

立法會
Legislative Council

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**Bills Committee on
Securities (Margin Financing) (Amendment) Bill 1999**

**Minutes of meeting held on
Tuesday, 1 June 1999, at 8:30 am
in Conference Room A of the Legislative Council Building**

- Members present** : Hon Ronald ARCULLI, JP (Chairman)
Hon Albert HO Chun-yan
Hon Jasper TSANG Yok-sing, JP
Hon FUNG Chi-kin
- Members absent** : Hon Bernard CHAN
Hon SIN Chung-kai
- Public officers attending** : Mr Bryan CHAN
Principal Assistant Secretary for Financial Services
- Miss Hanny LAM
Assistant Secretary for Financial Services
- Ms Vicki LEE
Government Counsel
Department of Justice
- Attendance by Invitation** : Securities and Futures Commission
Mr Andrew PROCTER
Executive Director of Intermediaries and
Investment Products

Mr Richard YIN
Director of Intermediaries Supervision

The Institute of Securities Dealers Ltd

Ms Chow Pei-fung, Audrey
Vice-Chairman

Hong Kong Stockbrokers Association Ltd

Mr Dannis LEE
Chairman

Mr Wilfred WONG
Vice-Chairman

Mr Paul FAN
Vice-Chairman

Mr Kenny LEE
Vice-Chairman

Hong Kong Securities Professionals Association

Mr TONG Leung-sang
Chairman

The Law Society of Hong Kong

Mr William Mackesy
Chairman of Securities Law Committee

Mr Alan Ewins
Member of Securities Law Committee

Ms Pauline Ashall
Alternate member of Securities Law Committee

Clerk in attendance : Ms Estella CHAN
Chief Assistant Secretary (1)4

Staff in attendance : Mr KAU Kin-wah
Assistant Legal Adviser 6

Ms Connie SZETO
Senior Assistant Secretary (1)1

I Discussion with deputations
(LC Paper No. CB(1)1410/98-99(01-03))

The Chairman welcomed representatives from the Hong Kong Stockbrokers Association (HKSA), the Hong Kong Securities Professionals Association (HKSPA), the Institute of Securities Dealers Limited (ISDL) and the Law Society of Hong Kong (LSHK) to the meeting to express their views on the Bill. He also advised that the Administration's paper tabled at the meeting contained the responses to deputation's written submissions which had been issued to members prior to the meeting. (The Administration's responses were also circulated to members subsequently vide LC Paper Nos. CB(1)1419/98-99(02), (03) and CB(1)1578/98-99)

2. Upon the Chairman's invitation, representatives of the deputations presented their written submissions on the Bill which were summarised below. All deputations were, in general, supportive of the initiative to bring securities margin financing activities into proper and prudential regulation by the Securities and Futures Commission (SFC).

Views of industry bodies

3. HKSA, HKSPA and ISDL stressed that the proposed regulatory regime had to strike a proper balance between enhancing investors protection and maintaining market integrity on the one hand and allowing commercial viability of securities margin financing business on the other. In this particular regard, HKSA expressed support for permitting the continued practice of "pooling" of clients' assets, which was considered vital to the survival of securities margin financing business. HKSA also opined that the Bill should cover the basic regulatory framework with details to be spelt out in subsidiary legislation or guidelines issued by regulatory bodies. HKSPA stressed that it was important to consult the industry on the new Financial Resource Rules (FRR).

4. In respect of registration of securities margin financiers (SMFs), HKSPA was of the view that given the sole-business requirement and stringent rules to be imposed on SMFs, it was doubtful whether firms would be interested in applying for registration under the particular class. ISDL opined that as problems associated with securities margin financing activities had so far been connected with unregulated finance companies, the simplest way to resolve the issues was to amend the Securities Ordinance (SO) (Cap. 333) to restrict the provision of securities margin financing service to registered securities dealers and authorised institutions (AIs).

5. On the scope of business of a SMF, HKSA was of the view that in order to provide clients with the flexibility of different investment choices, margin loans offered by SMFs should also be permitted to facilitate investment in financial products other than securities, such as futures trading.

