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**Legislative Council**

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**Panel on Financial Affairs**  
**Special meeting on 17 December 2004**

**Background Brief**  
**on proposed measures to address risks**  
**arising from securities margin financing**

**Purpose**

This paper sets out the background of the proposals by the Securities and Futures Commission (SFC) to address risks arising from business of securities margin financing, and summarizes the major views and concerns expressed by Members when the proposals were deliberated at meetings of the Panel on Financial Affairs (FA Panel) on 7 July 2003 and 1 March 2004.

**Background**

2. When examining the Securities (Margin Financing) (Amendment) Bill 1999 introduced to address the inadequacy of the then regulatory framework exposed by the collapse of C.A. Pacific in early 1998, Members requested the Administration to review the effectiveness of the regulatory measures in dealing with the risks arising from the practice of some securities margin finance (SMF) providers pooling and re-pledging their margin clients' securities for obtaining loan facilities. SFC agreed to conduct the review.

3. At the FA Panel meeting on 6 May 2002, SFC briefed members on two proposed interim measures<sup>1</sup> under the then Financial Resources Rules (FRR) to address the financial risk posed to SMF providers and their clients due to the former's aggressive lending and funding practices. Members noted that

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<sup>1</sup> The two measures are:

- (a) to apply a 80% haircut on certain stocks and warrants pledged with securities margin financiers and brokerage firms as margin collateral; and
- (b) to include in a firm's ranking liabilities the amount of its total borrowings secured by re-pledging margin clients' securities that is in excess of 65% of the total amount of loans extended to margin clients.

during consultation on these proposed measures, the industry had requested SFC to examine two issues, namely the need to tailor regulatory capital requirements to securities firms based on the risk level of the line of business, and the practice of firms being permitted to pool their margin clients' securities and re-pledge the securities of even the non-borrowing margin clients as collateral for obtaining bank loan facilities. As these concerns were fundamental issues underlying the overall regulatory framework, SFC undertook to review the regulatory framework for managing brokers' financial risks in other securities market jurisdictions and the adequacy of the existing regulatory framework. SFC then set up a working group<sup>2</sup> (the Working Group) to take forward the review.

4. At the FA Panel meeting on 7 July 2003, SFC briefed members on the work progress of the Working Group. SFC published its report on the recommendations of the Working Group in February 2004 and then briefed the FA Panel on the subject at its meeting on 1 March 2004. Members noted that implementation of the two major proposed measures would require amendments to the FRR and the Client Securities Rules which are subsidiary legislation under the Securities and Futures Ordinance (Cap. 571). Members also noted SFC's plan to consult the public on the recommendations of the Working Group and the proposed legislative amendments in the second quarter of 2004. SFC would then consult the Administration on the proposed legislative amendments before consulting the FA Panel in the 2004-05 legislative session.

### **Major findings and recommendations of the Working Group**

5. At its meetings on 7 July 2003 and 1 March 2004, the FA Panel noted the major findings and proposed measures of the Working Group, as follows -

#### Major findings

- (a) It is international practice to require brokers to be well capitalized. The capital level should be commensurate with their risks. The Working Group would continue to examine whether the present capital level in Hong Kong should be increased;
- (b) On pooling and re-pledging client collateral, it is international best practice to segregate non-borrowing margin client collateral;

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<sup>2</sup> The Working Group on the Review of the Financial Regulatory Framework for Intermediaries was convened by SFC in May 2002. The Working Group was subsequently renamed to "Working Group on the Review of the Financial Regulatory Framework for Licensed Corporations". It comprises 15 members, including representatives of securities firms of different sizes, fund managers, academia, and a representative of the Consumer Council.

- (c) The present capital requirements for share margin finance providers engaged in re-pledging should be strengthened; and
- (d) Margin clients should be better informed regarding the re-pledging of the securities collateral. SFC should be requested to step up investor education on the risks of pooling and re-pledging of securities collateral.

