

Oversight

September 2019
simmons-simmons.com
elexica.com



New SFC requirements for client asset accounts with authorised institutions

On 8 July 2019, the Securities and Futures Commission (SFC) published a circular (Circular) highlighting its concern with the lack of protection of client assets by intermediaries. The Circular specifically flagged that SFC is aware that standard terms and conditions (T&Cs) entered into between Managers and authorised institutions (AIs) for the opening of client asset accounts often grant AIs a right of set-off or lien. SFC's view is that such rights are fundamentally incompatible with the requisite standards of protection which should be accorded to client assets under the SFC's Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (Code of Conduct).

Over recent years, the SFC has issued a number of regulations as well as guidance relating to the treatment and safeguarding of client assets. General Principal 1 of the Code of Conduct requires intermediaries licensed with the SFC to act honestly, fairly and in the best interests of their clients and the integrity of the market when conducting their business activities. General Principal 8 and paragraph 11(a) of the Code of Conduct further requires intermediaries to ensure that client assets are adequately safeguarded.

The Fund Manager Code of Conduct (FMCC) requires fund managers (Managers) to segregate fund assets from their own assets. An independent custodian may be appointed for the safeguarding of the client assets, and where the Manager opts for self-custody of the assets (i.e. hold these debts for the client), adequate policies, procedures and internal controls should be in place, and the applicable rules set out in the Securities and Futures (Client Securities) Rules (Client Securities Rules) and the Securities and Futures (Client Money) Rules (Client Money Rules) (collectively, SFO Rules) should also be complied with. The SFC often imposes a licensing condition on intermediaries prohibiting them from holding client assets.

The Circular introduces a standardised acknowledgment letter (Standard Letter) to be adopted on or before 31 July 2020. The Standard Letter, which shall prevail against any earlier conflicting T&Cs agreed with AIs, includes a prohibition on recourse against client assets by the AI and an acknowledgment by the AI of the intermediary's obligation to segregate client assets.

This *Oversight* (i) provides a regulatory overview of the treatment of client assets under the Code of Conduct, the FMCC, the SFO Rules and the SFC licensing regime, (ii) addresses the Circular and the terms of the Standard Letter, and (iii) considers the practical implications of the Standard Letter for Managers and AIs.

elexica.com is the award winning online legal resource of Simmons & Simmons

© Simmons & Simmons LLP 2019. All rights reserved, and all moral rights are asserted and reserved.

This document is for general guidance only. It does not contain definitive advice. SIMMONS & SIMMONS and S&S are registered trade marks of Simmons & Simmons LLP.

Simmons & Simmons is an international legal practice carried on by Simmons & Simmons LLP and its affiliated practices. Accordingly, references to Simmons & Simmons mean Simmons & Simmons LLP and the other partnerships and other entities or practices authorised to use the name "Simmons & Simmons" or one or more of those practices as the context requires. The word "partner" refers to a member of Simmons & Simmons LLP or an employee or consultant with equivalent standing and qualifications or to an individual with equivalent status in one of Simmons & Simmons LLP's affiliated practices. For further information on the international entities and practices, refer to simmons-simmons.com/legalresp

Simmons & Simmons LLP is a limited liability partnership registered in England & Wales with number OC352713 and with its registered office at CityPoint, One Ropemaker Street, London EC2Y 9SS. It is authorised and regulated by the Solicitors Regulation Authority.

A list of members and other partners together with their professional qualifications is available for inspection at the above address.

Overview of Regulation of Client Assets

SFC Licensing Regime

The SFC is empowered under the Securities and Futures Ordinance (SFO) licensing regime to impose conditions on any licences granted to intermediaries. An “intermediary” for this purpose is any licensed corporation or AI engaging in a SFO regulated activity therefore registered with the SFC. A common condition imposed upon Managers is a stipulation not to hold client assets (No Client Assets Licensing Condition). The No Client Assets Licensing Condition may be varied, revoked or imposed by the SFC from time to time.

