

Client Identity Rule Policy

1. This note explains the new client identity rule (“**Rule**”), paragraph 5.4 of the Code of Conduct for persons registered with the SFC (“**Code of Conduct**”), and the general approach the SFC will take in enforcing the Rule. It addresses concerns raised by industry participants about aspects of the Rule.

A. Introduction

2. The Rule implements the Government’s policy that client information should be available to the SFC and the Exchanges (collectively or singularly “**Regulators**”, unless the distinction is important). It complements the amended rules of The Stock Exchange of Hong Kong Limited (“**SEHK**”) which require that brokers ascertain and record client identity details before executing a transaction on the Exchange. The new SEHK rules were implemented on 26 October 1998. The amendment to the Code of Conduct was gazetted and came into force on 13 November 1998.
3. These rules and the corresponding rules of the Hong Kong Futures Exchange Limited are intended to enhance the market surveillance capabilities of the Exchanges, as front-line regulators of trading in their markets, and of the SFC.
4. It is expected that all exempt dealers will comply with the Rule.

B. Nature and enforcement of the Rule

5. The Code of Conduct does not have the force of law. A registered person should not interpret the Rule as if it were found in a statute but rather have regard to the spirit, as well as the letter, of the Rule, as with other Code of Conduct provisions. When a registered person considers the steps that it must take to comply with the Rule, it should focus on its responsibility to act in a fit and proper manner.

If it acts honestly and reasonably in attempting to comply with the Rule, it will not be the subject of disciplinary action.

6. The SFC will administer the Rule flexibly and will, in deciding whether or not to take disciplinary action, take into account difficulties that a registered person may face in complying.
7. The SFC will assess compliance by whether, in practice, the information is available to the Regulators upon request. During inspections, the Regulators will check that systems are in place to ensure that the required information will be made available and, if they are not, will normally require correction, rather than take disciplinary action.

C. Transactions to which the Rule applies

8. The Regulators will usually ask for client identity information in relation to transactions in securities listed or futures contracts traded on one of the Hong Kong Exchanges but may occasionally ask for it in relation to over-the-counter (“**OTC**”) transactions in Hong Kong.
9. However, given the SFC’s obligations to assist regulators in other jurisdictions, the Rule extends to similar transactions overseas, both on-exchange and OTC and to securities which are not listed in Hong Kong or futures contracts which are not traded in Hong Kong.
10. The Rule does not apply to transactions executed before 13 November 1998. However, the Rule applies to all transactions executed on or after 13 November 1998, irrespective of whether the client was taken on before or after that date.

D. Timing of the provision of information to the Exchanges and/or to the SFC

11. Strictly, the Rule requires that the client identity information must be obtained and recorded before anything is done to effect a transaction.

12. The SFC expects this to be done where it is practicable. For example, a registered person with a local client acting as principal should be able to obtain and record the information required by the Rule before anything is done to effect a transaction on that client's behalf.
13. The SFC understands that, in some circumstances, it may not be practicable to obtain or to record all of the required information before a transaction. For example:
- where the client is an institutional client acting as agent for a large number of underlying clients through a nominee or omnibus account;
 - where the client uses a central dealing desk and the procedures used do not enable the full allocation details of a transaction to be provided until after the transaction is executed; and
 - where, in relation to a block order from a fund manager, the information about the allocation of that order between several collective investment schemes or accounts is not available at the time the order is effected by the registered person.¹
14. For surveillance purposes, the Regulators will usually ask for the required client information at the close of trading on the day of the transaction or on the following business day. Once the request is made, the required client information must be available within two business days of the day the request was made although, in exceptional market conditions, the Regulators may require information shortly after a transaction occurs.

¹ This does not mean that a fund manager does not have to decide the allocation of a block order among several collective investment schemes which it manages before placing the order. Fund managers should refer to paragraph 3.3 of the Code of Conduct and paragraph 3.4 of the Fund Manager Code of Conduct.

E. Rule as applied to collective investment schemes, discretionary accounts and discretionary trusts

15. The SFC will not require information under the Rule in relation to subscriptions in, redemptions from or switches between collective investment schemes.
16. Collective investment schemes, discretionary accounts and discretionary trusts may have many beneficiaries and are normally structured so that a professional investment manager makes the investment decisions. Where a registered person effects a transaction on behalf of a collective investment scheme, discretionary account or discretionary trust, that registered person is only required to ascertain or record the name of the scheme, account or trust in question and of the person who ultimately originates the instruction in relation to that transaction (i.e. usually the individual investment manager responsible for that investment decision).
17. It may be acceptable for a registered person to provide to the Regulators a number to identify a scheme, discretionary account or discretionary trust, but only if the registered person also gives the Regulators a key from which, together with that number, the Regulators can determine the actual name of that scheme, account or trust.
18. If, in respect of a particular transaction the discretion of the investment manager is overridden by one or more of the beneficiaries of a scheme, account or trust (or someone else), the Rule requires that the registered person record the required information about the beneficiary or beneficiaries (or others) who has or have given the instructions in relation to the transaction. A registered person may wish to amend its contractual arrangements with an investment manager of collective investment schemes, discretionary accounts or discretionary trusts with which it deals to require that investment manager to tell the registered person when investment discretion has been overridden.

