Code of Conduct

Code of Conduct Enquiry

(Answers to Q27 and Q57 were updated on 12 May 2015)

General

Q1: If a licensed or registered person does not follow the Code (say it has repeatedly failed to time stamp records), will it be considered not fit and proper?

A: Generally non-compliance will mean falling below SFC's expectation and possibly industry standard. Whether the SFC will take any disciplinary action depends on all factors such as whether the non-compliance is intentional, whether it has any investor protection issues and how rectification steps have been taken.

Q2: Can an intermediary receive cash or third party cheques for clients to settle transactions?

A: Intermediaries are not prohibited from receiving cash from clients though they should be mindful of money laundering issues. A person may inadvertently breach the Drug Trafficking (Recovery of Proceeds) Ordinance and the Organized and Serious Crime Ordinance if he/she fails to report suspected transactions. The risk is lower where a client's business is known to involve the receiving of cash. Intermediaries should also be weary of the risks arising from third party cheques (unless they are known to be closely related, such as husband and wife, owner of a private company). You should consult the Guidance Note Issued by SFC on Money Laundering.

Q3: With the deletion of HKFE Rules 617(f) and 618, must HKFE exchange participants collect from their clients margin which is set at the highest rate amongst rates set by the exchange company, the clearing house, the execution agent and the dealer itself?

A: With the deletion of HKFE Rules 617(f), the HKFE does not require an exchange participant who trades in markets other than those operated by the Exchange collecting from their clients margin at a rate stipulated by the relevant party.

In addition to para. 3.6 of the Code which requires licensed or registered persons to collect promptly from clients any amounts due as margin. A firm must also bear in mind the effect this may have on its liquid capital.

Under section 2 of the Securities and Futures (Financial Resources) Rules, "amount of margin required to be deposited" has to be calculated as the highest amongst the prevailing amounts stipulated by

a. the exchange on which the futures contract or options contract is traded;
b. the clearing house who registers such trade;
c. the agent who executes such trade for the licensed corporation;
d. the counterparty who executes such trade with the licensed corporation; and
e. the licensed corporation itself.

Hence, a firm should collect appropriate amount of margin from its client after proper assessment of the risk involved. The firm's liquid capital must be strong enough for the purpose of including any shortfall in margin as a ranking liability.

With the deletion of HKFE Rule 618, there is no restriction on extending any credit or giving any rebate although an exchange participant must still comply with the Minimum Margins Requirement under Rule 617.

Q4: Account executives may be earning a small amount of commission when taking on the default risk of their clients. Is there any way to limit the exposures of the account executives?

A: This is a private agreement between the account executive and his employer. It may not be feasible to limit each party's rights and responsibilities.

Generally, we will expect account executives to know their clients. Account executives, being closer to the clients, are in a better position to assess clients' default risk; account executives should not encourage clients to over-trade.

Specific Application to fund managers

Q5: Under para. 1.4, can fund management companies apply the Fund Manager Code of Conduct as opposed to both Codes across

its normal fund management activities (including management of collective investment schemes, management of discretionary accounts and fund distribution, whether authorized or otherwise?)

A: No, fund management companies should follow the Code in respect of management of discretionary accounts, distribution of funds and securities dealing.

However, in view of different compliance requirements as stated in both the Fund Manager Code of Conduct and the Code, the Commission will be flexible in our application of two codes where a firm manages both collective investment schemes and discretionary accounts. In general, we would expect the tighter requirement to prevail.

Q6: With reference to para 2.2, it is difficult to reconcile this with para. 8.2 of the Fund Manager Code of Conduct (FMCC) where there is an additional prohibition for fund manager acting as agent from receiving markups.

A: The Code applies to fund managers managing discretionary accounts whereas FMCC applies to fund managers managing collective investment schemes. It should be noted that under GP2, a licensed or registered person should act in the best interests of its clients and more specifically under para. 2.2 of the Code, a licensed or registered person should ensure that any mark-ups etc. should be fair and reasonable and be characterized by good faith.

Diligence

Q7: With reference to para 3.5, can a salesperson withhold a client order without passing the order ticket to the dealer in the first instance and monitor the price trend for the client at his own discretion? In other words, does a salesperson have any discretion or say in the execution of the order?

