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Panel on Financial Affairs
Meeting on 6 February 2006

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

Purpose

This paper sets out the background of the Securities and Futures Commission (SFC)'s proposals 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 1 March and 17 December 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 measures¹ 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

¹ 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 examine the regulatory framework for managing brokers' financial risks in other securities market jurisdictions and review the adequacy of the existing regulatory framework. SFC then set up a working group² (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. Members noted 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 clients' collateral. On integrity risk, there had been nine cases of misappropriation of client assets with total loss amounting to \$186.6 million in the previous 15 months. As regards risky margin lending practices, there were no restrictions on brokers pooling and re-pledging clients' collateral. If a broker failed, the loss to investors could be huge. Moreover, the current capital requirements for brokers under the FRR had not been revised for a long time and were thus out of step with the level of risks assumed by brokers in the conduct of their business. The current liquid capital requirement of \$3 million for licensed brokers had been set in 1993 when the FRR was first introduced, and the current paid-up capital requirement of \$5 million for agency brokers had been in place for over 15 years. Members noted that SFC would work with the Working Group and the industry to find a suitable solution to protect investors and the integrity of the market.

5. SFC then published its report on the recommendations of the Working Group in February 2004 and briefed the FA Panel on the subject at its meeting on 1 March 2004. Members noted the two principal proposed measures put forward by the Working Group, namely, the imposition of a limit on the amount of margin clients' collateral that a firm could re-pledge to secure its borrowing, and the increase in the haircut percentages applied to margin clients' collateral under the FRR³. Members noted that implementation of the two principal

² 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.

³ FRR haircut percentages on clients' collateral are used to calculate the amount of liquid capital a SMF provider is required to maintain as buffer against market and liquidity risks. The Working Group considers that the current haircut percentages do not reflect market and volatility risks and has therefore recommended increases in the percentages.

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 and the market on the recommendations of the Working Group and the proposed legislative amendments.

6. In September 2004, SFC published a consultation paper to consult the public and the market on the recommendations of the Working Group. At the FA Panel meeting on 17 December 2004, SFC reported on the outcome of the consultation. Members noted that SFC had received 24 written submissions, 17 of which were from industry respondents. While all non-industry respondents supported the proposed measures, the majority of the industry respondents either had concerns that the proposed measures would affect their business, or did not support the proposals. SFC undertook that it would continue discussions with the brokerage industry, with a view to finalizing the proposals in 2005. The FA Panel requested the Administration and SFC to report the progress to the Panel before the end of December 2005, including the proposed timetable for achieving complete segregation of collateral of borrowing and non-borrowing margin clients.

Major findings and recommendations of the Working Group

7. At its meeting on 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 clients' collateral, it is international best practice to segregate non-borrowing margin clients' collateral;
- (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 percentages 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.

8. The FA Panel also noted that the Working Group recommended a 12-month transitional period for licensed corporations to attain full compliance with the proposed measures.

Outcome of public consultation conducted in 2004

9. At its meeting on 17 December 2004, the FA Panel noted the major views expressed in the submissions responding to the consultation conducted by SFC, as follows:

- (a) All respondents generally accepted that the rationale behind the proposed reforms was to enhance investor protection. All non-industry respondents supported the proposed measures, and some of them even criticized that the proposed measures did not go far enough to provide complete protection for investors. Of the industry respondents, some expressed their support while the majority had either expressed concerns that the proposed measures would affect their business, or disagreed with the proposals;
- (b) On the proposal of imposing a re-pledging limit, all non-industry respondents fully supported the proposal for better investor protection. In this connection, the Consumer Council (CC) and Hong Kong Bar Association advocated complete segregation of borrowing and non-borrowing margin clients' collateral to protect investors. Of the industry respondents, while two brokerage associations and some brokers expressed support, others either had reservation about or disagreed with the proposal. A broker (which was one of the existing 89 SMF firms that re-pledged clients' collateral, and had a sizeable margin financing business) preferred complete segregation to the re-pledging limit. However, some industry respondents argued that existing brokerage firms would be

impacted by the proposed re-pledging limit, and suggested a wider re-pledging limit ranging from 180% to 300%. A few industry respondents did not agree with the mechanism at all. They pointed out that pooling was a long-established common practice of the securities industry, and the proposal would increase their costs and affect their profitability and business; and

- (c) As regards the proposal of increasing FRR haircut percentages, some respondents supported the proposed percentages, while others suggested modest increase or preferred no change at all. The CC suggested bringing the haircut percentages in line with the average haircut rates adopted by banks and SMF providers (i.e. higher rates than those proposed by the Working Group).