Proposed measures

- (e) To impose a limit on the amount of clients' collateral that a SMF provider could re-pledge to secure its borrowing; a limit within the range of 130% to 150% of the total loans lent by a SMF provider may be considered;
- (f) To increase the haircut percentage rates on clients' collateral prescribed in FRR to encourage SMF providers to adhere to prudent lending ratios by collecting adequate collateral from margin clients;
- (g) To improve the Code of Conduct disclosure obligations by requiring SMF providers to disclose additional information to their clients and/or SFC; and
- (h) To step up investor education on the risks of pooling and re-pledging of securities collateral.

6. Members also noted that according to the studies conducted by SFC, the two core proposed measures mentioned in paragraph 5(e) and (f) above would affect only a small number of firms. Moreover, the Working Group recommended a 12-month transitional period for licensed corporations to attain full compliance with the proposed measures. SFC was prepared to work closely with any affected firms to resolve their problems during the transitional period.

**Major views and concerns expressed by Members at meetings of the Panel on Financial Affairs**

7. At the FA Panel meetings on 7 July 2003 and 1 March 2004, members indicated support for the Working Group's proposed measures to address risks arising from securities margin financing and to enhance investor protection. Some members urged that the measures be implemented as soon as possible. The views and concerns expressed by members are summarized as follows:

- (a) In formulating any new regulatory measures, a balance should be struck between investor protection and the additional burden to be imposed on the industry by the measures;
- (b) As a matter of principle, SMF providers should not be allowed to re-pledge the collateral of non-borrowing margin clients. The restriction, which was in line with international practice, would enhance investor protection and reinforce Hong Kong's position as an international financial centre;
- (c) On the need to increase the capital requirements for brokers, comparison of the capital requirements in Hong Kong with those in other places might not be appropriate because of the differences in market conditions; and
- (d) It was not sure whether the proposed 12-month transitional period was adequate for licensed corporations to attain full compliance with the two core proposed measures mentioned in paragraph 5(e) and (f) above.

8. The extracts of the minutes of the FA Panel meetings on 7 July 2003 and 1 March 2004 are in **Appendix I and II** respectively.

### **Latest developments**

9. In September 2004, SFC published a consultation paper to consult the public and the market on the proposed measures to strengthen the overall regulatory framework to address risks arising from securities margin financing. The consultation period ended on 31 October 2004. SFC will report to the FA Panel on the preliminary outcome of the consultation in December 2004.

### **Reference**

10. A list of relevant papers is in **Appendix III**.

**Extract from the minutes of meeting  
of the Panel on Financial Affairs on 7 July 2003**



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**V. Proposed consultation on Review of the Financial Regulatory Framework for stockbrokers**

(LC Paper No. CB(1)2109/02-03(04) — Information paper provided by the Administration)

Briefing on the Review of Financial Regulatory Framework

13. At the Chairman's invitation, the Permanent Secretary for Financial Services and the Treasury (Financial Services) (PSFS) briefed members on the background of the Review on the Financial Regulatory Framework for Securities Dealers and Securities Margin Financing Providers (the Review) conducted by the Working Group on the Review of the Financial Regulatory Framework for Intermediaries (the Working Group). He pointed out that when the Securities and Futures Commission (SFC) briefed the Panel on 6 May 2002 on its interim measures under the then Financial Resources Rules (FRR) for reducing the financial risk posed to securities margin financing providers and their clients, SFC had undertaken to review the regulatory framework for managing brokers' financial risks in other securities market jurisdictions and the adequacy of the existing regulatory framework in Hong Kong. The Administration had reported progress to the Legislative Council (LegCo) in the context of the FRR made under the Securities and Futures Ordinance in September and December 2002 that SFC had formed the Working Group to take forward the Review. The Executive Director of SFC would update members on the progress of the Review at this meeting; and the Government and the SFC would wish to seek Members' views on the broad direction.

