

Consultation Paper

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

Hong Kong
September 2000

Introduction

1. The Securities and Futures Commission (SFC, the Commission) releases for public consultation the attached revisions to the Code of Conduct for Persons Registered with the Securities and Futures Commission (revised Code).
2. These revisions to the Code represent the incorporation of specific provisions currently contained in the rules of The Stock Exchange of Hong Kong Limited (SEHK) and Hong Kong Futures Exchange Ltd. (HKFE) (collectively, the Exchanges) into the Code, and the addition of new conduct rules.

Background

3. The International Organization of Securities Commissions (IOSCO) stated in its 1998 report entitled “Objectives and Principles of Securities Regulation” that “[m]arket intermediaries should conduct themselves in a way that protects the interests of their clients and helps to preserve the integrity of the market.”¹
4. Under section 4(1) of the Securities and Futures Commission Ordinance (Cap. 24) (SFCO), the SFC is charged with the responsibility to promote and maintain the integrity of registered persons in the securities and futures market.
5. The SFC has produced a number of codes and guidelines which provide guidance to the market on the expectations of the SFC in discharging its responsibilities. The SFC released policy statements on Fit and Proper Criteria and the Code of Conduct for Persons Registered with the SFC (the Code) in 1990 and 1994. These statements were last updated in July and November 1999, respectively.
6. The Fit and Proper Criteria sets out the SFC’s general expectations on the fitness and properness of registered persons. It does not contain a code of business conduct. The Code supplements the Fit and Proper Criteria with business conduct principles which are broadly comparable to those in place internationally, and are based on the seven International Conduct of Business Principles developed by IOSCO and other principles considered by the SFC as fundamental to the undertaking of a registered person’s business. The Code is used by the Commission in considering whether a registered person is or has been guilty of misconduct or is a fit and proper person to remain registered; and hence further indicates the manner in which the SFC performs its function of ensuring that all registered persons are fit and proper.
7. The Code aims to supplement related legislation, rules, codes and guidelines; and does not replace any existing codes or guidelines.

¹ See Section 12.5 (“The Conduct of Business Rules and Other Prudential Requirements”) of the abovementioned IOSCO report.

Rationale for the Revised Code

Market Reforms and Rationalised Market Regulation Necessitated Revisions to the Code and Rules of the Exchanges

8. In connection with the merger of the Exchanges into Hong Kong Exchanges and Clearing Limited (HKEx), a new model for the division of regulatory functions between the SFC and HKEx has been adopted. In relation to market surveillance and intermediaries supervision, the SFC will take over from the Exchanges the supervision of exchange participants' conduct. More specifically, as stated in the Hong Kong Government Position Paper²:

“market surveillance - the division of functions will remain substantially as at present, albeit with clearer delineation and refinement of respective responsibilities which will be formalised in written procedures. HKEC's market surveillance will focus on trading operations and risk management whilst the SFC will be primarily responsible for detecting market malpractices with statutory implications;

intermediaries supervision - the **prudential regulation** function currently performed by the Exchanges, including routine inspections of the businesses of members of the Exchanges, monitoring their compliance with **conduct rules** and the liquid capital requirements, and ensuring that members of the Exchanges have in place **proper systems of management and control**, will be moved to the SFC. HKEC would still need to retain a capacity though to ensure that its risk management measures are adequate and that trading rules are properly complied with...[emphasis added]”.

9. Accordingly, it is generally no longer appropriate for conduct rules to be contained in the rules of the Exchanges. It is proposed that the following framework for restructuring the conduct rules be adopted:
- conduct rules related to management of the Exchanges' business risks will be retained in the rules of the Exchanges³;
 - Exchange conduct rules whose subject matters are already covered in the relevant Ordinances (as defined in the SFCO) or SFC codes and guidelines will, in general, be repealed; and

² See paper entitled "Hong Kong Exchanges and Clearing Limited: Reinforcing Hong Kong's Position as a Global Financial Centre" issued by the Government in July 1999.

³ For instance, it is proposed that regulations on short selling and securities borrowing and lending be retained in the SEHK rules.