10. The FA Panel also noted that SFC would continue dialogue with the industry to identify the most suitable measures for reducing risks and give the industry a reasonable transitional period for accommodating changes to the existing practice. SFC planned to finalize the proposals in 2005.

Members' major views and concerns expressed at meetings of the FA Panel

11. At the FA Panel meetings on 1 March and 17 December 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 major 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. In this connection, concern was raised about the impact of the proposed measures on the small SMF providers;
- (b) As a matter of principle, SMF providers should not be allowed to re-pledge the collateral of non-borrowing margin clients. SFC should work out a concrete timetable for achieving complete segregation of borrowing and non-borrowing margin clients' collateral so as to enhance investor protection and enable Hong Kong's regulatory system to meet international standards;
- (c) The proposed imposition of a re-pledging limit would not solve all the existing problems associated with aggressive and imprudent practices of SMF providers. In this connection, SFC should

consider further measures for enhancing investor protection, including the following suggested measures -

- (i) Requiring SMF providers to inform clients in writing of the potential risks they would be exposed to under the pooling and re-pledging practices;
 - (ii) Introducing a categorization system of SMF providers to differentiate SMF providers which pooled and re-pledged clients' collateral from those which had no such practice; and
 - (iii) Stepping up investor education on the risks of SMF activities, such as by reminding investors that SMF providers were not permitted to pool and re-pledge clients' collateral without clients' authorization.
- (d) It was not sure whether the proposed 12-month transitional period was adequate for licensed corporations to attain full compliance with the two principal measures.

12. The extracts of the minutes of the FA Panel meetings on 1 March and 17 December 2004 are in **Appendices I** and **II** respectively. At the meeting on 17 December 2004, the FA Panel requested the Administration and SFC to report progress to the Panel before the end of December 2005, including the proposed timetable for achieving complete segregation of collateral of borrowing and non-borrowing margin clients.

Latest developments

13. On 2 December 2005, SFC provided the FA Panel with a progress report on the subject (LC Paper No. CB(1)454/05-06(01)). SFC advised that it had conducted a number of meetings with brokers associations in 2005 and studied the viability of complete segregation of borrowing and non-borrowing margin clients' collateral. SFC highlighted the following points:

- (a) SFC supported segregation as a long-term goal. However, in light of its potential impact on the industry as well as investors, SFC needed to further assess the possible consequences of the segregation proposition and how it could be implemented cost-effectively. In the short to medium term, SFC considered the better solution would be to adopt a re-pledging limit for clients' collateral; and
- (b) Having considered the divergent views expressed by brokers associations on the proposed re-pledging limit, SFC was prepared

to adopt a two-stage approach by setting a higher level of re-pledging limit initially and reducing the limit to 130%-150% in accordance with a mutually agreed timetable.

14. In its progress report, SFC indicated that it would press on with the discussion with the brokerage industry on the proposed re-pledging limit and assess further the viability and impact of implementing complete segregation. It would seek to conclude the consultation and put in place a re-pledging limit and other measures as soon as possible.

15. SFC will brief the FA Panel on the progress report at the Panel meeting on 6 February 2006.

Reference

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

Council Business Division 1
Legislative Council Secretariat
3 February 2006

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



Action

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 -

Stocks and warrants	Existing FRR haircut %	Proposed new FRR haircut %
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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**Extract from the minutes of special meeting
of the Panel on Financial Affairs on 17 December 2004**



II. Progress of public consultation on proposed measures to address risks arising from securities margin financing

(LC Paper No. CB(1)458/04-05(02) — Paper provided by the Securities and Futures Commission

LC Paper No. CB(1)458/04-05(03) — Background brief prepared by the Legislative Council Secretariat)