14. PSFS highlighted two points on Government policy. First, the Government attached primary importance to investor protection, and to minimizing systemic risks. The objective that the Government wished to achieve through the SFC was to put in place effective and balanced measures to address the risks facing both practitioners and investors in the securities market. Second, the Government wished to encourage the healthy development of the industry. It had been and remained Government policy that the regulatory regime should be as light as possible, and consistent with the principles of prudence and equity. The Government trusted that the measures eventually devised by SFC in consultation with the industry would be balanced and targeted, and would thus avoid overburdening responsible practitioners. The Government had confidence in SFC's ability to achieve these objectives.

15. At the Chairman's invitation, Mrs Alexa LAM, the Executive Director of SFC, briefed members on the progress of the Review. She said that the Working Group had identified two major reasons for brokers default under the current market structure and business model: integrity risk (misappropriation of client assets) and risky margin lending practices and pooling and re-pledging client collateral. In the last 15 months, there had been nine cases of misappropriation of client assets with total loss amounting to \$186.6 million. As regards margin financing and pooling risks, there were no restrictions on brokers pooling and re-pledging client collateral. If a broker failed, the loss to investors could be huge. The failure of CA Pacific was a good example. Moreover, current rules on financial resources of brokers were old rules. The current liquid capital level of \$3 million had been set in 1993 when the FRR was first introduced and the current required paid-up capital level of \$5 million (agency brokers) had been in place before SFC came into existence. Market conditions and risk levels had substantially changed since then but the required capital levels remained the same. It was therefore timely to conduct a review and introduce changes to protect investors and the integrity of the market. Mrs LAM also highlighted the following findings and recommendations of the Working Group:

- (a) After studying models adopted in the Mainland, Singapore and Taiwan, the Working Group concluded that it was international practice to require brokers to be well capitalized.
- (b) The capital level of brokers should be commensurate with their risks. Capital level should be lower for brokers who did not hold client assets (i.e. no integrity risks) and higher for those who did. The Working Group would continue to examine whether the present capital level should be increased. It recognized that if capital levels were increased for brokers holding client assets, there should be a solution for existing brokers who could not meet the new capital requirements. The Working Group would explore possible options, including the new Investor Participation Account (IP Account) model being developed by the Hong Kong Exchanges and Clearing Limited (HKEx).
- (c) On pooling and re-pledging client collateral, the Working Group agreed that it was international best practice to segregate non-borrowing margin client collateral. However, the Working Group could not reach a consensus on a workable model for segregation.
- (d) The Working Group had formed no definitive view on the capital level for share margin financing providers. However, there was broad consensus among members of the Working Group that the present capital requirements for share margin financing providers engaged in re-pledging should be strengthened and that the Working Group should continue to examine the following interim measures:

- Giving SFC a reserve power to require individual firms to reduce their risks (e.g. by retaining higher levels of shareholders equity in the firm itself);
  - Tightening FRR to curb risky margin lending practices (e.g. imposing capital charge on the portion of a margin loan exceeding a prudent level).
- (e) Margin clients should be better informed regarding the re-pledging of the securities collateral. SFC should be requested to step up investor education on the risks of pooling and re-pledging.

16. Mrs Alex LAM said that SFC fully understood that the securities industry was undergoing a period of difficulty and stress as market conditions continued to change. However, under the Securities and Futures Ordinance (Cap. 571), the SFC had statutory obligation to put the interest of investors as priority. It was also in the industry's long term interest to protect investors. As such, SFC would work together with the Working Group, the industry, LegCo and the Administration to find a suitable solution as soon as possible.

*(Post-meeting note: The speaking notes of the Executive Director of SFC were circulated to members vide LC Paper No. CB(1)2176/02-03 on 8 July 2003.)*

## Discussion

### *Impact of the Review on the securities industry*

17. Mr Henry WU expressed the concern of the securities industry over the Review. While recognizing the need for reviewing the current regulatory framework for brokers in order to strengthen investor protection, the industry was concerned how far the current framework would be tightened up and what impact the new measures would have on brokers. The industry considered that the Working Group, in formulating any proposed new regulatory measures for consultation, should strike a balance between investor protection and the additional burden to be imposed on the industry by the measures. As regards the need to increase the capital requirements for brokers, comparison of the capital requirements in Hong Kong with those in other places might not be appropriate because of the differences in market conditions. Mr WU urged the Working Group to examine the relevant issues thoroughly before putting forward any proposals for consultation, taking into account the impact of the proposals on brokers under the present unfavourable economic condition.