- With respect to conduct rules not related to risk management and whose subject matters are currently *not* covered in the relevant Ordinances or SFC codes and guidelines:
 - (a) selected provisions of such conduct rules will be repealed, incorporated into the revised Code and: (i) applied solely to the exchange participants of SEHK or HKFE; (ii) extended to all persons registered with the SFC which transact in securities and/or futures contracts of SEHK and/or HKFE; or (iii) extended to all persons registered with the SFC; and
 - (b) the remaining provisions, deemed to be outdated or inappropriate⁴, will be repealed.
10. A joint exercise is currently being conducted by the SFC and HKEx to restructure the rules of Exchanges and the clearing houses. HKEx will inform the exchange and clearing participants of the specific amendments to the rules of the Exchanges and the clearing houses in due course.

New Conduct Provisions for Registered Persons Conducting Securities Margin Financing

11. The Securities Ordinance (Cap. 333), as amended by the Securities (Margin Financing)(Amendment) Ordinance (Ord. No. 20 of 2000), which came into effect on 12 June 2000, generally requires non-bank intermediaries and representatives of these intermediaries which provide securities margin financing in Hong Kong to be registered with the SFC.
12. To provide guidance on the standard of conduct expected of practitioners engaged in the business of securities margin financing, the SFC has drawn up a specific set of provisions for registered persons conducting securities margin financing. It will be used as a benchmark, along with other SFC codes and guidelines, against which the fitness and properness of a registered person engaged in securities margin financing will be measured. These provisions are based on the proposals contained in the 1998 Consultation Paper on Share Margin Financing issued by the Financial Services Bureau.⁵
13. It is proposed that the provisions for securities margin financing be incorporated into a schedule to the revised Code (new Schedule 5).

⁴ These include, for instance, the HKFE requirement on pre-approval of advertisements by exchange participants (HKFE Rule 523) and certain transitional provisions (HKFE Rules: Schedule 2).

⁵ It is noted that few comments were received in relation to that 1998 Consultation Paper.

Summary of Revisions to the Code

14. The SFC wishes to highlight the following proposed revisions to the Code.

New drafting conventions

15. Throughout the Code, minor changes have been made to simplify sentence structures and use gender neutral language.
16. As mentioned above, the SFC is guided by the Code in determining whether a registered person satisfies the fit and proper test to remain registered. Accordingly, in laying down the conduct principles to be complied with by registered persons, the SFC considers it more appropriate to adopt the term 'should' in the revised Code (in place of the imperative 'shall', which appears in the existing Code).

Derivative column

17. A derivative column and cross references to legislation, codes and guidelines administered by the SFC have been added to the Code. These references are not intended to be exhaustive and do not form part of the revised Code.

Explanatory notes

18. The revised explanatory notes emphasize the importance of compliance with both the general principles and the letter of the revised Code; and clarify the Commission's position that breaches of either will be taken equally seriously. The explanatory notes also draw the attention of registered persons to the various Schedules to the revised Code, and in particular, Schedules 3 and 4 which are applicable to registered persons which transact in securities and/or futures contracts of SEHK and/or HKFE.
19. In light of the realities of today's markets, the revised Code also acknowledges the need to differentiate between professional and non-professional investors and keep business conduct principles flexible.

General principles

20. In addition to the seven International Conduct of Business Principles developed by IOSCO, two additional general principles have been included in the revised Code. These two general principles follow:
21. *GP8 Client assets.* This principle reiterates, in part, the provisions currently contained in paragraph 11 of the Code which require prompt and proper accounting as well as adequate safeguards for client assets. The Commission wishes to elevate the importance of this element of business conduct, given that

violation of this principle constituted one of the major failings in Hong Kong's securities sector recently.

22. *GP9 Responsibility of senior management.* This principle stresses that the responsibility for ensuring the maintenance of appropriate standards of conduct and adherence to proper procedures by the whole firm rests with the senior management of a registered person.

