

LEGISLATIVE COUNCIL BRIEF

Securities and Futures Ordinance (Cap. 571)

SECURITIES AND FUTURES (FINANCIAL RESOURCES) (AMENDMENT) RULES 2006

INTRODUCTION

Pursuant to section 145 of the Securities and Futures Ordinance (Cap. 571 (the SFO), the Securities and Futures Commission (“the SFC”), after consultation with the Financial Secretary, has made the Securities and Futures (Financial Resources) (Amendment) Rules 2006 (the Amendment Rules) at the **Annex**.

BACKGROUND

2. The SFC released the Consultation Paper on Proposed Measures to Address Risks Arising from Securities Margin Financing (“the SMF Consultation”) together with the relevant draft rule amendments on 28 September 2004 for comment by the public. The SMF Consultation introduced, among other proposals, two principal measures to reduce securities margin financing risks, i.e. imposing a repledging limit¹ and raising certain haircut percentages² under the Securities and Futures (Financial Resources) Rules —(Cap. 571 sub. leg. N) (“FRR”) (“FRR haircut percentages”). The consultation also sought the public’s views on relaxation of certain existing FRR requirements.

3. On 29 June 2005, the SFC published the Consultation Paper on the Regulation of Sponsors and Compliance Advisers (“the Sponsor Regulation Consultation”). The Sponsor Regulation Consultation proposed, as one of the eligibility criteria, that those firms wishing to act as sponsors under their Type 6 Regulated Activity licenses (“sponsors”) must have a minimum paid-up share capital of HK\$10 million. Currently, the Growth Enterprise Market (“GEM”) Listing Rules require sponsors of GEM listing applicants to have a paid-up share capital and/or non-distributable reserves of not less than HK\$10 million.

¹ Repledging limit is the maximum amount of clients’ securities collateral that an intermediary licensed for dealing in securities or securities margin financing or an associated entity of such intermediary is permitted to repledge as collateral for financial accommodation provided to the intermediary.

² The application of haircut percentages is a key risk management tool under the FRR, set to value securities prudently to take into account their broad characteristics.

4. The Amendment Rules aim to amend the FRR to raise certain FRR haircut percentages, relax certain existing FRR requirements, provide for the proposed paid-up share capital requirements for sponsors and make consequential changes.

PUBLIC CONSULTATION

The SMF Consultation

5. A total of twenty-four submissions were received and numerous discussions concerning the proposals have been held with industry participants and other interested parties. The SFC has also reported twice, in December 2004 and February 2006, to the Panel on Financial Affairs regarding the consultation feedback and subsequent discussions.

6. Non-industry respondents and several industry respondents supported raising the FRR haircut percentages for shares listed in Hong Kong, whereas most industry respondents wanted no change at all or only a modest increase to the FRR haircut percentages.

7. As for warrants, respondents generally shared the view that these are volatile instruments and supported the proposal to increase the applicable FRR haircut percentage.

8. Most respondents suggested that the gearing adjustment³, concentration discounting factor⁴ and the concentrated margin client adjustment⁵ under the FRR should be relaxed or abolished.

The Sponsor Regulation Consultation

9. The SFC received a total of 14 responses from industry players,

³ Gearing adjustment is an interim FRR measure introduced in 2002 which provides that where a licensed corporation obtains any financial accommodation wholly or partly secured by collateral provided by its margin clients, it is required to adjust its ranking liabilities if such financial accommodation exceeds the threshold of 65% of the aggregate of amounts receivable from its margin clients.

⁴ The concentration discounting factor provides for an additional haircut deduction where firms have particularly large exposures to individual stocks held as clients' collateral.

⁵ The concentrated margin client adjustment provides for an additional charge to liquid capital where firms have particularly large exposures to individual margin clients or group of related margin clients.

professional bodies, as well as individual investors to the Sponsor Regulation Consultation. The majority of these respondents were supportive of the minimum paid-up share capital proposal.

MAJOR POLICY CONSIDERATIONS

The SMF Consultation

10. The SFC has considered all the comments received and revised the Rules as appropriate. We have decided:

- to raise the FRR haircut percentage for non-index constituent stocks⁶ held as client collateral to 60% for firms that repledge clients' collateral, and keep the existing haircut percentage unchanged for firms that do not repledge clients' collateral;
- to raise the FRR haircut percentage of warrants to 100% (this is applicable to clients' collateral (whether the firm repledges clients' collateral or otherwise), house positions and other securities transactions);
- to keep all other existing haircut percentages unchanged.