SFC

18. Mr CHAN Kam-lam saw the need to strengthen investor protection through tightening up the regulatory requirements on brokers. He however shared Mr Henry WU's view that the impact of the proposals on brokers under the present unfavourable economic condition should also be taken into consideration. He commented that increase in capital requirements for brokers might not necessarily strengthen protection for investors against risks resulted from brokers' engagement in aggressive and imprudent lending. Mr NG Leung-sing shared Mr CHAN's view.

19. Given that the industry was facing great difficulty under the present market condition, Mr SIN Chung-kai considered it more appropriate to introduce risk control measures than reform measures. He suggested that further discussion among SFC, the Administration and the industry should be held with a view to reaching a consensus on the solutions to the problems identified. In response, PSFS said that given the complexity of the issues involved, it would take time to work out a balanced and practicable solution which would strengthen investor protection without imposing excessive burden on market practitioners.

*Representativeness of the Working Group*

20. Pointing out the contributions of small and medium brokers, Mr NG Leung-sing was concerned whether the interests of these brokers and their clients were adequately represented in the Working Group.

21. Mrs Alexa LAM responded that the 15-member Working Group included 11 broker representatives of different sizes. The remaining four members included representatives of the Hong Kong Investment Funds Association, academia, the media and the Consumer Council. The representative of the Consumer Council represented the interests of investors as a whole. While SFC aimed to balance views from market participants and investors through appointing members of different background to the Working Group, the membership might not be able to represent all the industry's views. Hence, after collecting Members' views on the Review, SFC would report back to the Working Group and finalize the proposals for public consultation. The submissions received during the consultation period would be made available to the public through the SFC website. In response to Mr NG Leung-sing's concern over the collection of views from clients of small and medium size brokers, Mrs LAM undertook to explore means to gauge the views of these clients during the consultation period.

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*Proposed Investors' Participation Account*

22. Mr CHAN Kam-lam opined that the implementation of the IP Account should be able to address some of the problems identified in the current system. Noting that HKEx had been developing a new IP Account model for some time, Mr CHAN enquired whether SFC and the Administration would support the implementation of the model, and the timing for implementation.

23. Mrs Alexa LAM responded that as far as she knew, the IP Account model being developed by HKEx would be ready for consultation in two months' time. Despite that various IP Account models were currently being provided by banks in the form of global custodian, market practitioners were in support of the development of an IP Account model by HKEx. Mrs LAM said that the priority of SFC was investor protection. Having identified the integrity risk posed to investors under the current market structure and business model, SFC considered that the problems should be resolved through appropriate improvement measures. SFC would explore all



proposed options, including the IP Account model being developed by HKEx or any other models proposed by the industry.

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24. Mr CHAN Kam-lam requested the Administration and SFC to urge HKEx for the early completion of its IP Account model.

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**Extract from the minutes of meeting  
of the Panel on Financial Affairs on 1 March 2004**



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**IV. Briefing on the Report of the Securities and Futures Commission on the Recommendations made by the Working Group on Review of the Financial Regulatory Framework for Licensed Corporations**

(LC Paper No. CB(1)1094/03-04(03) — Paper provided by the Administration

LC Paper No. CB(1)1094/03-04(04) — Report of the Securities and Futures Commission on the Recommendations made by the Working Group on Review of the Financial Regulatory Framework for Licensed Corporations)

7. The Deputy Chairman pointed out that at the meeting on 7 July 2003, the Panel had been briefed on the progress of the review conducted by the Working Group on the Review of the Financial Regulatory Framework for Intermediaries convened by the Securities and Futures Commission (SFC) in May 2002. The Working Group was subsequently renamed to “Working Group on Review of the Financial Regulatory Framework for Licensed Corporations” (the Working Group). Taking into account members’ views expressed at the meeting on 7 July 2003, the Working Group had further examined different proposals and agreed on some recommended measures. The Working Group’s report was submitted to the Panel on 23 February 2004 to seek members’ views before conducting a public consultation exercise.