Briefing by the Securities and Futures Commission

10. At the invitation of the Chairman, Mrs Alexa LAM, Executive Director, Intermediaries and Investment Products of the Securities and Futures Commission (SFC) gave a power-point presentation on the background of the measures proposed by SFC to address risks arising from securities margin financing (SMF), major responses received on the recent public consultation on such measures, and the way forward. She highlighted the following points:

- (a) SFC's Working Group on the Review of the Financial Regulatory Framework for Licensed Corporations (Working Group) was formed in 2002 in response to the call made by the Panel on Financial Affairs (the FA Panel) for more effective measures to manage risks in the securities industry, in particular risks arising from pooling and repledging of margin clients' collateral. In March 2004, SFC reported to the FA Panel on the recommendations made by the Working Group. In September 2004, SFC published a consultation paper to consult the public and the market on the proposed measures. The consultation period ended on 31 October 2004.
- (b) The problem of pooling and re-pledging of clients' collateral still existed in the securities industry. Margin clients, who had not borrowed or had borrowed very little, could have all their shares re-pledged by their broker. If the broker failed, these clients would suffer from losses. No other major financial markets allowed re-pledging of non-borrowing margin clients' collateral. The Mainland completely disallowed re-pledging of clients' stocks.

- (c) The Working Group had proposed two principal measures to address the problem. Firstly, to impose a limit on the amount of clients' collateral that a SMF provider could re-pledge to secure its borrowing. The limit should be set within the range of 130% to 150% of the total amount of margin loans lent by a SMF provider. Secondly, to increase the haircut percentage rates on clients' collateral prescribed in the Financial Resources Rules (FRR) to encourage SMF providers to adhere to prudent lending ratios. If a SMF provider wished to lend more, it would need to finance the additional amount with its own capital. The objectives of these measures were to improve fairness and protection for investors, protect Hong Kong's reputation as a premier financial centre, enhance investor confidence in brokers, and keep cost burden to industry to a minimum.
- (d) During the public consultation on the proposed measures, SFC received 24 written submissions, 17 of which were from industry respondents.
- All respondents generally accepted the rationale that the proposed reforms would enhance investor protection. Those who supported the measures recognized the necessity for better investor protection and the resulting benefit for the whole industry.
 - Public opinion, based on commentaries in the media, was supportive of the need for reform.
 - On the proposal of imposing a re-pledging limit, two brokerage associations and some brokers expressed support while others either had reservation about or disagreed with the proposal. A broker (which was one of the existing 89 SMF firms that re-pledged clients' collateral, and had a sizeable margin financing business) preferred complete segregation to the re-pledging limit. The Consumer Council (CC) and Hong Kong Bar Association also advocated complete segregation of borrowing and non-borrowing margin clients' collateral to protect investors. However, some industry respondents argued that existing brokerage firms would be impacted by the proposal, and suggested a wider re-pledging limit ranging from 180% to 300%. A few industry respondents did not agree with the mechanism at all. They pointed out that pooling was a long-established common practice of the securities industry, and the proposal would increase their costs and affect their profitability and business.
 - As regards the proposal on increasing FRR haircut percentages, some respondents supported the proposed percentage rates, while others suggested modest increase or preferred no change at all. CC suggested bringing the percentage rates in line with the average rates adopted by banks and the industry (i.e. higher rates than those proposed by the Working Group).

- (e) SFC had conducted impact analysis of the proposed measures which revealed that seven firms might be impacted more significantly by the 130% re-pledging limit and the proposed FRR haircuts. These firms re-pledged about \$3.5 billion clients' collateral in aggregate to banks and served 42 000 clients. It would have great impact on clients and the market if they were to collapse. SFC had started dialogue with these firms. With strong turnover and profitability, these firms were generally positive about compliance with the new requirements. SFC would continue discussions with them to ensure that they would take appropriate steps to meet the new requirements.
- (f) SFC expected that market turnover in 2004 would break the all-time high record in 1997. Total margin loans and total re-pledged collateral value had increased by 20% and 27% respectively within the period from June 2003 to September 2004. There was evidence that the problem of concept stock bubbles had re-surfaced. SFC considered it necessary to introduce the reform measures to plug the loophole before any possible market overheating.
- (g) On the way forward, SFC would continue dialogue with the industry to identify the most suitable measures for reducing risks and give the industry a reasonable transitional period for accommodating changes to the existing practice. Once measures were decided upon, SFC would revise the rules and submit them to the Department of Justice for comments. SFC planned to finalize the proposals and issue rule amendments in 2005.