F. Manner in which information is provided

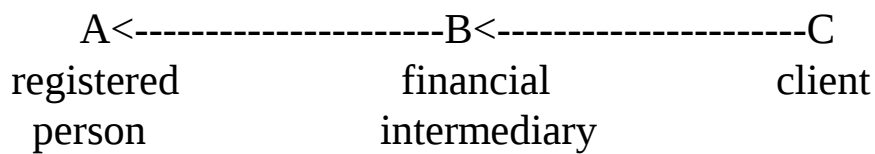
19. The SFC understands that registered persons may occasionally, for genuine commercial reasons, find it difficult to obtain the required information. For example, some market participants may not want to disclose the identities of their clients to their competitors.
20. The SFC will not take disciplinary action where satisfactory alternative measures to fulfil the objective of the Rule are in place. The SFC will not specify any particular way in which a registered person can comply with the spirit of the Rule. For example, for a financial intermediary client, it is not expected that a registered person would have recorded the details of the ultimate client prior to execution of an order on that client's behalf.
21. For example, the records of the client information of a registered person could be kept outside Hong Kong in the same corporate group.
22. It would also be acceptable if, before executing a transaction, an agreement were in place whereby the registered person's client agreed to provide information about the beneficiary of that transaction and details of the person originating the instruction for that transaction on request directly to the Regulators, without having to pass the same information to the registered person. The agreement would have to provide that the obligation to ensure that the information was provided to the Regulators continued even after the agreement ended. Examples of such an arrangement in practice are as follows.

Example 1

A = registered person

B = financial intermediary unaffiliated with A, acting as agent for C

C = B's underlying client



- A is dealing with B who does not want to disclose the identity of C to A.
- A could obtain an agreement from B that, upon a request from the Regulators, B will provide the required information about C directly to the Regulators.

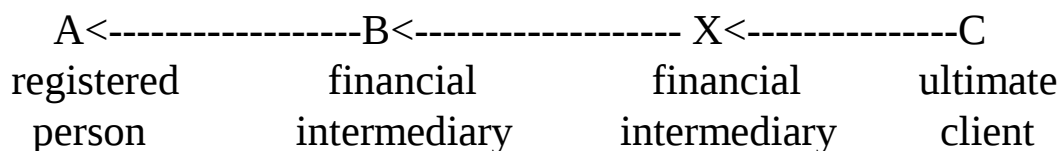
Example 2

A = registered person

B = financial intermediary A is dealing with, B acting as agent

X = financial intermediary B is dealing with, X acting as agent

C = X's underlying client



- The same facts as the example above, but B is not dealing directly with the ultimate client C, but rather with X, another financial intermediary, who is dealing directly with the ultimate client C.
- If X, for good commercial reasons, does not want to disclose the required information about C to B, A needs to obtain from B an agreement that confirms that the required information about the ultimate client, C (who in these circumstances will not be known to A and B) would be provided to the Regulators upon request. B in turn would have to enter into a similar agreement with X containing a similar confirmation. X would then provide the information directly to the Regulators.

23. The agreements contemplated in the examples above could be obtained either through addenda to existing agreements or through new agreements.
24. Where a registered person is dealing with an intermediary in a jurisdiction with client secrecy laws, the registered person must inquire and be satisfied on reasonable grounds that an agreement has been entered into by the ultimate client that waives the benefit of the secrecy laws in respect of providing the required information to the Regulators upon request. One method of doing this is for a registered person to require the financial intermediary with whom it is directly dealing to confirm that the agreement is binding under the relevant foreign law. That financial intermediary, in turn could obtain a similar confirmation from the financial intermediary with which it is dealing, and so on, up until the final financial intermediary dealing directly with the ultimate client. In this manner, the registered person itself would not have to obtain a legal opinion on the validity of the ultimate client's waiver under the relevant foreign law.
25. The policy underlying the Rule is that the Regulators must be able to ascertain the identity of anyone transacting in Hong Kong upon request and therefore a registered person must refuse the business of those who are not prepared to provide that information to the Regulators within two business days of a request.

G. Disciplinary proceedings

26. Failure to comply with the Rule will reflect on the fitness and properness of a registered person.
27. The SFC would not institute disciplinary action where the information is available to the Regulators within a reasonable time after the transaction. The litmus test will be whether the information is available within two business days of a request by

the Regulators. Where the information is not available, the SFC's disciplinary inquiry will focus on whether the registered person was satisfied on reasonable grounds at the time of the transaction that it would be able to provide the required information in due time. If a registered person were so satisfied, it would not be subject to disciplinary action.