Briefing on the Working Group’s recommendations

8. At the invitation of the Deputy Chairman, Mrs Alexa LAM, Executive Director for Intermediaries and Investment Products, SFC briefed members on the Working Group’s recommendations and the proposed way forward. She highlighted the following points:

- (a) The main task of the Working Group was to recommend effective measures for managing default risks in the securities industry, in particular those arising from pooling and re-pledging margin clients’ securities collateral as seen in the default of C.A. Pacific in 1998. Such measures were important in enhancing investor protection and the quality of Hong Kong’s securities market, and reinforcing Hong Kong’s position as an international financial centre.

- (b) The Working Group recommended two core measures to address pooling and re-pledging risks. First, it recommended the imposition of a limit on the amount of clients' collateral that a securities margin finance (SMF) provider could re-pledge to secure its borrowing. As proposed by the Working Group, a limit within the range of 130% to 150% of the total loans lent by a SMF provider might be considered. This core measure, which was modelled on the practice in the United States (US), would result in SMF providers re-pledging a smaller proportion of clients' collateral with banks, thus increasing the amount of clients' collateral available for distribution in the event of the firm's collapse. The measure would also prevent SMF providers from over-borrowing against clients' collateral, thereby encouraging them to adopt more cautious lending and borrowing practices. To allow flexibility for SMF providers, the re-pledging limit would be calculated on the total loans lent by a firm instead of on an individual client basis as in the case of the US.
- (c) Secondly, the Working Group recommended an increase in the haircut percentage rates prescribed in the Financial Resources Rules (FRR). FRR haircut percentages on clients' collateral were used to calculate the amount of liquid capital a SMF provider was required to maintain as buffer against market and liquidity risks. The Working Group considered that the current haircut percentages did not reflect market and volatility risks and therefore recommended increases in the percentages, as follows -

<b>Stocks and warrants</b>	<b>Existing FRR haircut %</b>	<b>Proposed new FRR haircut %</b>
HSI/HSHK LargeCap Index	15%	20%
HSHK MidCap	20%	40%
MSCI HK/ MSCI China Index	N/A	40%
Other Hang Seng Composite Index constituents	30%	60%
All other stocks	30%	80%
Warrants	40%	100%

The proposed new FRR haircut percentages would still be significantly lower than the average haircut percentages used by banks and brokerages. The measure would not affect the haircut rates on collateral set by SMF providers with their clients; nor would it stop an investor from trading in

any stocks, or a broker from lending against any stocks. The measure was designed to encourage SMF providers to adhere to prudent lending ratios by collecting adequate collateral from margin clients. SMF providers that lent at high lending ratios would be required to use their own capital so that market and credit risks would be borne by SMF providers instead of their clients.

- (d) The Working Group also recommended two supplementary measures. The first measure was to improve the Code of Conduct disclosure obligations by requiring SMF providers to disclose additional information to its clients and/or the regulator. The second measure was to step up investor education on the risks of pooling and re-pledging of securities collateral.
- (e) According to the studies conducted by SFC, the two core measures would affect only a small number of firms. With the recent increase in market turnover and improved profit levels, SFC believed that these firms should be in a better position to achieve compliance. Moreover, the Working Group recommended a 12-month transitional period for licensed corporations to attain full compliance with the proposed measures. SFC was prepared to work closely with any affected firms to resolve their problems during the transitional period.
- (f) SFC planned to commence a public consultation exercise on the Working Group's recommendations in the second quarter of 2004. Subject to the public comments received, SFC would consult the Administration on the proposed legislative amendments before consulting Legislative Council (LegCo) Members at the next legislative session. SFC maintained an open mind on the recommendations and welcomed views from Members, market and the investing public.
- (g) The Working Group had included in the Report its own views on some of the key long-term issues, including the need to converge with international standards of achieving complete segregation of non-borrowing margin clients' collateral and the consideration of tiering capital requirements to levels commensurate with the risks assumed by firms. Moreover, SFC also took the view that more could be done to minimize the risk of brokerage failure. It proposed that an internal working group be established to examine the complex issue arising in the context of appointing a manager to take over and manage the business of a firm which was considered likely to default on its obligations. SFC would report the outcome of the review to the Panel in due course.