11. In view of the above increases in FRR haircut percentages and other measures proposed under the SMF consultation, we have also decided to relax the triggering threshold of the gearing adjustment from 65% to 80% to allow firms to have greater business flexibility⁷.

12. We will abolish the concentration discounting factor and the *ad hoc* notification requirement on the amount of concentrated margin client adjustment made under the FRR.

⁶ Non-index constituent stocks means stocks listed in Hong Kong other than constituents of the Hang Seng Composite Index or the MSCI Hong Kong and China indices compiled by Morgan Stanley Capital International Inc.

⁷ For existing licensed corporations, this 80% threshold will only apply from 1 October 2007 onwards, i.e. after the end of the transitional period.

The Sponsor Regulation Consultation

13. Sponsors play a significant role as corporate finance advisers to companies applying for listing on the Stock Exchange of Hong Kong. The SFC believes that a sponsor should be sufficiently capitalized to carry out sponsor work and as such, have decided to introduce the minimum paid-up share capital requirement of HK\$10 million to all sponsor firms.

THE AMENDMENT RULES

14. The Amendment Rules amend the FRR to raise certain FRR haircut percentages, relax certain existing FRR requirements, provide for the proposed paid-up share capital requirements for sponsors and make consequential changes.

15. Section 2 amends section 2(1) of the FRR by repealing the definition of “concentration discounting factor”, amending the definitions of “haircut amount” and “haircut percentage” and adding definitions of “no sponsor work licensing condition” and “repledge”.

16. Section 3 amends section 5 of the FRR to provide that licensed corporations licensed for Type 6 regulated activity are exempt from the paid-up share capital requirement only if they are subject to both the specified licensing condition (under which they will not hold client assets) and the no sponsor work licensing condition (under which they will not act as sponsor in respect of an application for listing of securities).

17. Section 4(1) amends section 22(1)(b)(i) of the FRR to abolish the application of the concentration discounting factor to securities collateral. Section 4(2) amends section 22(1)(b)(ii) of the FRR to effect an increase in the haircut percentage on listed warrants to 100%.

18. Section 5 amends section 42(2) of the FRR in order to raise the triggering threshold for making gearing adjustment from 65% to 80%.

19. Section 6 repeals section 55(1)(h) and (2)(c) and (d) of the FRR to remove the notification requirements for licensed corporations under section 55(1)(h) of the FRR. Section 7 makes consequential amendments to section 56(5) and (6).

20. Section 8 adds section 60(6A) to the FRR which provides for a 12-month transitional period for the amendment to section 42(2).

21. Section 9 amends Table 1 in Schedule 1 to the FRR to provide for the paid-up share capital requirement for sponsors.

22. Section 10(1) amends Table 1 in Schedule 2 to the FRR so that it contains haircut percentages for shares listed in Hong Kong for the purposes of the FRR except for the purpose of calculating the haircut amount under section 22(1)(b)(i) of the FRR.

23. Section 10(2) adds Table 1A to Schedule 2 to the FRR which contains haircut percentages for the purpose of calculating the haircut amount under section 22(1)(b)(i) of the FRR. In the case of shares which are not constituents of any of the specified stock indices, a higher haircut percentage is prescribed in Table 1A for a licensed corporation that repledges securities collateral (60% in item 1(e)(ii)) than that prescribed for a licensed corporation that does not repledge securities collateral (30% in item 1(e)(i)).

24. Section 10(3) amends Table 2 in Schedule 2 to the FRR so that it contains haircut percentages for specified overseas listed securities.

25. Section 10(4) makes a consequential amendment to Table 3 in Schedule 2 to the FRR.

26. Section 10(5) amends Table 7 in Schedule 2 to the FRR so as to specify a 100% haircut percentage for warrants.

FINANCIAL AND STAFFING IMPLICATIONS

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

COMMENCEMENT DATE

28. The Rules, except sections 3 and 9, will come into operation on 1 October 2006. Sections 3 and 9 will come into operation on 1 August 2007.