A: Under normal circumstances, a salesperson should pass his client's orders to the dealer for execution as soon as possible regardless of whether it is a market order or a careful discretion order. Having said that, one also needs to consider the special circumstances of each case, e.g. whether specific authorization has been given to the salesperson to exercise such discretion.

Q8: According to para 3.7, a licensed or registered person should keep separate accounts for each client for dealings in securities and futures contracts, and where relevant, for transactions concluded on a cash basis or a margin basis.
Must a client open separate client accounts for dealing in securities and futures contracts given that the banks allow client to maintain just one account for all types of transactions?

A: A client can open sub-accounts for different types of transactions.

Q9: A client has maintained both a cash and a margin account with an intermediary. However, the client will not usually specify which account he will use when placing orders. Therefore, it is that intermediary's practice to book all trades into his margin account. The question is, if at the end of the day, the client decided to settle some of his transactions by cash, does the intermediary have to transfer the transactions from the client's margin account to cash account according to para 3.7?

A: Unless the client specifically requests that the transactions be executed under his cash account, no transfer is necessary. It is indeed very common for a margin client (whether he operates a cash account at the same time) to settle the full amount by cash wherever possible in order to avoid interest charges.

To avoid disputes, it will be useful where a client opens two accounts for the written agreement to specify the allocation method in the absence of instruction to the contrary.

Q10: What does "reporting limit" mean in para 3.8 and how frequent shall we report to the client?

A: The Securities and Futures (Contract Limits and Reportable Positions) Rules prescribe limits, as listed out in Schedule 1 & 2 to the rules, for a number of HKFE products. Take HSI for example, the reporting level is 500 contracts in any one contract month per product (i.e. the client can exceed this but will need to report).

The prescribed limit (which cannot be exceeded, the HKFE may require a closure of position otherwise) is 10,000 long/short position delta limit for all contracts months combined in HSI futures/options (provided the position delta for the Mini-Hang Seng Index futures contracts or Mini-Hang Seng Index options contracts shall not at any time exceed 2,000 long or short for all contract months combined). The Code requires a firm to advise the client of such limits (since the client's positions may be maintained with other firms at the same time) and to monitor the client's position in its own books. The Code does not prescribe any detailed requirements as to the frequency. Generally, we would expect a firm to advise clients of the limits when they first open accounts with the firm and to advise them of any subsequent changes.

Telephone recording and time stamping

Q11: In many cases, a client will call an AE at the office and talk about the market for some time before he places an order (if at all). Will the firm need to tape such telephone conversation according to para 3.9?

A: This is not required under the Code. However, it should be noted that in the larger firms using multi-channel tape recording device, recording will automatically start when a phone is picked up. Firms should consider doing the same as that could help protecting the firm (e.g. a placement would strictly not fall under client orders to buy/sell securities when potential disputes might arise).

Q12: Under para. 3.9, a firm should record instructions from clients when they place their order instructions on the phone. Will the firm require client's consent for taping the conversation?

A: It is good practice for a firm to put its clients on notice that their telephone conversations would be taped at the account opening stage or when the process is first put in place.

Q13: If the firm inputs the details directly into a trade terminal (which logs the time) of the SEHK or the HKFE, without filling in a deal slip, upon receiving an order, must it still comply with the time-stamping requirement in para. 3.9?

A: This will not be necessary provided that staff strictly follow the firm's policy to direct input into the trade terminals without first recording the details in any written form.

Q14: A firm presently records orders onto trade blotters. Does it need to change its system so that it can time-stamp the deal slips as under para. 3.9?

A: This should not be necessary as it should be possible to time-stamp the blotters.

Q15: If a client gives full discretion to a firm to operate his account, how can the firm comply with the telephone recording requirement under para. 3.9 in these circumstances?

A: The telephone recording requirement will not apply since the client never calls to place an order himself. As a reminder, the firm must still timestamp the internally generated order.

Q16: If the clients are on the office premises when they wish to place an order, will they need to use a phone in order to have the conversation taped under para. 3.9?

A: No. Instead, a deal slip will need to be filled and time stamped instead.

Q17: If the tape recording maintained is very sophisticated allowing easy retrieval, can this replace time stamping as required under para. 3.9?