(Post-meeting note: The presentation material was issued to members vide LC Paper No. CB(1)569/04-05(02) on 21 December 2004.)

11. Upon invitation by the Chairman, the Acting Permanent Secretary for Financial Services and the Treasury (Financial Services) (Acting PS/FST(FS)) said that it was the Administration's policy to ensure that the overall regulatory framework for managing financial risks of the brokerage industry would enhance investor protection, conducive to long term development of the industry, and reinforce Hong Kong's position as an international financial centre. The Administration considered that SFC's proposed measures were a step forward in the right direction and supported SFC's decision to engage in close dialogue with the industry to work out the final measures and details.

Discussion

Measures to regulate SMF activities

12. Mr SIN Chung-kai pointed out that following the collapse of C.A. Pacific in 1998, the Government and SFC had undertaken to implement a series of measures to

step up regulation of SMF activities. He enquired about the progress made so far.

13. In response, Mrs Alexa LAM advised that the Securities (Margin Financing) (Amendment) Ordinance was enacted in 2000 to put all SMF providers including unregulated finance companies under the regulatory framework of SFC. At that time, SFC had proposed implementing segregation of borrowing and non-borrowing margin clients' collateral, but given the grave concern expressed by small and medium-sized SMF providers about the possible negative impact of the proposal on their business, SFC had finally agreed to review the matter after two years. In May 2002, SFC introduced two new financial requirements under the FRR to manage margin financing risks, namely, the 65% gearing ratio adjustment and the illiquid collateral haircut. During consultation on these new measures, the securities industry and some LegCo Members requested SFC to examine issues related to the regulatory capital requirements of securities firms and the practice of pooling and re-pledging of clients' collateral. SFC therefore established the Working Group to take forward the task.

14. Mr Albert HO expressed concern about the losses suffered by margin clients of C.A. Pacific. He pointed out that these clients had lost all their collateral deposited with the firm and were not eligible for compensation under the Investor Compensation Fund (ICF). Moreover, they were required by the liquidator of C.A. Pacific through court order to re-pay the outstanding margin loans they owed to the firm. Mr HO was of the view that clients' outstanding margin loans and their claims for losses of collateral could be off-set. However, the liquidator had taken a different view. Mr HO urged SFC to look into the matter with a view to enhancing the protection for investors. In this connection, Mr Ronny TONG remarked that whether margin clients were required to re-pay their outstanding margin loans owed to the firm would depend on the terms of the margin contracts they had entered into with the firm. Moreover, margin clients might consider taking legal action against C. A. Pacific for breach of trust.

15. In reply, Mrs Alexa LAM said that SFC was aware that some margin clients of C.A. Pacific were not eligible for compensation under the ICF. She explained that SFC had considered different proposals to help these clients including the suggestion raised by Mr Albert HO. However, as the matter was very complex involving the general law relating to liquidation of companies, it was necessary to consider related issues in a prudent manner. Mrs LAM also pointed out that SFC had reviewed the operation of the investor compensation arrangements, the details of which would be discussed under Agenda Item III of this meeting. Representatives of SFC would be pleased to discuss related issues with members under that item.

Impact of the proposed measures on the securities industry

16. Mr CHAN Kam-lam said that LegCo Members of the Democratic Alliance for Betterment of Hong Kong were in support of SFC's proposed measures. He however expressed concern about the impact of the measures on the small SMF providers. In particular, he was concerned that the small firms might become less competitive vis-à-vis the large brokerage firms and banks. He enquired about the measures to be

taken by SFC to help small SMF providers.

17. On the impact of the proposed measures on SMF providers, Mrs Alexa LAM re-iterated that according to SFC's analysis, only seven firms might be impacted more significantly by the two proposed measures. SFC had already started discussion with these firms to help them resolve possible compliance problems. In general, these firms were confident about complying with the new requirements. Moreover, SFC would work out with the industry on the most suitable transitional period to allow firms to make proper preparation for and adapt to the changes. Mrs LAM stressed that SFC recognized the need to give smaller firms leeway to continue their business. Depending on the level of protection afforded by the new measures, SFC would consider the need for relaxing certain existing financial resources requirements.