Interpretation and application (paragraph 1)

23. *Securities margin financing.* In light of the enactment of the Securities (Margin Financing)(Amendment) Ordinance (Ord. No. 20 of 2000) which came into effect on 12 June 2000, the definition of "registered person" in the Code has been expanded to include a "securities margin financier" and "securities margin financier's representative". Similarly, a section 121S(1) inquiry under the Securities Ordinance (Cap. 333) (which relates to 'powers of Commission in relation to misconduct of registered financier') has been included in the list of Commission inquiries which would likely be impacted by findings of breaches of the revised Code.
24. *Definition of "Person".* A definition of "person" has been inserted to clarify that all bodies of persons, corporate or unincorporate, are covered. This interpretation is consistent with the provisions of the Interpretation and General Clauses Ordinance (Cap. 1).
25. *Persons to which the Code does not apply.* It is emphasized that managers of authorized unit trusts and mutual funds, although not subject to the Code, are generally required to comply with the Fund Manager Code of Conduct issued by the SFC.

Honesty and fairness (paragraph 2)

26. *Advertising.* This new provision states that a registered person should ensure that invitations and advertisements do not contain any information that is false, biased, misleading or deceptive. This provision is derived, in part, from the Code on Unit Trusts and Mutual Funds and the rules of the Exchanges.
27. *Anti-bribery guidelines.* The SFC believes that a registered person should not solicit or accept an advantage which is likely to cause the recipient to treat the giver favourably or unfairly as regards other parties. Accordingly, the revised Code stresses the importance of compliance with the Prevention of Bribery Ordinance (Cap. 201) and related guidance issued by the Independent Commission Against Corruption. This provision is derived, in part, from the rules of the Exchanges.

Diligence (paragraph 3)

28. *Advice to clients: due skill, care and diligence.* The SFC wishes to reiterate the importance of proper disclosure to clients. Henceforth, the revised Code explicitly states that a registered person should disclose all material facts to a client when providing advice to a client.
29. *No withholding of orders for convenience; Collection of margins; Maintenance of separate accounts; Derivative position and reporting limits.* The revised Code expects 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 a vis a margin basis; and inform clients of any applicable derivatives position and reporting limits. These provisions are derived, in part, from the relevant Ordinances and rules of the Exchanges.
30. *Order recording.* Pursuant to existing SEHK Options Trading Rule 410 and HKFE Rules 531 and 531A⁶, SEHK Options Exchange Participants and HKFE exchange participants are, in general, obliged to record and time stamp client and house orders. In addition, HKFE exchange participants are obliged to install a telephone recording system to record client orders received through the telephone and keep such recordings for a specified period. The SFC believes that the foregoing requirements are consistent with the duty of a registered person to maintain proper accounts and records, and should be applicable to all registered persons. Accordingly, the revised Code extends these requirements (with modifications)⁷ to all registered persons.

The Commission realises that some registered persons may not currently have telephone recording systems to record clients' order instructions received by telephone. The Commission generally expects such registered persons to arrange to put a recording system in place within six months of the effective date of the new provision. The Commission notes that mobile telephones are widely used in Hong Kong. In this regard, the Commission expects registered persons to arrange for the use of a telephone recording system in their offices. Although use of mobile phones for receiving client order instructions is discouraged, where orders are accepted by mobile phones outside of the office, the time of receipt and the order details should be recorded immediately (e.g. by a call to the office system or in writing by hand).

31. *Best interests of clients.* A registered person should act in the best interests of its clients. This would also entail that the registered person takes into account

⁶ See also HKFE Circular dated 12 September 1994 (Reference No. MEM/CIR/9409002/002).

⁷ For instance, it is proposed that the telephone recordings be maintained for a period of 6 months (as opposed to 3 months under the HKFE rules).

the clients' best interests in recommending the services of another person to clients.

Information about clients (paragraph 5)

32. *Know your client: in general.* The Code requires the establishment of client identity. The revised Code emphasizes that where the account opening does not involve a face-to-face meeting, client identity should be ascertained in a satisfactory manner and the client agreement (plus other identity documents) should be certified by a professional person.

Client agreement (paragraph 6)

33. *Client agreement in writing.* The SFC considers it desirable to clarify the existing requirements on client agreements by stating in the revised Code that (i) the client should be able to specify the language (that is, English or Chinese) used for the client agreement, authority, risk disclosure, or any other supporting document or agreement; and (ii) the registered person should: (x) explain (either in person or in any other manner that reasonably ensures that the client is properly advised); and (y) provide copies of all of the abovementioned documents to the client.
34. *Minimum content of client agreement.* In light of the enactment of the Securities (Margin Financing) (Amendment) Ordinance (Ord. No. 20 of 2000), the SFC considers it appropriate, *under specified circumstances*, to require registered persons which deal in securities or act as securities margin financiers to explain to clients sections 81, 81A and/or 121AB of the Securities Ordinance (Cap. 333)⁸ and the risk of loss of securities.