6. With regard to proposals on position risk adjustments under the proposed FRR, HKSA, HKSPA and ISDL considered it inappropriate to include the stocks of related companies in the ranking liabilities of SMFs as this would have the effect of encouraging SMF to diversify their loan portfolios by accepting second or third line stocks which were of higher risk. On counter party risk adjustments, HKSA and HKSPA opined that the proposed 10% threshold in respect of exposure to individual client should be raised to 20%. ISDL was of the view that while the threshold in respect of exposure to individual client should be raised to 20%, the acceptable concentrated positions in respect of exposure to individual stock collateral should be prescribed according to different categories of stocks i.e., below 30% for Hang Seng Index (HSI) constituent stocks, below 15% for HSI 100 constituent stocks, and below 10% for other stocks.

7. On disclosure of information to clients under the proposed Code of Conduct, HKSA and ISDL considered it adequate to inform clients that their securities collateral would be deposited or pledged with AIs or the Central Clearing and Settlement System (CCASS), the exact place where the securities were kept would not need to be specified. Moreover, such risk disclosure statements and acknowledgement by clients should not be required to be included in every statement of account.

8. Regarding transitional arrangements, HKSPA was of the view that the period allowed for an existing registered securities dealers to indicate their interest to continue providing securities margin financing service should be extended to 60 days and the transition period for the firm to meet the new FRR requirements should be extended to one year.

9. HKSA also proposed that small capital sized companies which financed the securities margin financing business out of the firm's own capital without repledging clients' securities for bank credits should be exempted from certain concentration risk adjustment rules. The Association was of the view that if the aggregate value of the loan portfolio of such firm did not exceed the total amount of its capital, the risk arising from the business would be sufficiently contained. Moreover, the requirement on smaller firms to report their top 20 margin clients should also be waived in order to prevent clients from switching to large finance companies for the sake of preventing their information from being disclosed.

10. The Chairman expressed reservation over HKSA's proposal of exempting small capital sized firms from certain FRR requirements. He doubted whether such exemption would be meaningful as he envisaged there would only be a small number of such firms conducting the business after the legislation was implemented.

11. In this connection, Mr FUNG Chi-kin remarked that apart from FRR there should be other risk management models which could better measure risks and ensure capital adequacy of SMFs. He shared HKSA's view that concentration risk adjustment measures should be linked up with the capital size of the firm. He further proposed that rules governing exposure to a particular client or to specific/related stocks should be relaxed if the exposure did not exceed a certain percentage level of the firm's capital. The operation of the rules could be similar to that of the capital adequacy requirements for banking institutions. Upon the Chairman's request, Mr FUNG Chi-kin undertook to provide a written submission on his proposal to the Committee and the Administration for consideration.

(Post-meeting note: Mr FUNG Chi-kin's proposal was circulated vide LC Paper CB(1)1468/98-99 (Chinese version) and LC Paper CB(1)1518/98-99 (English version))

12. In response, the Executive Director of Intermediaries and Investment Products, Securities and Futures Commission (ED/IIP(SFC)) pointed out the inadequacy of the proposals of HKSA and Mr FUNG Chi-kin on FRR in controlling risks of SMFs since share capitals of securities dealers and SMFs were not required to be held in specific forms and were usually dissipated by firms in pursuit of the business of the enterprise and therefore might not be readily realisable to cover risks arising from the business. Hence, the concept of liquid capital was introduced, the level of which would be adjusted to take into account price fluctuations in stock collateral and over-exposure to any individual clients or stock collateral, and which securities dealers and SMFs were required to maintain at all times for meeting the business risks. On the other hand, it was necessary to distinguish the capital requirement on SMFs from that prescribed for AIs. Indeed, there had been on-going criticisms on the stringency of the capital requirement rules in the banking sector, which resulted in too much capital being locked up against the trading books of banks. While the international trend was to review these harsh provisions, it would be inappropriate to adopt a banking style capital regime for controlling risks of securities margin financing business. As regard concerns about viability of small sized firms and their genuine difficulties in complying with FRR requirements, there were existing legal provisions which enabled SFC to deal with these situations flexibly.

13. Some members remained concerned about the adequacy of the protection for clients' assets under the "pooling" arrangement and sought the views of industry bodies on possible safeguards in this respect.