9. The Permanent Secretary for Financial Services and the Treasury (Financial Services) (PS/FST(FS)) advised that the Administration welcomed the Working Group's recommendations which were in the right direction in enhancing investor protection and facilitating the healthy development of Hong Kong's securities market.

He stressed that the Administration maintained an open mind on the recommendations and looked forward to views from Members and the public.

*(Post-meeting note: The presentation material provided by SFC and Mrs Alexa LAM's speaking note were circulated to members and non-Panel Members vide LC Paper Nos. CB(1)1179/03-04(01) and (02) on 5 March 2004 respectively.)*

## Discussion

### *Pooling and re-pledging collateral of non-borrowing margin clients*

10. Mr CHAN Kam-lam welcomed the proposed core measures and urged that the measures be implemented as soon as practicable. However, Mr CHAN considered that as a matter of principle, SMF providers should not be allowed to re-pledge the collateral of the clients who had not borrowed from the providers. Pointing out that it was unfair to the clients concerned, Mr CHAN stressed the need to protect their interests.

11. Mrs Alexa LAM shared Mr CHAN Kam-lam's view that the re-pledging of non-borrowing margin clients' collateral was unfair to them. She pointed out that the Working Group recognized the need to address the issue in the long run, as the existing infrastructure of the market did not permit segregation of margin clients' collateral. As an interim measure, the Working Group considered the proposed imposition of a re-pledging limit a viable option to address the risks concerned because at least a portion of clients' collateral would not be re-pledged. Mrs LAM stressed that it remained the long-term goal of SFC to achieve complete segregation of non-borrowing margin clients' collateral so as to comply with international standards.

12. Mr Albert HO, on behalf of the LegCo Members of the Democratic Party, expressed support for the proposed measures to enhance investor protection. Sharing Mr CHAN Kam-lam's view that SMF providers should not be allowed to re-pledge the collateral of non-borrowing margin clients, Mr HO considered that the ultimate solution to the problem was to prohibit SMF providers from pooling such collateral at the outset.

13. Mrs Alexa LAM explained that unless authorized by their clients, SMF providers were not permitted to pool and re-pledge clients' collateral. As clients usually borrowed and re-paid their margin loans frequently, it would be very difficult and would involve costs for SMF providers to differentiate the collateral of borrowing clients from that of non-borrowing clients.

14. Noting that re-pledging of non-borrowing margin clients' collateral was not permitted in other major international financial centres, Ms Emily LAU stressed the importance for Hong Kong to meet international standards so as to enhance investor protection and reinforce Hong Kong's position as an international financial centre. In this connection, she enquired about the arrangement for segregation of non-borrowing

clients' collateral in other financial centres and suggested that SFC should expedite its study in this respect.

15. Mrs Alexa LAM explained that other major international financial centres required brokerages to segregate and keep the collateral of non-borrowing margin clients in safe custody. However, re-pledging of clients' collateral was a practice historically permitted in Hong Kong for SMF providers to finance their working capital. While the Working Group recognized that segregation of non-borrowing margin clients' collateral was the best international practice, it also noted that the requirement would impose financial burden on most firms in Hong Kong, in particular the small ones. For example, firms would be required to acquire and maintain sophisticated information technology systems to differentiate the collateral of borrowing clients from that of non-borrowing clients. It would also involve costs for the firms to move securities in and out of accounts held with banks to which the non-borrowing clients' collateral was re-pledged. Mrs LAM further pointed out that other financial centres were able to implement segregation of non-borrowing margin clients' collateral because SMF providers used their own capital to finance loans to margin clients instead of relying on re-pledging of clients' collateral as a resource of funding. Mrs LAM reiterated that it was the long-term goal of SFC to achieve complete segregation of non-borrowing margin clients' collateral so as to meet international standards. SFC would explore with the market the possible means to improve the present infrastructure to facilitate segregation of clients' collateral. It would also reflect members' views in this regard to the public during the public consultation exercise to be conducted later.