Discretionary accounts (paragraph 7)

35. *Authorization and operation of a discretionary account.* To minimize the potential abuse of discretionary power granted by a client to a registered person or an account executive, the revised Code includes the following new provisions for the authorization and operation of discretionary accounts: (i) a client must authorize in writing any person employed by the registered person to conduct transactions for the client⁹; (ii) 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; (iii) discretionary accounts should be designated as such in the books and records of the

⁸ 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.

⁹ The existing Code requires the client to authorize a registered person to effect transactions but does not explicitly require the client to so authorize a person employed by a registered person.

registered person; (iv) senior management should approve the opening of discretionary accounts; and (v) internal control procedures should be implemented to ensure proper supervision of the operation of such accounts.

Information for clients (paragraph 8)

36. *Information about the firm: in general.* To minimize the potential of misleading or confusing clients, the revised Code emphasizes that, when employees wear “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.
37. *Prompt confirmation.* The existing Code generally provides that a registered person should furnish prompt trade confirmations to clients. The revised Code elaborates on the specific requirements for the contents and timing of confirmations relating to options contracts.
38. *Timely and accurate reporting.* The revised Code states that statements of accounts should be furnished to clients on a *monthly* basis (as opposed to a quarterly basis under the existing Code), except in respect of dormant accounts. The revised Code also elaborates on the content requirements of statements of accounts and contract notes.
39. *Information about the firm: financials.* The revised Code clarifies the SFC’s expectation that a registered person delivers its latest ‘audited balance sheet’ and ‘profit and loss account’ (as opposed to ‘the most recent accounts’ stated in the existing Code) to a client upon the latter’s request. The requirement to disclose to clients all material adverse changes in a registered person’s financial condition has been removed because it is believed that the underlying concerns are adequately addressed under the Financial Resources Rules.
40. *Information on corporate actions.* It is stated explicitly in the revised Code that a registered person that has control of a client’s assets should respond promptly to such client’s requests for information on corporate actions.

Client priority (paragraph 9)

41. *Nonpublic, material information.* The existing Code states that a registered person should avoid dealing in securities and futures contracts about which it possesses nonpublic and material information. The revised Code expands this requirement by incorporating the following provisions currently contained in

the SEHK rules: (i) the duty not to deal includes not dealing for any client; and (ii) the term “information” covers research and analysis.¹⁰

Compliance (paragraph 12)

42. *Employee dealings.* The revised Code specifies the conditions and procedures under which a registered person may permit its employees (including directors) to deal for their own accounts. In general: (i) there should be a written policy on employee dealings; (ii) related accounts (including accounts held by minor children; and accounts in which the employees hold beneficial interests) should be reported to senior management; (iii) employees may generally deal through another dealer only where they arrange for senior management of the employer-registered person to be provided with duplicate trade confirmations and statements of accounts; (iv) transactions for employees’ related accounts should be properly recorded and accounted for; and (v) transactions for employees’ related accounts should be actively monitored by independent senior management who should also maintain procedures to detect any irregularities or client conflicts.
43. The above provisions are derived, in part, from HKFE Rules and the Management, Supervision and Internal Control Guidelines for Persons Registered with or Licensed by the Securities and Futures Commission (Appendix A, paragraph 4).
44. *Notifications to the Commission.* The revised Code requires a registered person to notify the Commission of specified matters, which include but are not limited to non-compliance with the law and rules by it, its employees or other registered persons; its bankruptcy or dissolution; the suspension of its business licenses; and material systems failures. These requirements are derived, in part, from rules of the Exchanges.

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

45. *Retention of Rebates, soft dollars, and connected transactions.* The revised Code emphasizes that a registered dealer should ensure that the goods and services listed in the invoices presented by a portfolio manager for payment comply with certain requirements stated in the existing Code (e.g., such goods and services are of demonstrable benefit to the clients of the portfolio manager).