14. Representatives of HKSA re-iterated that the continuation of the pooling arrangement would be crucial to the viability of securities margin financing business. They pointed out that since the failure of some finance companies which had exposed the problem of pooling, existing securities margin financing service providers and banking institutions had become more prudent in pooling of clients' collateral in their business. Indeed, the new sole-business requirement on SMFs would effectively bring those finance companies conducting securities margin financing business under the regulation of SFC. Coupled with proposed safeguards including more stringent FRR, clear segregation of clients' cash and margin accounts, proper record keeping, contract documents with clear provisions on consent of pooling and the revised Code of Conduct for SMFs, the risks associated with pooling should have been sufficiently contained.

15. As regard the concern about possible problem of mingling of clients' assets and unauthorized use of the assets for meeting liabilities of other clients or the SMF himself, Mr Wilfred WONG of HKSA assured members that it was the industry practice for SMFs to maintain clear records on client accounts and to make timely disclosure whenever required. Moreover, SMFs had put in place internal control systems to monitor the exposure to their clients. In the event of a volatile market, SMFs would take immediate action to make margin calls on clients and collect intra-day margins to make up the shortfalls in their accounts.

16. Recognising that mingling of clients' securities collateral under the pooling arrangement would enhance SMFs' ability to obtain credit facilities from banks by repledging these assets in aggregate, Mr Albert HO suggested that the Singaporean model could be adopted. As he understood, under the model, the amount of bank credits secured with an individual client's securities collateral was limited to the amount of margin loan drawn down by that particular client. This would impose a limit on the extent to which clients' assets could be used by a SMF to obtain bank credit, hence offering better protection for clients. He sought views of the industry bodies and the Administration on the practicability of introducing such a system in Hong Kong.

17. Mr Wilfred WONG said that SMFs usually adopted a more aggressive approach in conducting business than that of AIs providing securities margin financing service to clients. While SMFs would accept second and third line stocks as collateral for margin loans, only those better quality stocks were repledged to banks for obtaining credits. SMFs would finance the balance of the margin loan by their own capital. With the requirement of a higher

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minimum paid-up capital on SMFs under the proposed FRR, their capital adequacy would be further assured to meet risks arising from exposure to lower quality stock collateral. Moreover, it was a common practice for SMFs to borrow an amount from banks only up to the amount of the loan extended to the margin client. He remarked that the Stock Exchange of Hong Kong (SEHK) might already have rules for its members specifying the lending ratio to margin clients vis-à-vis the borrowings from banks.

18. In this connection, the Chairman remarked that a possible reason for SMFs to borrow from banks in excess of the amount of loans extended to clients was to maintain a working credit line with banks to facilitate the daily operation of their business.

Admin

19. The Principal Assistant Secretary for Financial Services (PAS/FS) said that he was not aware of such SEHK Rules specifying the lending ratio to margin clients and undertook to clarify with SEHK on this point. However, he stressed that in any case there would be no incentive for SMFs to borrow in excess of margin loans extended to clients since such borrowings would be counted as liabilities for SMFs in the calculation of their liquid assets under the FRR requirements.

Admin

20. On the appropriateness of adopting the Singaporean model on pooling in Hong Kong, HKSA was of the view that the Singapore experience might not be suitable for Hong Kong as the local securities margin financing market was much more active than that of Singapore and the majority of participants in the local market were retail investors. PAS(FS) re-iterated the Administration's stance that the proposed regulatory regime had struck an appropriate balance between maintaining market viability and enhancing investor protection. It believed that risks associated with pooling would be sufficiently contained by the various proposed safeguards. Nonetheless, he undertook to obtain further information on the implementation of the pooling system in Singapore for members' reference.

21. Mr Dannis LEE of HKSA did not agree with HKSPA and ISDL's suggestion of effecting regulatory control over securities margin financing activities by simply disallowing the conduct of securities margin financing business by entities other than registered dealers and authorized institutions. Notwithstanding that the suggestion would ban the improper operation of currently unregulated companies, it would create market barrier for operators who would prefer to provide the service as stand-alone companies.

Views of Law Society of Hong Kong

22. Referring to the Administration's response to LSHK's submission, Mr William Mackesy of LSHK made the following points -

(a) *Sole-business requirement and unlisted securities*

SMFs should be permitted to provide funding to margin clients for acquisition of unlisted securities including bonds issued by large corporations which could be converted into listed securities, and to enter into futures and options transactions to hedge their positions. LSHK welcomed the Administration's decision to consider whether SMFs should be allowed to engage in other business which were incidental to their normal course of business.