PUBLICITY

29. The Rules will be published in the Gazette on 19 May 2006. The SFC will issue a press release on the same day.

ENQUIRIES

30. For any enquiries on this brief, please contact Mrs. Yvonne Mok of the Intermediaries Supervision Department of the Commission at 2842 7638.

The Securities and Futures Commission
17 May 2006

**SECURITIES AND FUTURES (FINANCIAL RESOURCES)
(AMENDMENT) RULES 2006**

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SECURITIES AND FUTURES (FINANCIAL RESOURCES) (AMENDMENT) RULES 2006

(Made by the Securities and Futures Commission under section 145 of the Securities and Futures Ordinance (Cap. 571) after consultation with the Financial Secretary)

1. Commencement

- (1) These Rules, except sections 3 and 9, shall come into operation on 1 October 2006.
- (2) Sections 3 and 9 shall come into operation on 1 August 2007.

2. Interpretation

(1) Section 2(1) of the Securities and Futures (Financial Resources) Rules (Cap. 571 sub. leg. N) is amended by repealing the definition of “concentration discounting factor”.

(2) Section 2(1) is amended, in the definition of “haircut amount”, by repealing paragraph (a) and substituting –

- “(a) in relation to any shares –
- (i) that are listed in Hong Kong, and specified in column 2 of Table 1 in Schedule 2;
 - (ii) that are listed in Hong Kong, and specified in column 2 of Table 1A in Schedule 2;
 - (iii) that are listed in the United Kingdom, the United States of America or Japan, and specified in column 2 of Table 2 in Schedule 2; or
 - (iv) that are listed, and specified in column 2 of Table 3 in Schedule 2,

means an amount derived by multiplying the market value of the shares by the haircut percentage in relation to such shares;”.

(3) Section 2(1) is amended, in the definition of “haircut percentage”, by repealing paragraph (a) and substituting —

“(a) in relation to any shares —

- (i) that are listed in Hong Kong, and specified in column 2 of Table 1 in Schedule 2;
- (ii) that are listed in Hong Kong, and specified in column 2 of Table 1A in Schedule 2;
- (iii) that are listed in the United Kingdom, the United States of America or Japan, and specified in column 2 of Table 2 in Schedule 2; or
- (iv) that are listed, and specified in column 2 of Table 3 in Schedule 2,

means —

- (v) subject to subparagraphs (vi), (vii), (viii) and (ix), the percentage specified in column 3 of the Table concerned opposite the applicable description set out in column 2 of that Table;
- (vi) where the shares fall within any of the descriptions in column 2 of Table 1A in Schedule 2 and within any of the descriptions in column 2 of Table 1, 2 or 3 in Schedule 2, subject to subparagraphs (vii) and (ix) and for the purpose of calculating the haircut amount under section 22(1)(b)(i), the percentage specified in column 3 of Table 1A in Schedule 2 opposite the applicable description set out in column 2 of that Table ;
- (vii) where the shares fall within 2 or more of the descriptions in column 2 of Table 1A in Schedule 2, subject to subparagraph (ix) and for the purpose of calculating the haircut amount under section

22(1)(b)(i), such percentage specified in column 3 of that Table opposite the applicable description set out in column 2 of that Table as may be elected by a licensed corporation;

(viii) where the shares fall within 2 or more of the descriptions in one or more of column 2 of Table 1, 2 or 3 in Schedule 2, subject to subparagraph (vi), such percentage specified in column 3 of the Table concerned opposite the applicable description set out in column 2 of that Table as may be elected by a licensed corporation; or

(ix) where the shares described in item 1(a), (b), (c) or (d) in column 2 of Table 1A in Schedule 2 –

(A) cease to be a constituent of the applicable index; and

(B) the cessation would result in the assignment to the shares of a higher percentage specified in that Table ,

in relation to the month in which the cessation occurs and for the period of the next 3 consecutive months and for the purpose of calculating the haircut amount under section 22(1)(b)(i), the percentage specified in column 3 of Table 1A in Schedule 2 which was applicable to the shares immediately prior to the cessation;”.

(4) Section 2(1) is amended by adding –

““no sponsor work licensing condition” (不任保薦人發牌條件), in relation to a licensed corporation licensed for Type 6 regulated activity, means a licensing condition that the licensed corporation shall not act as a sponsor in respect of

an application for the listing on a recognized stock market of any securities;

“repledge” (再質押), in relation to a licensed corporation, means an act by which the licensed corporation or an associated entity of such licensed corporation deposits securities collateral of the licensed corporation as collateral for financial accommodation provided to the licensed corporation;”.