A: Telephone taping and time stamping are 2 separate requirements: time stamped records need to be kept for 2 years under the Securities and Futures (Keeping of Record) Rules whereas tapes need only to be kept for 3 months under the Code. As most tapes cannot remain in good working order for so long, it may not be appropriate for tape recording to replace time stamping.

Q18: Must a firm time stamp order confirmation time as well?

A: This is not required under the Code. However, for licensed or registered person trading in HKFE products should telephone record confirmations of executed trades made through the telephone (as required under para. 1A of Schedule 4).

Q19: When the tape recording system normally works well, it is conceivable that the tape may not be available at the most critical time (e.g. when SFC staff wish to check a transaction or when a client disputes a certain trade) due to corruption etc. Will this be taken as a breach of para. 3.9?

A: To minimize the risk, firms could consider ensuring that tapes to be re-used are in a reasonable state and to clean the head from time to time.

Q20: Some clients may place orders when they meet for breakfast, lunch or dinner. How should they record these orders in accordance with para. 3.9?

A: They should write up the deal slips once they get back to the office, recording the actual time of order receipt, whether the order is received within or outside office hours is irrelevant.

Q21: Will Commission staff listen to these telephone tapes which are required to be kept under para. 3.9?

A: Staff may listen to the tapes on a sample check basis when they conduct routine inspections and are likely to listen to the tapes in the course of an investigation.

Q22: Does it mean that if a trade is more than 3 months old (i.e. the relevant tape has been erased under para. 3.9), it can no longer be subject of a claim?

A: This is a legal question and it is up to the Court to decide whether it wishes to consider a claim or not.

Q23: Under para. 3.9, can a firm time stamp records based on order confirmation time instead of order receiving time?

A: No.

Know your client

Q24: The signing of client agreements and the sighting of related identity documents are not done in the presence of an employee of the licensed or registered person or any other licensed or registered person, JP, or professionals, etc. Does this practice violate para. 5.1(a) of the Code? Are the investors required to have a licensed or registered person, JP, or a professional to countersign on the photocopy of documents?

A: Yes, investors are required to have a licensed or registered person, JP etc to countersign on the photocopy of documents.

Q25: Is it possible to allow PRC non-affiliate brokers to do the certification under para. 5.1(a)?

A: No.

Q26: Under para. 5.1(a), instead of obtaining third party certification, could the branches of an overseas parent of an intermediary help to open accounts for and on behalf of the firm for clients residing in that country (e.g. the PRC)?

A: Certification by an affiliate is permitted under para. 5.1(a). However, the firm should ensure that

a. its affiliates must have established and maintained effective control procedures with regard to the account opening as would be required of the firm itself;
b. for the opening of accounts using a non face-to-face approach, its covering correspondence should specifically direct the client's attention to the appropriate risk disclosure statements in accordance with para. 6.1;
c. in accordance with para. 8.1(a), it should provide clients, including those who are outside Hong Kong, with adequate and appropriate information about its business, including contact details, and the identity and status of employees and others acting on its behalf with whom the client may have contact; and
d. its affiliates will not be in breach of any local requirements by so doing.

Q27: According to para 5.1(a), where the account opening documents are not executed in the presence of an employee of the licensed or registered person, the signing of the client agreement and sighting of related identity documents should be certified by an affiliate of a licensed or registered person. Is it possible for an affiliate to be an individual?

A: An affiliate is generally expected to cover a group company and not an individual. If an affiliate of a licensed or registered person is appointed to conduct certification of the signing of the client agreement and sighting of related identity documents ("the Certification Process"), it is the responsibility of the licensed or registered person to ensure that the affiliate has maintained and implemented the equivalent policies and procedures that are applicable to licensed or registered persons in performing the Certification Process. Licensed or registered persons are reminded that while affiliates which are regulated financial institutions (such as banks and brokers) may already be subject to similar know your client requirements and have a good understanding of the function of, and the responsibility associated with, the Certification Process carried out for licensed or registered persons, an affiliate which is not a regulated financial institution may not possess the necessary

knowledge and experience for properly carrying out the Certification Process. Accordingly, licensed or registered persons are strongly discouraged from appointing any affiliate which is not a regulated financial institution to conduct the Certification Process. *(Updated on 12 May 2015)*

Q28: Where an account executive meets with a prospective client outside the office and the prospective client signs the client agreement in front of the account executive, will third party certification still be required in these circumstances under para. 5.1(a)?
Are there any additional requirements where the account executive travels overseas to open account with new clients?