(b) *Third party arrangers*

As the Administration had clarified in the response that the definition of "SMF" was intended to capture only those persons who "provide" the financial accommodation and that third party arrangers did not fall within the definition, it was necessary to provide this expressly in the Bill to avoid ambiguity.

(c) *Exemptions*

(i) LSHK did not agree with the Administration's view that exemptions to the Bill should be dealt with on a case-by-case basis. Apart from increasing the cost of business as SFC would charge for considering applications for exemption, the approach was against the principle of providing "good legislation" which should strive for clarity, consistency and predictability.

(ii) LSHK suggested setting out an extensive list of exemptions in the Bill, leaving as little residual power as possible for SFC to deal with unusual or unpredictable cases.

(d) *Client information*

The requirements on SMFs under certain provisions in section 121 Y of the Bill to provide clients with a detailed statement of account in respect of every transaction and monthly statements irrespective of whether there had been any movements were onerous.

(e) *Securities collateral and safe custody*

(i) Section 121 AA of the Bill restricted the disposition of securities collateral by requiring SMFs to obtain authorization by clients which were subject to annual

renewal. In case of client defaults, the interests of SMFs would not be adequately protected since they might not be able to dispose of the collateral to meet the obligations if clients refused to sign or renew the authorization, as the case may be. The position of a third party, such as a bank to which a SMF had pledged clients' securities for a loan, would also be jeopardized. Some "bona fide third party" provisions should be introduced to clarify the issue.

- (ii) A SMF had to register a client's securities in the client's name or deposit them in safe custody in accordance with section 121 AA of the Bill. This requirement might not be practical as, very often, SMFs would deposit clients' securities in CCASS where registration of securities in any particular name would not be possible.

(f) *Miscellaneous*

The points raised in LSHK's submissions were valid concerns and should be properly addressed in order to facilitate smooth implementation of the regulatory regime. The Administration was urged to re-consider its views in this respect.

23. Responding to members' enquiry about factors for consideration in drawing up the exemption list, Mr Mackesy re-iterated that the list should be sufficiently extensive so that those activities which were clearly not intended to be covered by the regulatory regime would be excluded, hence providing maximum flexibility for conducting proper business. He explained that exemptions proposed in LSHK's submission were based on types of transactions and/or types of borrowers where the Society considered appropriate based on past experience and after examination of relevant ordinances. In this connection, the Chairman remarked that while it might be inappropriate to describe in the law the details of exempted transactions so as to prevent SMFs from circumventing the regulation, it would be necessary to define exemptions clearly to avoid ambiguity and misunderstanding. He invited LSHK to study the matter and give further suggestions on the exemption list.

LSHK

(Post-meeting note: LSHK provided another submission on exemptions which was circulated vide LC Paper No. CB(1)1533/98-99(01))

24. ED/IP(SFC) shared LSHK's view that exemptions should be specified in the legislation as far as possible. Nevertheless, in order to avoid abuse, it was necessary for SFC to reserve the discretionary power to consider exemption on a case-by-case basis. To this end, SFC considered it appropriate

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to continue with the granting of class exemption to specific types of persons by way of Commission rules and to waive or modify certain specific provisions on a case-by-case basis upon application. SFC recognised that it would be in the interest of market certainty and transparency to clearly explain how applications should be made and what information was required. SFC would also observe procedural fairness and notice of concerns in considering applications, and maintained internal consistency in its decisions.

FSB 25. Some members opined that there would be greater flexibility if exemptions were included in a Schedule under the Ordinance and amendment of which could be subject to the negative vetting of the Legislative Council, as opposed to the present approach of listing exemptions in section 121B of the Bill and its amendment could only be made by way of an amendment bill. The Administration undertook to consider the proposal.

(Post-meeting note: The Administration's response accepting the proposal was circulated to members vide LC Paper No. CB(1)1599/98-99(01).)

II Any other business

Date of future meetings

26. The Chairman reminded members that the next meeting was scheduled for 2 June 1999 at 8:30 am. Due to the indisposition of the Chairman, members agreed to cancel the meeting scheduled for 14 June 1999. Two further meetings were scheduled for 21 and 22 June 1999, both at 8:30 am.

(Post-meeting note: The Committee subsequently agreed to cancel the meeting scheduled for 22 June 1999.)

27. There being no other business, the meeting ended at 10:30 am.

Legislative Council Secretariat
20 January 2000