18. As regards the concern about competition faced by small SMF providers, Mrs Alexa LAM emphasized that the proposed measures were expected to help small firms. She said that some investors had pointed out that the C.A. Pacific incident and other broker failures in recent years had eroded their confidence in brokers and prompted them to trade securities through large banks. The new measures would help small firms to re-establish their credibility and image. As small firms had competitive advantages of flexible operation and good quality service, they should be able to attract more business.

19. Noting that the practice of pooling and re-pledging clients' collateral might help lower the service fees paid by clients, Mr Ronny TONG enquired about the impact of SFC's proposed measures on the fees paid by clients. In response, Mrs Alexa LAM advised that among the existing 243 brokerage firms providing SMF service, 154 firms ran the business with their own capital and did not re-pledge clients' collateral to banks while the remaining 89 firms pooled and re-pledged clients' collateral to finance their loans. Investors could choose among various SMF providers. Mrs LAM also pointed out that SMF providers had their own pricing strategy. The fees charged by SMF providers were affected by a number of factors including the relationship between SMF provider and its client, terms of the margin contract, etc. SFC did not envisage that the proposed measures would have impact on the level of fees charged by SMF providers.

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

20. Mr Ronny TONG considered that the practice of pooling and re-pledging of non-borrowing clients' collateral, which was unfair to clients and infringed their rights, should be abolished. He urged that the Administration and SFC should work out a concrete timetable for abolishing such a practice and achieving complete segregation of borrowing and non-borrowing margin clients' collateral. Mr SIN Chung-kai shared his view.

21. Mr Andrew LEUNG also supported Mr Ronny TONG's request for a concrete timetable for achieving complete segregation of borrowing and non-borrowing margin clients' collateral. He pointed out that the proposed imposition of a re-pledging limit

would not solve the existing problem where SMF providers re-pledged liquid stocks of margin clients to banks. In the event of collapse of these firms, the clients who owned liquid stocks would suffer more losses than those owned third or fourth liner stocks. Mr LEUNG urged that SFC should examine how the interests of margin clients could be protected, and how margin clients' awareness of the risks of the pooling and re-pledging of their collateral could be enhanced.

22. Mr Albert CHENG supported Mr Andrew LEUNG's views. He suggested that margin clients should be properly informed in writing about the potential risks they would be exposed to. In order to enhance protection for cash clients, Mr CHENG further suggested that SFC should encourage cash clients to deposit their shares in investor participant (IP) account at the Central Clearing and Settlement System (CCASS).

23. Ms Emily LAU was of the view that the existing practice of pooling and re-pledging of non-borrowing clients' collateral should not be continued. She urged SFC to expedite action in achieving complete segregation of borrowing and non-borrowing clients' collateral so as to enhance investor protection and enable Hong Kong's regulatory system to meet international standards. She also supported Mr Ronny TONG's request for the Administration and SFC to work out a timetable for achieving this target.

24. Mrs Alexa LAM advised that unless authorized in writing by their clients, SMF providers were not permitted to pool and re-pledge clients' collateral. Under SFC's Code of Conduct for SMF providers, SMF providers were required to clearly explain the content of the margin contract to clients including the implications of pooling and re-pledging of their collateral. Mrs LAM also pointed out that SFC recognized that complete segregation of borrowing and non-borrowing clients' collateral was the best measure to protect the interests of non-borrowing clients. However, given the SMF industry's concern about the difficulty and costs involved for SMF providers to differentiate the collateral of borrowing clients from that of non-borrowing clients, and the need to ensure the viability of business of SMF providers, SFC considered the proposed imposition of a re-pledging limit a feasible interim measure to address the risks concerned because with the proposed re-pledging limit in place at least a portion of clients' collateral would not be re-pledged. Mrs LAM stressed that SFC was fully aware of its primary objective of protecting investors and it remained the goal of SFC to achieve complete segregation of borrowing and non-borrowing margin clients' collateral so as to comply with international standards. She undertook to reflect members' views to the industry.