A: This will not be necessary in the circumstances though the firm may wish to satisfy itself that the client's identity and information are accurate and the client is actually contactable at that address and phone number.

Under para. 12.1, firms should comply with all requirements of **any** regulatory authority that are applicable to them. Firms should enquire into local regulations etc to ensure that they would not breach any such requirements by so doing.

Q29: If the firm's practice (as specified in a client agreement) is only to allow the account holder and all of his authorized representatives (if any) to place or originate instructions, can the firm regard the account holders and their authorized representatives as "persons ultimately responsible for originating instructions" and will this ensure compliance with para. 5.4(a)(i)(A)?

A: This practice appears acceptable *in the ordinary course of events*. However, the firm should go beyond these steps where there are suspicious circumstances by making further inquiries or by refusing the business.

Generally, a firm's only duty is to be satisfied on reasonable grounds about the person etc. ultimately responsible for originating an instruction. How it fulfills that duty is up to the firm. The firm should seek appropriate professional advice in developing a compliance program for the rule where necessary.

To further strengthen its case, the firm in question may consider including the following terms in its client agreement:

- warranties that the account holder is the only person with a beneficial interest in the account;
- specific contractual terms that the firm only accepts instructions from the account holder and his authorized representatives; and
- an undertaking from the account holder along the lines that he will take efforts to ensure that only he or his authorized representatives will place instructions with the firm in relation to his account.

Client agreement

Q30: With reference to para 6.1, is it possible to provide copies of the signed client agreement authority, risk disclosure statements, or supporting document to clients for their record in electronic format. e.g. by scanning and e-mailing to the client's designated email address?

A: This is acceptable provided that the clients consent to this agreement.

Q31: When an account is opened overseas, must the original client agreement (as required under para. 6.1) and the supporting papers be sent back to HK for filing purposes?

A: Yes, this will generally be the case. If the firm wishes to maintain such records overseas, it must obtain prior consent from the Commission as required under section 130 of the Securities and Futures Ordinance.

Q32: SEHK used to provide its participants with proforma client agreements in accordance with para. 6.2. Will the Commission provide proforma client agreements for firms to use?

A: No, this is not considered to be appropriate given that firms vary in sizes and offer different services and products. The Code can only list out provisions which client agreements should include as a minimum.

Q33: What does CE number, referred to in para 6.2(b), mean?

A: CE number means Central Entity number, a unique identifier used by the SFC. For information, CE numbers of firms and individuals are now available on the SFC's web under Public Register, Intermediaries, Licensing & Investment Products.

Q34: Why must one use the CE number (referred to in para 6.2(b)) and not the registration number?

A: Only the CE number is unique but not the registration number.

Discretionary accounts

Q35: Under para. 7.1, can an employee (such as a general clerk) who is not a licensed or registered person manage a discretionary account for his/her relative?

A: In some circumstances this may be unlawful and there is a high risk that it will lead to cases of unregistered dealing. It is also not regarded as good practice and is therefore said to be unacceptable under the Code. The practice raises serious investor protection issues (clients become confused as to the capacity in which the donee of the discretion is acting).

Q36: Is it possible under para. 7.1 for a client to give discretion to his relative to operate his account without involving the company when that relative is an employee of the company?

A: No. The client will need to sign the discretionary client agreement and the relative should be a licensed or registered person. The operation of the account will also be subject to management review.

Q37: If a husband wants to authorize his wife to operate his discretionary account where the wife is not an employee or agent of an intermediary (or vice versa), must the authority be renewed every year under para. 7.1?

A: No, provided that there is valid authority (such as power of attorney) in place.

Q38: With respect to para 7.1(b), in the case of fund managers, is it necessary to send out annual confirmations to all existing discretionary accounts?

A: In the case of fund managers, if the original agreement is a perpetual one, then it will not be necessary to send out the annual confirmation. If the original agreement has an expiry date, then, of course, it will be necessary to send out the annual confirmation.

