proposed revisions. The proposed revised Code specified that: (i) the duty not to deal in securities and futures contracts about which one possessed non-public and material information included not dealing for any client; and (ii) the term “information” covered research and analysis.
100. Public comments. Commentators generally supported the proposal that the firm should not deal in its own account or solicit trades from a client when the firm has knowledge of impending research and analysis intended for public dissemination. Commentators, however, argued that the proposal was too broad and the SFC should not restrict a registered person from using research and analysis not intended to be published.
101. SFC’s response. These points are accepted and the relevant provisions have been amended to specifically prevent “front-running” (for the registered person itself or for its client) based on knowledge of pending transactions for or with clients or other non-public information which is to be released to the market and the disclosure of which is expected to have a material effect on prices of securities or futures contracts.

Compliance (paragraph 12)

Employee dealings

102. The proposed revisions. The Consultation Paper stated that the conditions and procedures under which a registered person might permit its employees (including directors) to deal for their own accounts should be specified. Amongst other things: (i) transactions for employees’ related accounts should be properly recorded and identified in the accounting records; and (ii) transactions for employees’ related accounts should be actively monitored by independent senior management.
103. Public comments. Commentators suggested that the term “employee” should not include non-executive directors; and a “registered person” (as opposed to “senior management”) should monitor and supervise the operation of employee accounts. Questions were raised as to: (a) the rationale for requiring employee accounts to be identified in the accounting records and the supply of transaction details on trades in a market where the employer had no business concerns; and (b) whether an account of an employee’s spouse was a related account.
104. SFC’s response. These points have been taken into consideration. It is made clear in the final revised Code that the term “employee” does not

include non-executive directors. In addition, this provision has been amended to limit the required supply of employee transaction details to those in respect of trades (dealt through another registered person) in securities or futures contracts listed or traded on one of the Hong Kong exchanges or in derivatives on such products, and where the employer itself provides services in these products.

105. To minimize abuses, however, the SFC believes that the proposal that transactions in employees' related accounts be properly recorded and identified as well as actively monitored by independent senior management should remain unchanged.
106. Finally, it is intended that a spouse account not be automatically deemed a related account but it will be caught if the employee holds a beneficial interest in the account.

Notifications to the Commission

107. The proposed revisions. It was proposed that a registered person be required to notify the Commission in writing immediately of specified matters, which included but were not limited to actual and suspected non-compliance with the law and rules by it, its employees or other registered persons.
108. Public comments. Many comments were made on this proposal. There was general support for the need to report violations of laws and rules to the SFC. Commentators did, however, consider the requirement too broad and raised the following specific concerns: (a) the proposal did not include a materiality requirement, and was not confined to laws or regulations relating to the securities or futures industries; (b) the obligation for immediate reporting in writing appeared impractical; (c) required reporting of breaches for which a registered person "has reason to suspect" (and in particular, those relating to other registered persons) is unduly burdensome; and (d) the reporting of events of "reorganization, reconstruction, amalgamation" might involve disclosure of price sensitive information.
109. SFC's response. The majority of the public comments are accepted. The subject requirements have been modified as follows: first, the notification requirement will apply only to "material" breaches of laws, rules, regulations and codes "administered or issued" by the SFC. Secondly, the obligation to report breaches where a registered person should have "reason to suspect" has been restated as one to report "suspected" breaches. Thirdly, notification can be either oral or in writing. Finally, with respect to events of re-organisation of shareholders, only those involving "substantial shareholders" (as defined

under the Securities and Futures Commission Ordinance (Cap. 24)) are to be reported to the SFC.

Rebates, soft dollars, and connected transactions (paragraph 13)

110. The proposed revisions. The proposed revised Code emphasized that a registered dealer should take reasonable steps to ensure that the goods and services listed in the invoices presented by a portfolio manager for payment comply with certain requirements stated in the Code (e.g., such goods and services were of demonstrable benefit to the clients of the portfolio manager).
111. Public comments. It was suggested that the SFC clarifies what constituted “reasonable steps”.
112. SFC’s response. This point is accepted. The registered person’s obligation has been modified as one to make enquiries where the type of goods and services listed in the invoices appear not to comply with the final revised Code.