Any Managers or other licensed entities which holds an unconditional licence with regard to holding client assets, i.e. a licence without the No Client Assets Licensing Condition, are subject to more stringent reporting obligations, as well as higher minimum paid-up share capital and liquid capital requirements. Managers holding, amongst others, an unconditional Type 4 (advising in securities), Type 5 (advising in futures contracts), and/or Type 9 (asset management) licence under the SFO are required to maintain minimum liquid capital of HK\$3 million (compared to HK\$100,000 without the Licensing Condition), and are subject to an additional minimum paid-up share capital requirement of HK\$5 million. They are also required to submit monthly (as opposed to semi-annual) financial resources returns to the SFC unless their licenses are subject to the No Client Assets Licensing Condition.

SFO Rules

More specific requirements relating to the treatment of client securities and client assets are also set out in the SFO Rules.

Client Securities Rules

The Client Securities Rules apply to client securities and securities collateral (collectively, Client Securities) of intermediaries received or held in Hong Kong by them (or their associated entities), which are either securities listed on The Stock Exchange of Hong Kong Limited or interests in a SFC-authorized collective investment scheme.

An intermediary which receives any Client Securities must ensure that, as soon as reasonably practicable, these are:

- deposited in a segregated account which is (i) designated as a trust account or client account and (ii) specifically established and maintained in Hong Kong by the intermediary (or its associated entity) with an AI, an approved custodian, or another intermediary licensed for dealing in securities, or
- registered in the name of that client or the associated entity (if any, but not the intermediary).

For securities collateral, the intermediary may, in addition to the above:

- deposit such securities collateral in an account in the name of the intermediary (or its associated entity), or
- arrange for it to be registered in the name of that client or of the intermediary (or its associated entity).

However, notwithstanding the above, an intermediary (or its associated entity) may, in general, deal with Client Securities in accordance with the following instructions from its client:

- any *oral or written* direction to sell such Client Securities or to settle a sale order (unless authority was previously provided by way of written agreement, in which case the latter prevails),
- any *written* direction to withdraw Client Securities, or
- any standing authority from the client (provided that such standing authority does not provide for the transfer of any Client Securities to the intermediary or its associated entities, affiliates, officers or employees).

Client Money Rules

The Client Money Rules apply to client monies received or held by intermediaries (or their associated entities) in the course of conducting regulated activities, but does not apply to any client monies which are received and held outside of Hong Kong.

Client money should be held in a segregated account maintained with an AI and designated as a trust or client account. Such monies should be paid into the segregated account or otherwise in accordance with any written direction or standing authority within one business day of receipt, less certain monies which are allowed under the rules, such as brokerage charges and reimbursements to the intermediary for monies previously paid to satisfy its client's settlement obligations.

Non-compliance and Self-Reporting

An intermediary which becomes aware of any non-compliance with the SFO Rules is under an obligation to inform the SFC by written notice within one business day. The penalties of dealing with Client Securities and/or client monies other than in accordance with the SFO Rules ranges from fines of various levels to imprisonment.

Code of Conduct

As a general obligation, intermediaries are required under General Principal 1 of the Code of Conduct to act honestly, fairly and in the best interests of their clients and the integrity of the market when conducting their business activities.

More specifically, under General Principal 8, intermediaries should ensure that client assets are promptly and properly accounted for and adequately safeguarded. This requirement is further expounded in paragraph 11.1(a) of the Code of Conduct, which states that where intermediaries or a third party on behalf of such intermediaries is in possession or control of client positions or assets, such parties should ensure that those are adequately safeguarded.

FMCC

Paragraph 4 of the FMCC also sets out further requirements with which Managers must comply in relation to the custody of client assets.

Managers should ensure that fund assets are segregated from their own assets and, unless held in an omnibus client account, from the assets of their affiliates and other clients. Fund assets not capable of being held in custody should be identified as being owned beneficially by the relevant funds, as opposed to the Managers or the custodians, through proper record-keeping.