However, where the firm is only licensed for Type 1(i.e. dealing in securities) and/or Type 2 (i.e. dealing in futures contract) but not type 9 (i.e. asset management) regulated activities and only manages discretionary accounts on the side, it is conceivable that some clients may not fully understand the nature of their discretionary accounts. Hence, intermediaries should send out annual confirmations to their existing clients.

Q39: With reference to para 7.1(d), does the signing of the agreement by authorised persons, which normally comprise of directors of the firm, satisfy the requirement of having discretionary accounts approved by senior management?

A: Yes.

Provision of information to clients

Q40: Para 8.2(b) specifies the requirement of confirmation to be provided to client on options trade. Should confirmations be provided on futures contracts trades or other commonly known derivatives?

A: Where a firm trades in derivatives which are neither futures nor options and fall out the definition of "relevant contracts" under the Securities Futures (Contract Notes, Statements of Account and Receipt) Rules, then it should have regard to the Code, and it is expected to issue confirmations based on the principles set out in para. 8.2(b).

Q41: According to para 8.4, a licensed or registered person should, upon request, provide clients with a copy of the latest audited balance sheet and profit and loss account. Must all licensed or registered persons comply with this requirement taking into account that the information is of a sensitive nature?
A firm has suggested that it may request its clients to sign a declaration to preserve confidentiality.
If a firm is unwilling to provide the information, can it avoid having to do this by ceasing to do business with the client making the request?

A: All firms need to comply with para. 8.4 in providing their latest audited balance sheet and profit and loss account to their clients.

Firms can request their clients to sign the declaration if they so desire.

Yes.

Compliance

Q42: Does para. 12.2 apply to house trading?

A: No, but house trading is subject to different requirements such as observing client priority and ensuring no conflict of interest etc.

Q43: With reference to para 12.2(b)(ii), does employee account include accounts of spouse and other relatives where the employee is authorized to operate those accounts?

A: It includes the employee's own account, accounts of his minor children and accounts in which he holds beneficial interest.

Q44: How often must the employee produce the trade confirmations and statements of account under para. 12.2(b)(iv)?

A: The Code does not lay down any specific timeframe. However, it is expected that staff should produce the trade confirmations and provide their firms with a copy on a timely basis.

Q45: Under para. 12.2(b)(iv), the licensed or registered person and employee should arrange for duplicate trade confirmations and statements of account to be provided to senior management of the licensed or registered person. Does the first-mentioned licensed or registered person refer to the employer or the firm that provides services to the employee?

A: The first-mentioned licensed or registered person refers to the employer.

Q46: When firms require staff to provide them with copies of contract notes and statements of account under para. 12.2(b)(iv), will they be breaching the Personal Data (Privacy) Ordinance?

A: Firms should explain to their staff why they require the copies and what they may do with these copies and obtained their consent.

Q47: Can employees trade in open-ended mutual funds without reporting to senior management of the firm as required in para. 12.2(b)(vi)?

A: Some firms generally encourage their employees to invest in open-ended mutual funds. Such investments do not require pre-clearance by the senior management of the firm as employees do not have discretion to direct fund as to individual security purchases. We agree that the reporting to senior management may not be necessary for the trading of open-ended mutual funds. However, we believe that a firm must, in order to guard against any possible impropriety related to employees dealing, put in place adequate preventive internal controls. These should include and are not limited to:

a. procedures to govern the flow of price sensitive information between divisions/departments;
b. procedures to ensure that employees do not deal in securities or futures contracts where there is probable front-running or use of non-public information which can reasonably be expected to materially affect prices of those securities and futures contracts upon release to the market; and
c. a system to explain concerns/implications to employees, such as the need to refrain from investment in sector funds in case of conflicts of interest.

Q48: According to para 12.2(c), when an employee of another registrant asks to open account with a licensed or registered person, the licensed or registered person will send a letter to that licensed or registered person to obtain written consent. Is it acceptable to obtain implied consent?

