

# LEGISLATIVE COUNCIL BRIEF

Securities and Futures Commission Ordinance  
(Cap. 24)

## FINANCIAL RESOURCES (AMENDMENT) RULES 2002

### INTRODUCTION

Pursuant to section 28 of the Securities and Futures Commission Ordinance (“**SFCO**”), the Securities and Futures Commission (“**the Commission**”), after consultation with the Financial Secretary, made the Financial Resources (Amendment) Rules 2002 (“**the Amendment Rules**”), at the Annex, on 21 May 2002.

### BACKGROUND

2. The Financial Resources Rules (“**FRRs**”) set out the financial resources requirements imposed on persons registered with the Commission. The Commission regularly reviews these requirements to ensure that they are adequate and effective in the light of changing market practices.

#### Imprudent Business Practices

3. Hong Kong currently has 8 securities margin financiers and 258 securities dealers that conduct securities margin financing<sup>1</sup>. Over the last year which saw keen competition for business among firms, the Commission has

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<sup>1</sup> Securities margin financing is the provision of loans or credit to clients to enable them to buy or continue to hold securities. Such loans or credit are commonly referred to as “margin loans” and clients who acquire or hold securities with the benefit of such financing are commonly referred to as “margin clients”. There are

observed a growing market practice of aggressive lending to capture a fair share of the margin loan market which stood at \$13 billion in January 2002.

4. The Commission has therefore recently reviewed the business practices of firms that provide securities margin financing (“**SMF firms**”) and identified two practices that are particularly imprudent and risky. These are –

(a) accepting as collateral for margin loans a large quantity of stocks that may be difficult to liquidate quickly; and

(b) pooling securities belonging to margin clients, including non-borrowing or low-borrowing margin clients (i.e., those clients who borrow very little or not at all, but have a relatively large amount of securities in their margin accounts), and repledging the more liquid of these securities with banks to obtain bank loans which are then used to finance the SMF firms’ business operations and loans to other margin clients against collateral that may not be acceptable to banks.

5. Such practices carry systemic, financial and credit risks. A default on a large margin loan by a single margin client can potentially cause a firm to default on its bank loans if it cannot otherwise obtain funds to meet its obligations to the bank. This is possible particularly if the securities collateral provided by the margin client to the firm cannot be readily liquidated and the SMF firm itself has no additional liquidity. Ultimately, this could result in the bank retaining any client securities repledged to it as collateral for the bank loan. An SMF firm’s default on its bank loans would have potentially damaging consequences for the firm, its clients and market stability in general.

6. The current FRRs safeguard an SMF firm from insolvency risks under normal circumstances, but will not be able to cover adequately the consequential risks of the practices described in paragraph 4 above. The risks further increase when market and economic conditions are unfavourable. It is necessary therefore to amend the FRRs to take such risks into account when calculating the liquid capital of SMF firms.

### The Proposal

7. The Commission made the Amendment Rules to –

- (a) apply an 80% discount on certain stocks and warrants identified as “illiquid” (i.e., difficult to quickly liquidate due to the amount held in relation to market demand<sup>2</sup>) that are pledged with SMF firms as margin collateral; and
- (b) include in a firm’s ranking liabilities the amount of its total borrowings secured by repledging margin clients’ securities that is in excess of 65% of the total amount of loans extended to margin clients. This is hereafter referred to as the “gearing adjustment”.

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<sup>2</sup> Specifically, the discount would apply to those stocks and warrants pledged as margin collateral where such stocks or warrants would:

- (a) likely take more than one month to liquidate based on their respective trading volume during the previous six months; or
- (b) constitute 5% or more of the market capitalization of the shares or the issue size of the warrants.

This analysis would be applied only to those shares and warrants identified as the three largest collateral holdings (based on the securities’ respective market value) of each firm’s top 20 margin clients (those with the largest outstanding margin loan balances). However, once any shares or warrants meet either of these tests, the 80% discount would apply to all such shares or warrants held by the firm as collateral.

Note that constituent stocks of certain specified major indices, such as the Hang Seng Index, the Hang Seng Hong Kong LargeCap Index and the Hang Seng Hong Kong MidCap Index are excluded from the application

8. The combined effect of these two requirements is to require firms that adopt the imprudent lending practices described above to increase their capital to cushion themselves and their clients against the credit, liquidity and other financial business risks attendant with SMF firms' aggressive practices. This will increase protection to clients and reduce systemic market risks.