SFC

25. On members' request for the Administration and SFC to work out a timetable for achieving complete segregation of borrowing and non-borrowing margin clients' collateral, the Acting PS/FST(FS) said that it was also the wish of the Administration and SFC to work out such a timetable. Given that the timetable had to be achievable by the industry, SFC would continue discussion with the industry so as to identify the most suitable model for addressing SMF risks and to work out such a timetable.

26. The Chairman considered that investors should be made aware of the pooling and re-pledging practice of different SMF providers. In this connection, Mr SIN Chung-kai suggested that SFC should explore the feasibility of introducing a categorization system of SMF providers to differentiate SMF providers which pooled and re-pledged clients' collateral from those which had no such practice.

27. Mrs Alexa LAM said that the Working Group had recommended two supplementary measures, namely, to improve the Code of Conduct on disclosure obligations by requiring SMF providers to disclose additional information to their clients such as stating in client's account statement whether the firm had adopted the practice of pooling and re-pledging clients' collateral, and to step up investor education on the risks of the pooling and re-pledging practice. On the suggestion of introducing a categorization system of SMF providers, Mrs LAM said that while SFC was not aware of any similar systems in other jurisdictions, it would look into the suggestion.

SFC

28. Mr CHIM Pui-chung declared interest that he was a LegCo Member returned from the financial services functional constituency. He pointed out that the C.A. Pacific incident was an individual incident and should not damage investors' confidence in the credibility and image of the brokerage industry. He stressed that the majority of SMF providers had been conducting their business in a prudent manner and had not pooled and re-pledged clients' collateral to banks. On the proposed measures to address SMF risks, Mr CHIM emphasized the importance for SFC to work out the final model with the brokerage industry in order to strike a proper balance between the interests of the industry and those of investors. He also indicated support for SFC to step up investor education on the risks of SMF activities. Investors should be made aware that SMF providers were not permitted to pool and re-pledge clients' collateral without clients' authorization. With a view to enhancing investor protection, Mr CHIM expressed support for implementation of the IP account system. He called on SFC to consider requiring brokers to transfer clients' shares to IP accounts within 48 hours after the transaction and stressed that the charges by CCASS for the service should be set at a reasonable level. He also pointed out that the objectives of SFC's work were to regulate the securities industry, to ensure a level playing field in the market, to promote development of the market and the financial services industry, and to enhance investor protection.

29. Mrs Alexa LAM shared the view that the majority of SMF providers had been conducting their business in a prudent manner. She re-iterated that the proposed measures were feasible options to address risks of pooling and re-pledging of clients' collateral and aimed to require those small number of imprudent SMF providers to cut down their aggressive re-pledging activities. On the suggestion of IP account, Mrs LAM said that while SFC encouraged cash clients to set up IP accounts, the measure could not address the problem and the risk associated with re-pledging of margin clients' collateral. It was because in margin finance business, a SMF provider would take collateral from its clients into its possession or control. These shares would not be held in the clients' own names and thus could not be kept in their IP accounts.

Conclusion

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30. The Chairman requested the Administration and SFC to take into consideration members' views when discussing further with the brokerage industry to finalize the proposed measures. In this connection, Mr SIN Chung-kai suggested and members agreed that the Administration and SFC should be invited to report the progress to the Panel in a year's time. The progress report should cover the proposed concrete timetable for achieving complete segregation of borrowing and non-borrowing margin clients' collateral.

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Proposed measures to address risks arising from securities margin financing

List of relevant papers
(Position as at 3 February 2006)

Paper	LC Paper No.
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
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>
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
Paper on “SFC progress report on the public consultation on proposed measures to address risks arising from securities margin financing”	CB(1)458/04-05(02) <i>(discussed at the FA Panel meeting on 17 December 2004)</i>

Paper	LC Paper No.
“Background brief on proposed measures to address risks arising from securities margin financing” prepared by the LegCo Secretariat	CB(1)458/04-05(03) <i>(for the FA Panel meeting on 17 December 2004)</i>
Minutes of the FA Panel meeting on 17 December 2004	CB(1)1017/04-05
Paper on “SFC’s progress report on proposed measures to address risks arising from securities margin financing”	CB(1)454/05-06(01) <i>(issued on 2 December 2005)</i>