3. Paid-up share capital requirement for licensed corporations

- (1) Section 5(*d*) is amended –
 - (a) by repealing “, Type 6”;
 - (b) by repealing the comma at the end and substituting a semicolon.
- (2) Section 5 is amended by adding –
 - “(da) a licensed corporation licensed for Type 6 regulated activity, which is subject to both the specified licensing condition and the no sponsor work licensing condition,”.

4. Amounts receivable in respect of providing securities margin financing

- (1) Section 22(1)(*b*)(i) is amended by repealing “and multiplied by the concentration discounting factor in relation to such collateral”.
- (2) Section 22(1)(*b*)(ii) is repealed and the following substituted –
 - “(ii) the market value of all illiquid collateral provided by the client, multiplied by –
 - (A) in the case of listed shares, 20%; and
 - (B) in the case of listed warrants, 0%;”.

5. Provision of securities margin financing

Section 42(2) is amended by repealing “65%” and substituting “80%”.

6. Licensed corporations to notify Commission of circumstances relating to financial resources and trading activities and to submit returns in certain cases

- (1) Section 55(1)(h) is repealed.
- (2) Section 55(2)(a) is amended by adding “and” at the end.
- (3) Section 55(2)(b) is amended by repealing the semicolon and substituting a full stop.
- (4) Section 55(2)(c) and (d) is repealed.

7. Licensed corporations to submit returns to Commission

- (1) Section 56(5) is amended by repealing “or section 55(2)(c) or (d)”.
- (2) Section 56(6) is amended by repealing “or section 55(2)(c) or (d)”.

8. Transitional

Section 60 is amended by adding –

“(6A) Where a licensed corporation is licensed immediately prior to 1 October 2006 for Type 1 or Type 8 regulated activity, for the period from 1 October 2006 to 30 September 2007, the reference in section 42(2) to 80% shall be construed as a reference to 65%.”.

9. Financial resources requirements

Schedule 1 is amended, in Table 1, by repealing the entry relating to “Type 6” and substituting –

“Type 6 –

- | | | |
|-----|--|---------------|
| (a) | in the case where the licensed corporation in question is not subject to the no sponsor work licensing condition | \$10,000,000 |
| (b) | in any other case | \$5,000,000”. |

10. Haircut percentages

- (1) Schedule 2 is amended, in Table 1 –
- (a) in the heading, by repealing everything after “HONG KONG” and substituting “FOR THE PURPOSES OF THESE RULES (EXCEPT FOR THE PURPOSE OF CALCULATING THE HAIRCUT AMOUNT UNDER SECTION 22(1)(b)(i))”;
- (b) by repealing item 2 and substituting –
- “2. Shares which are listed on a recognized stock market but are not stratified according to stock indices 30”.
- (2) Schedule 2 is amended by adding –

“TABLE 1A

HAIRCUT PERCENTAGES FOR SHARES LISTED IN HONG KONG FOR THE PURPOSE OF CALCULATING THE HAIRCUT AMOUNT UNDER SECTION 22(1)(b)(i)

Item	Description	Haircut Percentage %
1.	Shares which are listed on a recognized stock market -	
(a)	being a constituent of the Hang Seng Index or the Hang Seng Hong Kong LargeCap Index	15
(b)	being a constituent of the Hang Seng Hong Kong MidCap Index	20
(c)	being a constituent of the Morgan	30

- Stanley Capital International Inc.
Hong Kong Index or the Morgan
Stanley Capital International Inc.
China Index
- (d) being a constituent of the Hang Seng Composite Index 30
- (e) being any share not referred to in paragraph (a), (b), (c) or (d) –
- (i) for a licensed corporation which does not repledge securities collateral 30
- (ii) for a licensed corporation which repledges securities collateral 60
2. Shares which are listed on a recognized stock market but are not stratified according to stock indices –
- (a) for a licensed corporation which does not repledge securities collateral 30
- (b) for a licensed corporation which repledges securities collateral 60”.
- (3) Schedule 2 is amended, in Table 2 –
- (a) in the heading –
- (i) by repealing “HONG KONG,”;
- (ii) by repealing “(SHARES NOT STRATIFIED ACCORDING TO STOCK INDICES)”;
- (b) by repealing item 1 and substituting –

