

LEGISLATIVE COUNCIL

PANEL ON FINANCIAL AFFAIRS

**REPORT ON THE IMPLEMENTATION OF
THE FINANCIAL RESOURCES RULES**

PURPOSE

This report updates Members on the implementation of the new Financial Resources Rules (“FRR”) made under the Securities and Futures Commission Ordinance (Cap. 24) since their commencement on 12 June 2000.

BACKGROUND

2. The new FRR were made on 12 April 2000 by the Securities and Futures Commission (“SFC”) to –

(a) implement changes proposed in a review of the previous FRR following public consultation in 1997. New capital as well as return and notification requirements were introduced subsequent to the review. Amendments were also made to position risk adjustment and counterparty risk adjustments; and

(b) extend appropriate financial supervision to securities margin financier which came under the supervision of the SFC after the enactment of the Securities (Margin Financing) Amendment Ordinance 2000. Securities margin financiers are required to comply with the financial resources requirements under the new FRR.

3. The new FRR came into operation on 12 June 2000. Securities dealers who were registered before 13 June 2000 were given a six-month grace period to comply with several provisions relating to securities margin financing. During that six-month period, the securities dealers did not have to make adjustments for concentration of margin loans or securities collateral. The six-month grace period expired on 12 December 2000.

4. The new FRR, in draft form, were first considered by the Legislative Council Bills Committee on the Securities (Margin Financing) (Amendment) Bill 1999, in view of their relevance to the Bill. The Bills Committee commented on the draft new FRR during its deliberations from April 1999 to February 2000. The proposed Rules were then revised and formally laid before the Legislative Council on 3 May 2000. A Subcommittee was established to examine the proposed Rules. At its meeting on 16 May 2000, the Legislative Council Subcommittee requested the Administration to report on the implementation of the new FRR to the Panel on Financial Affairs following their implementation.

COMPLIANCE SITUATION

5. Table 1 below shows the compliance situation in respect of the minimum liquid capital requirement from June to December 2000. Only two incidents of breaches by one corporate Exchange Participant and one corporate Non-Exchange Participant respectively, both caused by increased business turnover, were identified as attributable to new requirements imposed under the new FRR. All the remaining breaches were mainly due to transactions undertaken which resulted in some of the registrants' assets not being eligible to be counted as liquid assets. These incidents would also have triggered breaches under the previous FRR.

6. Upon becoming aware of these breaches, the SFC has taken immediate action, including discussion with the registrants concerned regarding the correct treatment under the new FRR; agreeing with the registrants rectification measures such as injection of additional capital in the form of share capital or subordinated loans; and monitoring their financial positions.

**Table 1. Failure to maintain minimum liquid capital
(June-Dec 2000)**

<u>Exchange Participants</u>	<u>No. of incidents</u>
-sole proprietor	2
-corporation	7
<u>Non-Exchange Participants</u>	<u>No. of incidents</u>
-sole proprietor	0
-corporation	11

7. Table 2 shows the compliance situation in respect of the minimum paid up capital requirement during the same period. The three corporate Exchange Participants have overlooked the higher capital requirement for carrying on securities margin financing business. Two of them rectified the breach by making capital injections and one of them rectified the breach by capitalising its retained earnings. All four of the above sole proprietor Exchange Participants and the one Non-Exchange Participant have either proprietorship funds (i.e. aggregate of capital, retained profits and proprietor current account) or shareholders funds (i.e. paid up capital and reserves) in excess of the minimum paid up capital requirement. The breaches by the sole proprietor Exchange Participants have been rectified by capitalising proprietor current account and retained profits. No actual cash injection is needed. The Non-Exchange Participant in breach of the requirement has since ceased business.

**Table 2. Failure to maintain minimum paid-up capital
(June-Dec 2000)**

<u>Exchange Participants</u>	<u>No. of incidents</u>
-sole proprietor	4
-corporation	3
<u>Non-Exchange Participants</u>	<u>No. of incidents</u>
-sole proprietor	0
-corporation	1

EXEMPTION NOTICES

8. On 19 June 2000, the SFC issued an exemption notice under section 29AA of the Securities and Futures Commission Ordinance exempting registered dealers from complying with sections 13(7) and (8) of the new FRR. These sections govern the treatment of balances maintained with a securities margin financier. The exemption notice was made to ensure registered dealers could continue to include such balances in their liquid capital during the transitional periods for registration of securities margin financiers.