Managers should select and arrange for the appointment of, and entrust the fund assets to, functionally independent custodians (or trustees, in the case of unit trusts). A custodian must be a registered trust company, an AI (i.e. a licensed bank, deposit-taking company or restricted-licence bank) or the subsidiary of an AI, a banking institution or trust company outside Hong Kong that is subject to prudential supervision, or any other appropriately qualified institution.

Managers who are responsible for the overall operation of a fund should exercise due skill, care and diligence in the selection, appointment and ongoing monitoring of the custodian, and take all reasonable steps to ensure the latter's proper qualification by taking the following factors into consideration:

- management of potential conflicts of interest of the custodian;
- its organisational capabilities;
- its sub-custodian agreements; and
- its treatment of client assets, in particular, whether the custodian has appropriate segregation arrangements in place such that the fund assets are segregated from (i) the assets of the custodian or sub-custodian and (ii) the assets of other funds and other clients of the custodian throughout the custody chain (unless the fund assets are held in an omnibus client account).

Where self-custody is adopted, Managers should ensure that they have policies, procedures, and internal controls in place to ensure that the persons fulfilling the custodial function are independent from the persons fulfilling the fund's management functions. Such Managers should also comply with the applicable requirements as set out in the SFO Rules which are further discussed below. The self-custody arrangement should be specifically disclosed to investors along with any additional safeguards that have been put in place to mitigate any potential conflicts of interest.

Standard Letter

The Circular seeks to remind intermediaries of their obligations to comply with the requirements under the Code of Conduct in relation to client assets as interpreted by the SFC.

The SFC reminds intermediaries that they should exercise all due skill, care and diligence in the selection and appointment of any party other than an AI with whom client assets are proposed to be placed, and bear in mind the best interests of its clients when doing so.

In particular, the Circular references industry usage of standard T&Cs between intermediaries and AIs with respect to client asset accounts which grant AIs a right of set-off or lien against those accounts. The SFC states that in its view such rights are fundamentally incompatible with the requisite standard of protection accorded to client assets under the Code of Conduct.

To reduce what the SFC considers to be a risk of mistreatment of client assets, the Circular introduces a new measure of protection through the mandatory use of a Standard Letter of acknowledgement – in effect an agreement to be signed by intermediaries and countersigned by AIs holding client assets for the Intermediary's clients.

The Standard Letter is required for the following types of client asset accounts which are opened with AIs in the name of intermediaries (Client Asset Accounts):

- accounts for holding client money;
- accounts for holding Client Securities; and
- accounts for holding non-repledged clients' securities collateral (which excludes intermediaries' accounts that hold clients' securities collateral repledged, with clients' authority, by intermediaries to AIs for obtaining financial accommodation from AIs).

While the SFC does not explicitly specify in the Circular whether the scope of the Standard Letter is limited to accounts holding client monies as governed by the Client Money Rules and/or Client Securities as governed by the Client Securities Rules, it would appear to be their intention, as the Circular begins by reminding intermediaries of their obligation to comply with the Code of Conduct when they are "in possession or control of client assets" – this is arguably most pertinent to the self-custody of client money and Client Securities within the scope of the SFO Rules.

The Standard Letter serves as "supplemental" T&Cs between AIs and intermediaries to govern the treatment of existing and future Client Asset Accounts opened in the course of regulated activities undertaken by the intermediaries. Existing or contemplated Client Asset Accounts with each AI are required to be identified and scheduled to each Standard Letter. As mentioned, this is compulsory.

The key elements of the Standard Letter are notification of purpose clauses, the no-recourse clauses and the conflict clauses, which the SFC says are comparable with requirements imposed by their counterparts in other major jurisdictions.

Notification of Purpose and Designation of Client Asset Accounts

In countersigning the Standard Letter, the AI acknowledges that it has been duly notified that (i) it is required to segregate client assets, (ii) it shall open a Client Asset Account and deposit client monies and/or securities in that account, and (iii) the intermediary holds all money and securities in the Client Asset Account in its capacity as trustee.

In addition to the above, the AI is required to designate and title the Client Asset Account to indicate that it is a client account or trust account (as the case may be).