A: The absence of a reply should raise a doubt or concern that the consent is not forthcoming. In such circumstances the licensed or registered person should proceed with caution, recognising that their reputation may also be affected by any misconduct on the part of the prospective client. At a minimum, before accepting instructions in these circumstances, the licensed or registered person:

a. specifies a reasonable time in its letter for the employee of another licensed or registered person to reply; and
b. has no reason to think the letter has not been received;
c. issues at least one reminder that if a non-reply will be taken as tacit consent; and
d. ensures that senior management are aware of and agree to the arrangement.

Q49: With reference to para 12.5(a), does it mean that any IMRO breach noted for delegated accounts should also be reported to the SFC?

A: Yes, when the breach is considered material.

Professional investors

Q50: Could the SFC elaborate on the requirements under para. 15.3(c) for being "active in the relevant market for at least two years"? For instance, does it mean that a client must have been active in the Philippine market for at least two years before the client can be treated as a "Category B" Professional Investor in relation to transactions in the Philippine market?

A: The "relevant market" in this context would mean markets that share similar characteristics. In the example on the Philippine market, the licensed or registered person may treat, say, another emerging market as a relevant market if he reasonably believes that they share similar characteristics.

Q51: What risks and consequences should be explained to professional investors as explained under para. 15.4(a)?

A: The licensed or registered person should make reference to the provisions that can be waived for professional investors as set out in para 15.5 for the risks and consequences. It is recommended that legal advice be sought when drafting such an explanation.

Q52: Under para. 15.4 (c), prior to treating persons in para.15.2B as Professional Investors, a licensed or registered person is required to have in place procedures to enable it to carry out an annual confirmation to ensure that clients who are "Category B" Professional Investors continue to fulfil the qualification requirements. We understand that, when performing the annual confirmation exercise, the licensed or registered person should document its own assessment of the portfolio or asset of each of its relevant clients and obtain further information from the client where appropriate. However, there is NO compulsory requirement for the licensed or registered person to obtain a signed declaration from each of its relevant clients annually.

A: Although the declaration need not be renewed or signed annually, on the basis of the annual confirmation exercise, a licensed or registered person should be able to reasonably satisfy himself that the clients concerned continue to fulfill the requirements.

Q53: Must an intermediary sign a client agreement as required under para. 15.5(b) with a fellow intermediary who qualifies as a professional investor?

A: An intermediary does not need to enter into a client agreement with a fellow intermediary where it has provided a written explanation to that intermediary and has not received any objection.

As these intermediary clients are likely to be operating an omnibus account, intermediaries acting for them should be mindful of the requirements under the Client Identity Rule Policy published by the Commission. Under Example 1, Section F, where a client places an order with a financial intermediary which then routes it to an intermediary, the intermediary should obtain an agreement from the financial intermediary that, upon a request from the Commission and the 2 exchanges, the financial intermediary will provide the required information about the client directly to the Commission and the 2 exchanges.

Q54: Is it correct that, pursuant to para. 15.5(d)(i), a licensed or registered person will not be required to fulfil the requirements set out in para. 8.1(a) and (b) of the Code while serving clients who are Professional Investors?

A: Yes, although the written description in para. 15.5(d)(i) only expressly refers to para. 8.1(a), para. 8.1(b) is so obviously a follow-on from para. 8.1(a) that it can also be waived.

Q55: Should a licensed or registered person obtain an authorization from a client who is a professional investor in order to effect transactions on the client's behalf under para. 15.5(c)(i)?

A: Yes, a licensed or registered person should obtain authorisation from the client though it does not need to be in a written form.

Risk disclosure statements

Q56: The risk disclosure statement "It is as likely that losses will be incurred rather than profit made as a result of buying and

selling securities" in Schedule 1 (Risk of Securities Trading) is considered inappropriate. The existing risk warning "The price of securities can and does fluctuate; and any individual security may experience upward or downward movements..." is considered adequate with perhaps the addition of the words "sometimes dramatically" as included in the new version.

A: All firms should include a risk disclosure statement in that form or to a substantially similar effect. You may speak to the SFC for guidance if you wish to use a form of risk disclosure that is different in content to the suggested form.

Q57: If the account opening procedures other than a face-to-face approach was used, who should sign the "declaration by staff" section under Schedule 1?