9. The proposed amendments have been designed to address specific risks arising from a particular type of business activity. They aim to achieve a targeted effect without affecting the general operation of the industry. The Commission estimates that about 95% of SMF firms will not need to inject additional capital as a result of the Amendment Rules. For the remaining 5%, the Commission will work with each affected firm to ensure compliance with the new requirements. In the event that any individual firm faces genuine difficulties in complying with the new requirements when they come into effect, the Commission will, pursuant to its powers under section 29 of the SFCO, consider granting temporary modifications of the new requirements where appropriate without undermining the interest of the investing public.

## **THE AMENDMENT RULES**

10. The Amendment Rules amend the FRRs to limit the main financial and credit risks arising from the provision of margin loans by securities dealers and securities margin financiers.

11. Section 2 of the Amendment Rules amends section 13 of the FRRs to require the application of a steep discount to the market value of certain securities held by the securities dealers and securities margin financiers as collateral, for the purpose of calculating their liquid assets.

12. Section 3 amends section 21 of the FRRs to require securities dealers and securities margin financiers to compare the total value of their margin loans to clients with the total value of loans they have obtained by re-pledging securities received from their margin clients. If the borrowings obtained by any securities dealer or securities margin financier exceed 65% of the total margin loans extended by him, the excess must be included in his ranking liabilities.

## **PUBLIC CONSULTATION**

13. The Commission published, on 4 March, a set of proposed amendments to the current FRR for public consultation. A total of 23 responses were received at the end of the consultation period. In the light of the responses, the Commission also met with industry bodies to discuss the proposals with them in more detail. After considering comments from the consultation and further discussions with the industry, the Commission made some adjustments to the discount rate and gearing adjustment ratio<sup>3</sup>. The final proposal as set out in paragraph 7 has already taken into account the comments and suggestions received.

14. The proposed amendments were considered by the Legislative Council Financial Affairs Panel at its meeting held on 6 May 2002. Members advised that as the proposal was accepted by the market in general and would be in the interest of the investing public, they supported the early implementation of the proposed amendments (as set out in paragraph 16 below). They noted that the

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<sup>3</sup> Specifically, the original proposal was to apply a 90% discount to certain illiquid shares and warrants. This has now been reduced to 80%. The ratio for the gearing adjustment was also originally set at 50%. This amount has been raised to 65%.

proposal would reduce risks in securities margin business and enhance protection for investors. They also noted the Commission's plan to study long-term measures for managing intermediaries' financial risks.

## **FINANCIAL AND STAFFING IMPLICATIONS**

15. There are no financial or staffing implications for the Government.

## **COMMENCEMENT DATE**

16. In order to allow time for registrants to prepare for the changes, the Amendment Rules will not come into operation until 1 October 2002. As explained to the Panel on 6 May 2002 (paragraph 14 above), the plan will meet the 28-day negative vetting requirement but the amendments would have taken effect before the expiry of the 21-day rule on extension for vetting because of the intervening summer recess. In view of the importance of the issue, we seek Members' understanding and support for this fast track arrangement.

## **PUBLICITY**

17. The Amendment Rules will be published in the Gazette on 31 May 2002. A press release will be issued on the same day. The Commission will issue a circular to registrants before the new requirements take effect.

## **ENQUIRIES**

18. For any enquiries on this brief, please contact Ms Thrity Mukadam of the Legal Services Division of the Commission at 2840 9209 or Ms. Yvonne Mok of the Intermediaries Supervision Department of the Commission at 2842 7638.

The Securities and Futures Commission

30 May 2002

## FINANCIAL RESOURCES (AMENDMENT) RULES 2002

(Made by the Securities and Futures Commission under section 28 of the Securities and Futures Commission Ordinance (Cap. 24) after consultation with the Financial Secretary)

### 1. Commencement

These Rules shall come into operation on 1 October 2002.