“1. Shares which are listed on a specified exchange in the United Kingdom (other than the London Stock Exchange plc–SEAQ International), the United States of America (other than the Nasdaq Stock Market, Inc. – Nasdaq National Market) or Japan (other than the Japanese Association of Securities Dealers Automated Quotations) –

(a) being a constituent of the FTSE-100 Index, Nikkei 500 Index or Standard & Poor's 500 Index; or

(b) being any share not referred to in paragraph (a)

(c) in item 2, in column 2, by adding “, but are not stratified according to stock indices” after “Quotations”).

(4) Schedule 2 is amended, in Table 3, in item 5, in column 2, by adding “, 1A” after “Table 1”.

(5) Schedule 2 is amended, in Table 7, in item 1, in column 3, by repealing “40%” and substituting “100%”.

Martin Wheatley
Chairman,
Securities and Futures Commission

15 May 2006

Explanatory Note

These Rules amend the Securities and Futures (Financial Resources) Rules (Cap. 571 sub. leg. N) (“the principal Rules”) to address risks related to securities margin financing by licensed corporations and to provide for paid-up share capital requirements for licensed corporations licensed for Type 6 regulated activity which act as sponsors in respect of an application for the listing of any securities on a recognized stock market.

2. Section 2 amends section 2(1) of the principal Rules by repealing the definition of “concentration discounting factor”, amending the definitions of “haircut amount” and “haircut percentage” and adding definitions of “no sponsor work licensing condition” and “repledge”.

3. Section 3 amends section 5 of the principal Rules to provide that licensed corporations licensed for Type 6 regulated activity are exempt from the paid-up share capital requirement only if they are subject to both the specified licensing condition and the no sponsor work licensing condition.

4. Section 4(1) amends section 22(1)(b)(i) of the principal Rules to abolish the application of the concentration discounting factor to securities collateral. Section 4(2) amends section 22(1)(b)(ii) of the principal Rules to effect an increase in the haircut percentage on listed warrants to 100%.

5. Section 5 amends section 42(2) of the principal Rules. Section 42(2) originally provides that where a licensed corporation obtains any financial accommodation wholly or partly secured by collateral provided by its margin clients, it is required to adjust its ranking liabilities if such financial accommodation exceeds the threshold of 65% of the aggregate of amounts receivable from its margin clients. Section 5 raises the threshold from 65% to 80%.

6. Section 6 repeals section 55(1)(h) and (2)(c) and (d) of the principal Rules to remove the notification requirements for licensed corporations under the said

section 55(1)(h). Section 7 makes consequential amendments to section 56(5) and (6) of the principal Rules.

7. Section 8 adds section 60(6A) to the principal Rules which contains a transitional provision for the amendment to section 42(2) of the principal Rules.

8. Section 9 amends Table 1 in Schedule 1 to the principal Rules to provide for the paid-up share capital requirement for licensed corporations which are not subject to the no sponsor work licensing condition.

9. Section 10(1) amends Table 1 in Schedule 2 to the principal Rules so that it contains haircut percentages for shares listed in Hong Kong for the purposes of the principal Rules except for the purpose of calculating the haircut amount under section 22(1)(b)(i) of the principal Rules.

10. Section 10(2) adds Table 1A to Schedule 2 to the principal Rules which contains haircut percentages for the purpose of calculating the haircut amount under section 22(1)(b)(i) of the principal Rules. These haircut percentages apply to shares listed in Hong Kong and held by a licensed corporation providing securities margin financing as security against amounts owed by its clients in their margin accounts. In the case of shares which are not constituents of any of the specified stock indices, a higher haircut percentage is prescribed in Table 1A for a licensed corporation that repledges securities collateral (60% in item 1(e)(ii)) than that prescribed for a licensed corporation that does not repledge securities collateral (30% in item 1(e)(i)).

11. Section 10(3) amends Table 2 in Schedule 2 to the principal Rules so that it contains haircut percentages for specified overseas listed securities.

12. Section 10(4) makes a consequential amendment to Table 3 in Schedule 2 to the principal Rules.

13. Section 10(5) amends Table 7 in Schedule 2 to the principal Rules so as to specify a 100% haircut percentage for warrants.