9. The SFC issued another exemption notice on 11 August 2000 exempting registered dealers from complying with sections 5(2)(b) and 15(a) of the new FRR. These sections govern the valuation of listed shares for the purposes of computing liquid assets. The exemption notice

was made to ensure registered dealers could continue to treat shares in Cable and Wireless HKT Limited as liquid assets and to define the basis of valuation of such shares during the merger of Cable and Wireless HKT Limited and Pacific Century CyberWorks Limited.

MODIFICATION DIRECTIONS

10. Section 29 of the Securities and Futures Commission Ordinance empowers the SFC to give directions to modify the requirement of the FRR applicable to an applicant if it is satisfied that the requirement in question is unduly burdensome in the case of the applicant and granting of the direction is not contrary to the interest of the investing public.

11. As the commencement of the new FRR would render modifications granted under the previous FRR inoperative, the SFC has proactively requested the registrants concerned to consider the need of renewal of directions previously granted. Since 12 June 2000, the SFC has given modification directions in fourteen incidents. Seven of these directions were renewal directions. Two of these directions were given to registrants who were planning to cease business, and as such certain provisions were not applicable. Two directions were given to two investment advisers, who purely provided investment advice to clients and did not hold client assets, to provide temporary relief while they were revamping their capital structure. The remaining three of these directions were in respect of the special circumstances of the business of the applicants. These modifications would have been applied for and given under the previous FRR.

ASSISTANCE EXTENDED TO REGISTERED PERSONS

12. The SFC recognised the need to explain the requirements of the new FRR to registrants as well as interested parties such as accountants. Since April 2000, the SFC has taken the following initiatives to assist them to become familiar with the new FRR—

- (a) a letter highlighting the key changes in the new FRR was circulated to all registrants in April 2000;
- (b) a copy of the new FRR was posted to the SFC website;

- (c) from April to August 2000, a total of 8 seminars were held for registered dealers and members of the Hong Kong Society of Accountants and Hong Kong Securities Institute to explain requirements under the new FRR;
- (d) presentation materials of seminars held for registered dealers, together with a list of frequently asked questions and answers, were posted to the SFC website;
- (e) briefing sessions were held for system vendors commonly used by registered dealers to explain the key changes under the new FRR and the format of the monthly returns;
- (f) a set of test data was prepared and posted to the SFC website for downloading by registrants who wish to utilise system software to compute their liquid capital position to test applying the system software;
- (g) a sample liquid capital computation with supporting schedules was posted to the SFC website to facilitate self-assessment by interested parties so that they can identify any errors or need for changes in their computation;
- (h) a list of related securities listed on the Stock Exchange of Hong Kong was posted to the SFC website for use by registrants in their liquid capital computation and the list will be updated on a quarterly basis; and
- (i) a letter was circulated to all registered securities dealers on 6 December 2000 reminding them that provisions in the new FRR relating to concentration of margin clients and securities collateral and minimum paid-up capital for carrying out securities margin financing business would become effective on 12 December 2000 and asking them to assess the impact of those provisions on their FRR compliance.

ELECTRONIC SUBMISSION SYSTEM

13. Besides giving assistance to facilitate compliance, the SFC has developed an electronic submission system to facilitate electronic

submission of returns by registrants under the new FRR. Use of the system commenced in August 2000. The system makes use of a programmed EXCEL template capable of detecting most of the potential compilation errors. Returns submitted by the system are transmitted to the SFC through the Securities and Derivative Network (“SD Net”) which is a private network developed by the SFC. In developing the system, registered dealers of different backgrounds and sizes were invited to become pilot users. The system is generally recognised as user friendly and effective in reducing errors.

14. To assist registrants to use the system, 16 briefing sessions have been held to explain this system. User guidelines were posted to the SFC website and a hotline was implemented to handle enquiries about the system. On-site technical assistance (including installation of system software and connection to the SD Net) has been offered to all registrants. Over 50 registrants have made use of this service. In December 2000, the SFC received 147 returns submitted through the system. In addition, since October 2000, the SFC has accepted from registrants, who did not use the SD Net for FRR returns, diskettes as an alternative means for submission. In December 2000, 190 registrants submitted their FRR returns using diskette. Altogether 337 registrants, or 39%, submitted their monthly returns using electronic medium.

15. The SFC has also worked with the Hongkong Post to simplify the application procedures of electronic certificate for registrants. Hongkong Post has agreed to provide on-site services to registrants for processing their electronic certificate applications.

CONCLUSION

16. The SFC is satisfied with the implementation of the new FRR and will continue to work with market participants to ensure their compliance.