### 2. Amounts receivable from clients and securities margin financiers arising from dealings in securities or the provision of securities margin financing

Section 13 of the Financial Resources Rules (Cap. 24 sub. leg.) is amended -

(a) in subsection (4)(b) -

(i) in subparagraph (i), by adding ", other than illiquid collateral," after "collateral";

(ii) by adding -

"(ia) the market value of all illiquid collateral provided by the client, multiplied by 20%";

(b) by adding -

"(10) In this section, "illiquid collateral" (非速動抵押品), in relation to



collateral provided to a dealer or securities margin financier by a margin client, means any listed or traded share or warrant which is of the same description as that identified as the top 3 collateral where -

(a) if it is a share, the aggregate market value of all shares of the same description as that share provided to the dealer or securities margin financier by his margin clients as collateral is equal to or greater than -

(i) the average monthly turnover of that share; or

(ii) 5% of the total market capitalization of that share as at the end of the month immediately preceding the month prior to the month in which the calculation is made; or

(b) if it is a warrant, the aggregate market value of all

warrants of the same description as that warrant provided to the dealer or securities margin financier by his margin clients as collateral is equal to or greater than -

- (i) the average monthly turnover of that warrant; or
- (ii) 5% of the warrant issue as at the end of the month immediately preceding the month prior to the month in which the calculation is made,

but does not include -

- (c) any listed or traded share or warrant which has been listed or traded for less than 6 consecutive months (including any period during which the share or warrant is suspended from trading) immediately preceding the month prior to

the month in which the  
calculation is made; and

(d) any listed share which is a  
constituent stock of any of the  
following indices -

- (i) Hang Seng Index;
- (ii) Hang Seng Hong Kong  
LargeCap Index;
- (iii) Hang Seng Hong Kong  
MidCap Index;
- (iv) FTSE-100 Index;
- (v) Nikkei 225 Index; or
- (vi) Standard & Poor's 500  
Index.

(11) In this subsection and subsection  
(10) -

"average monthly turnover" (平均每月成交額), in  
relation to a listed or traded share or  
warrant, means one sixth of the aggregate  
value of transactions in that share or  
warrant on any stock market on which it  
is listed or traded for a period of 6  
consecutive months (including any period  
during which the share or warrant is  
suspended from trading) immediately

preceding the month prior to the month in which the calculation is made;

"calculation" (有關計算) means a calculation made for the purposes of subsection (4);

"market capitalization" (市場資本值), in relation to a share, means the total number of shares of the same class as that share issued by the issuer of that share, as multiplied by their market price;

"top 3 collateral" (首3位抵押品), in relation to a top margin client of a dealer or securities margin financier, means any of the 3 highest listed or traded shares or warrants in terms of market value among all shares or warrants provided by him to the dealer or securities margin financier as collateral;

"top margin client" (佔首位的保證金客戶), in relation to a dealer or securities margin financier, means -

(a) where he has less than 20 margin clients, each of his margin clients; or

(b) where he has 20 or more margin clients, each of the 20 margin

clients with the largest  
outstanding margin loan  
balances;

"traded" (買賣), in relation to any share or  
warrant, means traded on a stock market."

### **3. Provision of securities margin financing**

Section 21 is amended -

- (a) By renumbering it as section 21(1);
- (b) by adding -

"(2) Where a dealer or securities margin financier obtains financial accommodation wholly or partly secured by collateral provided by his margin clients, he shall include in his ranking liabilities the amount by which such financial accommodation exceeds 65% of the aggregate amount receivable from his margin clients arising from the provision of securities margin financing."

### **4. Liquid capital computation**

Schedule 7 is amended -

- (a) in item 21, in column 3, by repealing "21(a)" and substituting "21(1)(a)";

(b) in item 22, in column 3, by repealing "21(b)" and substituting "21(1)(b)";

(c) in item 29, in columns 2 and 3, by adding -

"—gearing adjustment		21(2)"
before -		
"—short selling of		24(6)".
securities on behalf		
of clients		

Andrew Len Tao SHENG  
Chairman,  
Securities and Futures Commission

2002

### **Explanatory Note**

The purpose of these Rules is to amend the Financial Resources Rules (Cap. 24 sub. leg.) ("the principal Rules") to limit the main financial and credit risks arising from the provision of margin loans by securities dealers and securities margin financiers.

2. Section 2 amends section 13 of the principal Rules to require the application of a steep discount to the market value of certain

securities held by the securities dealers and securities margin financiers as collateral, for the purpose of calculating their liquid assets.

3. Section 3 amends section 21 of the principal Rules to require securities dealers and securities margin financiers to compare the total value of their margin loans to clients with the total value of borrowings they have obtained by re-pledging securities received from their margin clients. If the borrowings obtained by any securities dealer or securities margin financier exceed 65% of the total margin loans extended by him, the excess must be included in his ranking liabilities.

4. Section 4 amends Schedule 7 to the principal Rules by introducing consequential renumbering of references to section 21 of the principal Rules, and adding a new item relating to the gearing adjustment required under the new section 21(2).