A: Where there is no face-to-face approach, the licensed or registered person should ensure that the covering correspondence should specifically draw the client's attention to the appropriate risk disclosure statements and client acknowledgement should be sought. It will not be necessary for the "declaration by staff" section to be signed. Nevertheless, the licensed or registered person is encouraged to contact the client directly to ensure the necessary risk disclosures and reminders under Schedule 1 are drawn to the client's attention. *(Updated on 12 May 2015)*

Q58: Comment on whether the following circumstances are acceptable under Schedule 1:

a. staff are required to sign off confirming that he has explained the risk disclosure statements to the clients (which is more onerous than the Code which requires confirmation that he has provided copy of risk disclosure statements and invited clients to ask questions and take independent advice); and

b. clients are required to sign off acknowledging that the AE has fully explained the risk disclosure statements and the client has understood the risks (which is more onerous than the Code requiring confirmation that he has received copy of risk disclosure statements and been invited to ask questions and take independent advice) on the client agreement.

A: a. This is acceptable.
b. This is acceptable.

Q59: Must a firm include the disclosure statement on the "risk of providing an authority to repledge you securities collateral etc." as required under Schedule 1 if the client does not give such an authorisation in the first place?

A: No.

Q60: Under Schedule 1, a firm should confirm with a client at least annually whether the client wishes to revoke the authority to hold mail or to direct mail to third parties and it can do this by sending a notification as a reminder.
Must the notification be sent out as a letter or can it be in the form of e-mail?

A: The notification can be in the form of e-mail provided that the client has given his consent to receiving communication via this channel. It will be adequate for the consent to be a general consent given at the account opening stage.

The firm is expected to maintain audit trail to demonstrate that it has indeed sent these e-mails to its clients.

Securities margin lending

Q61: Under para. 11(b) and (c) of Schedule 5, securities margin lending policy should avoid building up excessive exposure to margin clients or collateral. Can a firm have concentration in margin clients or collateral if this can comply with the Securities and Futures (Financial Resources) Rules?

A: Yes, if the firm is prepared to tolerate the higher risks attached to such concentration and its liquid capital can afford the making of the related risk adjustments.

For information, the SFC is prepared to modify the Securities and Futures (Financial Resources) Rules where the firm has a single large client and the value of his securities collateral (consisting mainly of blue chip stocks) is substantial greater than the outstanding loan. In this case, the loan is considered to be of relatively low risk despite the concentration.

Q62: Under para. 12(a) of Schedule 5, a firm should collect objective proof of net income or net worth from its margin clients. Can a firm not collect objective proof where the credit limit granted is only small?

A: It is acceptable for a firm not to collect objective proof where it is the firm's policy not to do so where the credit limit is below a level (which should be set and subject to regular review bearing in mind the firm's risk appetite and financial position).

Q63: A firm has not collected any objective proof of net income or net worth (as required under para. 12(a) of Schedule 5) from its existing margin clients. Can the firm rely on past settlement history etc. as a base of its securities margin financing policy?

A: This depends on the circumstances. If a client has not traded for a long time or he is buying stocks whose prices are likely to fluctuate very widely, the firm may wish to review its credit policy by reassessing the client's latest financial position.

Q64: When a client cannot pay margin within the prescribed time and asks for an extension, the sales team leader is likely to be making a business decision in saying yes or no, without having to worry about the Securities and Futures (Financial Resources) Rules impact which is primarily a concern of the back office. Is this acceptable under para. 12(l) of Schedule 5? When the Code requires written explanations for deviation from the "policy", is the SFC primarily interested in any deviation from the firm's internal policy or only where there is an adverse effect on the Securities and Futures (Financial Resources) Rules?

A: This will depend on the circumstances. For example, if the firm has substantial excess liquid capital or the firm's lending policies are considerably more prudent than those permitted under the Securities and Futures (Financial Resources) Rules, then the sales teams can exercise a certain amount of discretion without having to worry about Securities and Futures (Financial Resources) Rules. Generally, we will expect the management to be mindful of the implications and alert their sales teams accordingly.

When the SFC will be more concerned where there is an adverse effect on the Securities and Futures (Financial Resources) Rules than where there is none, a deviation without written explanations may suggest fundamental deficiencies in the internal controls where there is general disrespect for laid down firm's policy. As far as possible, management should formulate clear policies laying down which level can exercise discretion for upto which amount etc and reduce any spontaneous human override.