16. The Deputy Chairman noted from the Report that members of the Working Group had different views on whether re-pledging of non-borrowing margin clients' collateral should be allowed. He doubted why SFC had concluded that achieving complete segregation of non-borrowing margin clients' collateral was the way forward for Hong Kong. He also remarked that some members of the Working Group were concerned that the restrictions imposed on pooling and re-pledging of clients' collateral might drive small brokers out of business, which would be detrimental to the long-term development of the market.

17. Mrs Alexa LAM advised that a few members of the Working Group had expressed strong support for the complete segregation of non-borrowing margin clients' collateral. SFC shared their view because the re-pledging of non-borrowing margin clients' collateral was unfair to the clients concerned and not in line with international practice. Mrs LAM also stressed that the purpose of regulating pooling and re-pledging activities of SMF providers was for the healthy development of the market. There was no intention to drive small brokers out of business. SFC recognized that the vast majority of SMF providers had been conducting their business prudently. They financed their lending business with their own funds and did not re-pledge client's collateral. However, other SMF providers who did re-pledge could re-pledge all available clients' collateral. The proposed measures aimed to require those small number of imprudent SMF providers to cut down their aggressive re-pledging activities.

18. Noting that SFC had stepped up regulatory measures on SMF activities after the C.A. Pacific incident in 1998, the Deputy Chairman enquired how far these measures had helped address the risks of pooling and re-pledging of clients' collateral.

19. Mr Stephen PO, Senior Director of Intermediaries and Investment Products, SFC advised that under the Securities (Margin Financing) (Amendment) Ordinance passed in 2000, all SMF providers, including unregulated finance companies, were brought under the regulatory framework of SFC. Moreover, SMF providers were required under the non-statutory Code of Conduct to limit the amount of borrowings secured by pledging of clients' collateral to not more than 120% of the total margin loans granted to all clients. Given that the latter measure was not effective, SFC introduced in May 2002 two new financial requirements, i.e. the 65% gearing ratio adjustment and the illiquid collateral haircut. These were designed to be interim measures pending the study of the Working Group on the long-term measures to manage margin financing risks. Mrs Alexa LAM added that while the interim measures had reduced margin financing risks to some extent, SMF providers might still re-pledge all clients' collateral and use the borrowings for different purposes. If an SMF provider adopted aggressive lending and re-pledging practices, in the event of its default, the disastrous outcomes of C.A. Pacific collapse where there were serious losses by clients and systemic risks on the market could recur.

20. The Deputy Chairman considered that SFC should study how far the measures implemented after the C.A. Pacific incident had addressed the problems related to the incident and how recurrence of similar incidents could be prevented. He pointed out that it might not be appropriate to follow the international regulatory standards, as the situations in Hong Kong's market were different from those in other jurisdictions. Mr Abraham SHEK also considered that the practices in other jurisdictions might not be suitable for Hong Kong. He urged SFC to develop regulatory measures catering for the situations in Hong Kong's market.

*Transitional period for the two core measures*

21. Mr CHAN Kam-lam was concerned whether the proposed 12-month transitional period was adequate for licensed corporations to attain full compliance with the two core measures. Mrs Alexa LAM said that the public would be consulted on the 12-month transitional period recommended by the Working Group. She also pointed out that only a small number of firms would be affected by the measures. With the recent increase in market turnover and improved profit levels, there should be no great problems for these firms to achieve full compliance by the end of the transitional period. In this connection, it was revealed from SFC's studies that the turnover for types B and C brokers had improved by three and four times respectively as compared to the levels a year before. To assist SMF providers to comply with the measures, SFC had started discussion with the likely affected providers to help them sort out related operational problems.