Professional investors (paragraph 15)

113. The proposed revisions. In light of the realities of today’s markets, the SFC acknowledged the need to distinguish between professional and non-professional investors and keep business conduct principles flexible. On 26 July 2000, the SFC released a Consultation Paper on the Code of Conduct for Regulated Persons Serving the Professional or Sophisticated Market. The proposed revised Code incorporated the draft provisions outlined in the aforementioned consultation paper relating to professional investors.
114. Public comments. Commentators had the following main concerns: (a) the definition for “professional investors” was too restrictive; and (b) the requirement that the registered person obtain the client’s consent for the client to be treated as a professional investor was too burdensome. A few commentators also believed that the list of conduct provisions to be waived with respect to professional investors should be expanded.
115. SFC’s response. The above concerns, amongst others, are being addressed in the SFC’s publication “Consultation Paper on Code of Conduct for Regulated Persons Serving the Professional or Sophisticated Market: Consultation Conclusions”. The final revised Code has incorporated the final provisions contained in that publication. In particular, the relevant provisions have been amended to clarify that *written* consent is required only from high net-worth individuals and corporations, and trustee companies. In addition, it is specified that

paragraph 7.1(a)(ii) and (b) (authorization and operation of a discretionary account) may be waived with respect to professional investors.

Other comments

Drafting comments

116. Other drafting comments were made about individual sections of the proposed revised Code and provisions already contained in the Code, and where appropriate and necessary, amendments have been made. As is usual with consultations of this type, however, it is not always possible to satisfy everyone. In particular, some law firms requested definitions and clarification of matters that were generally clear to registered person-practitioners. Given that the final revised Code is targeted at registered persons, fresh definitions have not been included except where clarification was felt to be clearly necessary.

Client identity rule and online trading

117. A few commentators sought clarification on the implementation of the client identity provisions contained in paragraph 5 of and Schedule 2 to the Code.⁵ Queries were also raised in relation to the application of the proposed revisions to online trading.
118. It is recommended that interested parties refer to the SFC Client Identity Rule Policy issued in July 2000 and other SFC guidance on client identity provisions for further details. Similarly, with respect to the regulation of online trading, it is suggested that practitioners refer to relevant guidance issued by the SFC.

OTHER AMENDMENTS

119. In light of the proposed Phase II Rule Amendments and upon further review of the proposed revised Code, additional amendments have been made to the original proposed revisions. These include an amendment to paragraph 4.1 (fit and proper staff) to ensure that any person employed or appointed by a registered person to conduct business is fit and proper and otherwise qualified to act in the capacity so employed or appointed.

⁵ For the latest amendments to paragraph 5.4 and Schedule 2 which took effect on 28 July 2000, see Gazette No. 30/2000. Note: the abovementioned paragraph 5.4 and Schedule 2 were not the subjects for public consultation in connection with the proposed revised Code.

120. Amendments have also been made to Schedule 3 to incorporate certain short selling, and stock lending and borrowing provisions which are currently contained in the SEHK rules but have been proposed for deletion (such as certain ledger, record-keeping, and client agreement and contract note related requirements). These newly incorporated provisions will apply only to registered persons which are SEHK exchange participants.
121. In addition, amendments have been made to Schedule 4 to: (i) require recording of telephonic trade confirmations comparable to the taping requirement for order instructions; (ii) incorporate and fine-tune specific HKFE provisions governing approved securities which are received by exchange participants to meet clearing house margins; (iii) prohibit the opening of open short option positions in a discretionary account unless prior written approval has been obtained from the client; (iv) delete all references to NYMEX contracts as that alliance had been terminated; and (v) update the list of “other requirements” (as imposed by HKFE from time to time).

EFFECTIVE DATE AND TRANSITIONAL ARRANGEMENTS

122. The revised Code will become effective on 1 April 2001 with the exception of paragraphs 3.9, 5.1, 6.1, 6.2 and paragraph 1A in Schedule 4, which will become effective on 1 October 2001. Paragraphs 5.1, 6.1 and 6.2 in the Code existing prior to 1 April 2001 will remain in force until 30 September 2001.