Responsibility of senior management (paragraph 14)

46. The revised Code states the SFC’s expectations that senior management of a registered person should, amongst other things, understand their

¹⁰ See SEHK Rules: Seventh Schedule (section 12c.i).

responsibilities, manage risks properly, and have timely access to all relevant information.

Professional investors (paragraph 15)

47. In light of the realities of today's markets, the revised Code acknowledges the need to differentiate between professional and non-professional investors and keep business conduct principles flexible. The SFC has released a Consultation Paper on the Code of Conduct for Regulated Persons Serving the Professional or Sophisticated Market. These provisions are to be finalized in light of the results of public consultation.

Schedules to the Code

48. *Revised Schedule 1 - Risk Disclosure Statements*¹¹. Six risk disclosure statements have been added to the existing Schedule 1 to the Code. They relate to: (i) transactions in SEHK Options Contracts¹²; (ii) transactions in HKFE Futures Contracts/Options Contracts; (iii) instances where client authority is obtained pursuant to section(s) 81, 81A or 121AB of the Securities Ordinance (Cap. 333)¹³; (iv) arrangements to hold mail or direct mail to third parties; (v) transactions involving securities margin financing; and (vi) transactions in securities under SEHK's Nasdaq-Amex Pilot Program. In this regard, to stress the importance that all applicable risk disclosure statements be explained to clients, Schedule 1 to the revised Code provides for the execution of a staff declaration and client acknowledgement affirming the explanation of the applicable risk disclosures by a staff member of a registered person¹⁴ to a client.
49. Three new Schedules have also been added to the Code.
50. *Schedule 3 - Additional Requirements for Registered Persons Transacting in Securities of The Stock Exchange of Hong Kong Limited.*¹⁵ As discussed above, selected rules of the Exchanges which deal with conduct will be repealed and incorporated into the revised Code. The provisions contained in Schedule 3 are derived, in part, from the SEHK Rules and SEHK Options Trading Rules. They include requirements relating to stock options client agreement, time stamping, stock options trade confirmations, the exercise of client contracts, capital adjustments, omnibus accounts, client's money, and

¹¹ Schedule 'I' has been renumbered as Schedule '1'.

¹² The risk disclosure contained in the SEHK Options Trading Rules First Schedule (Item A1) has been incorporated into the revised Code.

¹³ See footnote 8 above.

¹⁴ Such staff member should also be a registered person.

¹⁵ Registered persons which are not SEHK exchange participants are exempt from specified provisions contained in Schedule 3.

other requirements contained in specific rules of SEHK (such as the securities borrowing and lending Regulations and short selling Regulations).

51. *Schedule 4 - Additional Requirements for Registered Persons Transacting in Futures Contracts and/or Options Contracts of Hong Kong Futures Exchange Ltd.*¹⁶ The provisions contained in Schedule 4 are derived, in part, from the HKFE Rules. They include requirements relating to books and accounts, discretionary accounts, omnibus accounts, client's money and approved debt securities of clients, and client's ledgers, the prohibition of set-off between the registered person's accounts and client's accounts, and other requirements contained in specific rules of HKFE.
52. *Schedule 5 – Additional Requirements for Registered Persons Conducting Securities Margin Financing.* As discussed above in this paper under the heading “**Rationale for the Revised Code: New Conduct Provisions for Registered Persons Conducting Securities Margin Financing**”, to provide guidance on the standard of conduct expected of practitioners engaged in the business of securities margin financing, the SFC has drawn up a specific set of provisions for registered persons conducting securities margin financing.

Consultation period

53. The SFC invites comments from the public on the proposed revised Code set out in this consultation paper. Comments in writing should be addressed to:

Supervision of Markets Division
Securities and Futures Commission
12/fl., Edinburgh Tower
The Landmark
15 Queen's Road Central
Hong Kong

Comments may also be faxed to (852) 2521 7917 or sent by email to code_rpconsult@hksfc.org.hk. In all cases, comments should be submitted by 27 October 2000.

Further copies of the consultation paper may be obtained from the above address of the SFC. A copy of this paper can be also found on the SFC website at <http://www.hksfc.org.hk>.

¹⁶ Registered persons which are not HKFE exchange participants are exempt from specified provisions contained in Schedule 4.