*Timetable for implementing the two core measures*

22. Mr SIN Chung-kai enquired about the timetable for implementing the proposed core measures. Mrs Alexa LAM advised that implementation of the measures would involve amendments to FRR and the Client Securities Rules (CSR), and both of them would be subsidiary legislation under the Securities and Futures Ordinance (SFO) (Cap. 571) subject to negative vetting of LegCo. SFC planned to consult the public on the Working Group's recommendations and the proposed amendments to FRR and CSR in the second quarter of 2004. The consultation would last for about a month. SFC would then consult the Administration on the proposed amendments before consulting Members in the next legislative session. Subject to public comments received during the consultation period and Members' views, SFC envisaged that the proposed measures could be implemented in the fourth quarter of 2004.

23. The Deputy Chairman considered it more appropriate for SFC to draft the proposed amendments after the outcome of the public consultation was known. Mrs Alexa LAM advised that as revealed from past experience, market practitioners preferred to be consulted on the proposed measures and the drafting of any proposed amendments at the same time. Where considered appropriate, SFC would revise the drafting of the proposed amendments in the light of the comments received during the consultation stage to facilitate compliance by market practitioners.

*Composition of the Working Group*

24. Noting that ten of the 13 members of the Working Group were representatives from the securities industry, Ms Emily LAU was concerned whether the Working Group was able to represent the interests of investors. Ms LAU considered that in future, SFC should ensure that composition of its working groups had a balanced representation.

25. In response, Mrs Alexa LAM advised that the ten members from the securities industry were appointed to the Working Group because of their experience and expertise in the industry. SFC recognized the important roles played by both market and non-market representatives in the Working Group. In the past 22 months, the Working Group had held 14 meetings. All members had worked together to formulate proposals that would enhance investor protection against risks of pooling and re-pledging of clients' collateral while imposing the least burden on the industry.

26. The Deputy Chairman considered that the Working Group had a broad based membership and was well-balanced in representation. The ten market members were from securities firms of different scale, while the three non-market members were from the academia, the Hong Kong Investment Funds Association and the Consumer Council. He stressed that the financial services industry strove to protect the interests of the investing public, as enhancement of investor protection would benefit the long-term development of the industry and the market. While the industry recognized the need to regulate imprudent margin lending and excessive re-pledging



practices of some SMF providers, it stressed that regulatory measures should not adversely affect the operation of the vast majority of firms which had been conducting their business prudently.

27. Mr James TIEN considered the appointment of ten market members to the Working Group acceptable if they could represent different categories of securities firms.

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**Proposed measures to address risks arising from securities margin financing**

**List of relevant papers**  
(Position as at 15 December 2004)

<b>Paper/Report</b>	<b>LC Paper No.</b>
Administration's paper on "Proposed amendments to the current Financial Resources Rules"	CB(1)1628/01-02(06) <i>(discussed at the FA Panel meeting on 6 May 2002)</i>
Minutes of the FA Panel meeting on 6 May 2002	CB(1)2289/01-02
Administration's paper on "Review on the financial regulatory framework for securities dealers and securities margin financing providers"	CB(1)2109/02-03(04) <i>(discussed at the FA Panel meeting on 7 July 2003)</i>
Minutes of the FA Panel meeting on 7 July 2003	CB(1)2392/02-03
Report of the Securities and Futures Commission on the recommendations made by the Working Group on Review of the Financial Regulatory Framework for Licensed Corporations	CB(1)1094/03-04(04) (Revised) <i>(discussed at the FA Panel meeting on 1 March 2004)</i>
Administration's paper on "SFC report on the recommendations of the Working Group on the Review of the Financial Regulatory Framework for Licensed Corporations"	CB(1)1094/03-04(03) <i>(discussed at the FA Panel meeting on 1 March 2004)</i>
Minutes of the FA Panel meeting on 1 March 2004	CB(1)1630/03-04