28. The SFC would not take disciplinary action against a registered person if, for any reason, the ultimate client or an intermediary in the chain of intermediaries processing a transaction refused to provide client identity information upon request where the registered person could not reasonably have foreseen that such an event would occur.
29. However, if a registered person were put on notice that some intermediary in the chain of intermediaries involved in a transaction might not comply with its agreement in relation to that transaction so that the registered person could no longer be satisfied on reasonable grounds that the information would be available to the Regulators on request (e.g., if a registered person became aware that an intermediary had breached its agreements in the past) and continued to deal with that intermediary, the SFC would consider taking disciplinary action against the registered person.
30. If a registered person in a chain of financial intermediaries dealing with a transaction refused to comply with an agreement it had entered into and the refusal caused the required information to be unavailable to the Regulators, disciplinary action would be brought against that registered person.
31. If a financial intermediary registered in a foreign jurisdiction similarly refused to comply with an agreement it had entered into, the SFC would request the relevant foreign regulator to take disciplinary action.

H. Clarification of terms used

“Satisfied on reasonable grounds”

32. What constitutes reasonable grounds will depend on the circumstances. A registered person should interpret the requirement in a common sense way. Some examples may assist:
- a registered person would usually have no reason to question the required information provided to it by a Hong Kong retail client acting as principal, if the client verified their identity, address and contact details with a reliable form of proof.
 - if a registered person is dealing with a reputable financial intermediary, it would usually have no grounds to doubt the information supplied to it, or the ability or willingness of that financial intermediary to comply with an agreement it entered into.
33. However, if a registered person were put on notice that any information supplied to it were wrong or misleading in any way, or that a person would not comply or has not complied with an agreement that it had entered into, that registered person should not be “satisfied on reasonable grounds” and must inquire further until satisfied on reasonable grounds that the information is accurate, or the agreement will be complied with. If a registered person cannot be so satisfied after reasonable inquiry, it should not effect a securities or futures transaction with or on behalf of that person.

“Person or entity...ultimately responsible for originating the instruction...”

34. Most simply, this would be the person or entity that first said to buy or sell a certain security or futures contract. The question is perhaps most easily answered by asking: “Who first gave the instructions in relation to this transaction?” For example, if a registered person were dealing with a client who was in turn acting as the agent for an underlying client who gave the original instruction in relation to the

transaction, the client identity information required would relate to the underlying client.

Corporations

35. A registered person would usually be able to assume that a transaction for a corporate client is for the benefit of the corporation and record the required information about the corporation rather than information about all its shareholders. The person ultimately responsible for originating the instruction in relation to a corporate transaction will usually be a director, executive officer or other person authorised by its board of directors.
36. In such circumstances, the Rule does not add any new requirements to the “know your client” rule in paragraphs 5.1 to 5.3 of the Code of Conduct.

Back-to-back principal-to-principal transactions

37. The Rule applies on a transaction-by-transaction basis and each transaction should generally be regarded separately. Therefore, if a registered person buys securities on its own behalf and later sells those securities to a client from whom it later receives an order, there are two separate transactions. First, there would be a “buy” transaction where the registered person itself was the ultimate originator of the instruction about the transaction and the ultimate beneficiary. Secondly, there would be a “sell” transaction, in which the client would be the ultimate originator of the instruction about the transaction and the ultimate beneficiary.
38. Where transactions are structured as a series of back-to-back principal-to-principal trades, (for example to comply with the US SEC solicitation rules) they will be regarded as a single transaction for the purposes of the Rule. Further, the transaction-by-transaction application of the Rule should not be used by a registered person to structure transactions so that it can avoid disclosing the identities of its clients. See the following example.

Example

A = registered person

C = A's underlying client

- A receives an order from C to buy 1 million shares in XYZ Ltd.
- A buys 1 million XYZ Ltd shares on-market on its own behalf.
- A then sells 1 million XYZ Ltd shares to C.
- Since A bought the 1 million XYZ Ltd shares knowing that it already had an order from C for the same shares, the SFC would consider that these transactions were possibly structured so as to avoid disclosing C as the ultimate beneficiary of the purchase of 1 million XYZ Ltd shares and would consider disciplinary action against A.

“Instruction”

39. The “instruction” in relation to a transaction is anything that the order-giver communicates to the registered person, or to their own immediate financial intermediary or anyone else in the chain of persons processing the transaction, that has a direct bearing on the nature of the transaction or how it is to be executed (for example, “buy”, “sell”, “careful discretion” and so on).

“Person or entity...that stands to gain the commercial or economic benefit of the transaction and/or bear its commercial or economic risk”

40. This would usually, but not always, be whoever is described as the “beneficiary” of that transaction, i.e. the person who stands to gain or lose by an increase or decrease in the value of the security or futures contract purchased or who receives the consideration on a sale of that security or the novation of that futures contract.

41. A registered person would not usually have to trace the ultimate beneficiary of a transaction in the case of an ordinary transaction where it had no reason to suspect that the person with whom it was dealing was not the ultimate beneficiary of that transaction. A registered person should, however, be satisfied that the person with whom it was dealing was the beneficiary of a transaction and not acting as an agent. If someone was acting as an agent, a registered person would have to ascertain who that person's principal was or have confirmation that the Regulators would be told this on request. Further, if, for any reason, a registered person were put on notice by the circumstances of a transaction that the client with whom it was dealing was not the beneficiary of the transaction or that the information that was given was false or misleading, the registered person would have to inquire further until it was satisfied on reasonable grounds.