No Recourse and Deduction from Client Asset Accounts

The no-recourse clauses prohibit recourse against Client Asset Accounts. In particular, the following (non-exhaustive) treatment by AIs is explicitly prohibited under the Standard Letter:

- using client monies or securities directly or indirectly as security for any loans made by the AI (or any of its agents or delegates) to the intermediary;
- combining the Client Asset Account with any other account;
- claiming any right of set-off or counterclaim with respect to the Client Asset Account; and
- deducting charges incidental to the servicing and maintenance of the Client Asset Account (however intermediaries agree in the Standard Letter to make good such charges).

The above does not prohibit recourse against assets required by legislation or court order. The SFC has also clarified in the Circular that, in the event of an issuer's default, clawback by AIs of prepaid dividends or interest in respect of the issuer's securities would not be considered as recourse prohibited under the Standard Letter.

Standard Letter to Prevail if Conflict with T&Cs

The Standard Letter provides that it shall prevail against any T&Cs agreed between the parties in relation to the Client Asset Accounts. The Standard Letter is, naturally, governed by Hong Kong law and in the event of any conflict, the courts of Hong Kong are stated to have the non-exclusive jurisdiction.

Transition Period

As specifically noted in the Circular as well as the Standard Letter, intermediaries are required to have the countersigned Standard Letters in place before depositing any client money or client securities into any new Client Asset Accounts. The SFC expects intermediaries and AIs to have the measures in place for all applicable Client Asset Accounts (new and existing) on or before 31 July 2020.

Practical Implications for Managers and AIs

Managers

The Circular reiterates the SFC's longstanding concern that client assets held in accounts with AIs are not adequately safeguarded. The new measures introduced in the Circular arguably illustrate the SFC's hardening stance towards a perceived unfairness within the industry. Managers should take steps to satisfy themselves that client assets are maintained not only in accordance with the Code of Conduct, but also with existing regulations under the FMCC, the SFO Rules (in the case of self-custody) as well as any conditions attached to their SFC licenses. Where Managers are not subject to the No Client Assets Licensing Condition and have accounts for funds or managed account clients with AIs, the Circular and Standard Letter is applicable to them.

By requiring intermediaries such as Managers to prepare and sign the Standard Letter and then obtain countersignatures from the appropriate AIs, the Circular specifically places the obligation of implementation of the new measure on Managers. Managers should therefore take steps to reach out to relevant AIs to ensure that the Standard Letters are in place by the transition deadline of 31 July 2020. The SFC has noted that the Standard Letter is standardised in the form of the template appended to the Circular, but the extent of which it will allow for deviation from the terms within (for instance, where parties wish for the letter to be exclusively governed by another jurisdiction) is unclear. It is likely that the SFC would expect no material change to its drafting. The relatively short length of the Standard Letter may be helpful in minimising discussion between AIs and Managers, but risks resulting in a lack of clarity as to the terms, especially in light of the SFC's intention for the Standard Letter to serve as a "blanket" agreement with AIs for all Client Asset Accounts.

However, the scope of *application* of the Circular is arguably limited, as it only applies to certain types of Client Asset Accounts held with AIs. As mentioned above, an "AI" refers to an authorised financial institution as defined in section 2(1) of the Banking Ordinance, i.e. a bank, a restricted-licence bank or a deposit-taking company. Practically speaking,

those refer to companies with a place of business in Hong Kong which holds a banking licence (restricted or otherwise) granted by the Hong Kong Monetary Authority (HKMA), or a deposit-taking company registered with the HKMA.

According to the HKMA register, as of the date of this *Oversight* there are 194 such entities. As a result, the Standard Letter obligation does not apply to entities not registered with the HKMA, or banks without any place of business in Hong Kong. Managers who have appointed as custodians other entities not falling within the scope of the above will not be required to enter into the Standard Letter. The Circular can be circumvented by transferring client assets to overseas branches which are not registered with the HKMA.

AIs

By countersigning the Standard Letter, AIs will have to acknowledge that they will not hold any right of set-off or lien against the Client Asset Accounts (save for those granted by legislation or court order), nor will they be allowed to use such client assets as security or deduct any amount in the manner prescribed by the Standard Letter.

AIs which originally retained such rights of set-off or lien, by way of standard T&Cs or otherwise, may therefore lack the incentive (or indeed any regulatory pressure from the SFC) to cooperate with Managers or other intermediaries in entering into the Standard Letter.

It is possible that AIs would be more amenable if Managers are able to offer alternative contractual protection in return, for instance, an agreement that the Manager would (i) maintain an account with that AI in the Manager's own name, (ii) ensure that a stipulated minimum sum of money is held in that account, and (iii) provide the AI with a contractual right to deduct any outstanding sums payable in relation to the Client Asset Account. The last point is perhaps already partially addressed in the Standard Letter, where the Manager agrees to pay charges associated with the Client Asset Account, but AIs are likely to prefer more clarity and protection than that provided for in the Standard Letter.

It is, however, unclear whether AIs would consider Client Asset Accounts to be fair game in cases where the Manager reneges on the contractual protection, for instance by allowing the balance in its account to fall below the minimum threshold. Practically speaking, each AI is likely to press for bespoke terms based on its existing client relationship with each Manager or intermediary and its own internal policies in relation to Client Asset accounts. Managers should be therefore be mindful of the above when approaching AIs to ensure a smooth execution of the Standard Letter before the expiry of SFC's grace period.

Conclusion

The SFC has throughout recent years published guidance and regulations governing the treatment of client assets in various sources, resulting in a fragmented regime which is often difficult for market players to navigate. While the Circular and the Standard Letter possibly represent a step in the right direction on the part of the SFC to strengthen protection of client assets, we note that the Standard Letter has a narrower scope and may not significantly impact the treatment of client assets. Nonetheless, the Circular is a signal that the SFC will now focus more on intermediaries' client assets held in accounts with AIs.

To find out more, contact:

Hong Kong

Rolfe Hayden

T +852 2583 8302

E rolfe.hayden@simmons-simmons.com

Gaven Cheong

T +852 2583 8323

E gaven.cheong@simmons-simmons.com

Eva Chan

T +852 2583 8216

E eva.chan@simmons-simmons.com

Ivy Yam

T +852 2583 8415

E ivy.yam@simmons-simmons.com

Grace Chong

T +65 6831 5626

E grace.chong@simmons-simmons.com

Louise Ma

T +852 2583 8406

E louise.ma@simmons-simmons.com

Ruby Ho

T +852 2583 8375

E ruby.ho@simmons-simmons.com

Candice Leung

T +852 2583 8398

E candice.leung@simmons-simmons.com

Simmons & Simmons navigator is our sector-leading online subscription service, covering key areas of financial services regulation. Since 2007, Simmons & Simmons navigator has provided cost-effective access to user friendly, comprehensive and regularly updated information regarding the key regulatory issues in the areas covered by the service. navigator is available through elexica, our award winning online legal resource, providing secure, 24/7, global access.

- **navigator: funds** - provides information on the key regulatory issues affecting the marketing and sale of investments in funds
- **navigator: share disclosure** - provides information on the key share disclosure requirements and short selling restrictions
- **navigator: derivatives and FX** - provides information on restrictions and issues when entering into OTC and exchange-traded derivatives and FX spot contracts with counterparties, aimed at both the sell and buy side
- **navigator: lending** - provides information on primary lending, factoring and invoice discounting as well as secondary market loan activities
- **navigator: banking** - provides information on deposit taking, foreign exchange trading and payment services
- **navigator: securities** - provides information on regulatory issues affecting the distribution of securities, including closed-ended funds, and
- **navigator: corporate finance** - provides information on licensing issues relating to corporate finance, M&A and equity capital market transactions.
- **navigator: product tax** - provides information on the key aspects of the domestic taxation of individual investors resident in ten key jurisdictions across Europe, the US and Japan on returns from investing in five common fund types.