立法會
Legislative Council

LC Paper No. CB(1) 843/99-00
(These minutes have been seen by the Administration)

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

Minutes of meeting held on
Wednesday, 2 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 Bernard CHAN Hon Jasper TSANG Yok-sing, JP Hon FUNG Chi-kin
Members absent	**:**	Hon SIN Chung-kai
Public officers attending	**:**	Mr Bryan CHAN Principal Assistant Secretary for Financial Services Miss Hinny LAM Assistant Secretary for Financial Services Mr William MADDAFORD Senior Assistant Law Draftsman Department of Justice 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

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 the Administration

Administration's responses to comments made by deputations

Responding to comments made by industry bodies and the Law Society of Hong Kong at the meeting on 1 June 1999, the Principal Assistant Secretary for Financial Services (PAS/FS) made the following points -

(a) The Administration remained of the view that the proposed regulatory regime on securities margin financing as a whole would help ensure capital adequacy of securities margin financiers (SMFs) for the protection of clients. With the new regulatory measures, the Administration believed that it would be appropriate to continue to permit pooling of client assets, which was crucial to the commercial viability of SMFs at this stage of development of the local securities market.

(b) The concentration risk adjustment requirements under the new Financial Resources Rules (FRR) aimed at encouraging SMFs to diversify their collateral or client portfolio with a view to addressing the problem of over-exposure to specific stocks collateral and individual clients. As to the industry's concerns expressed during the public consultation, he pointed out that the Securities and Futures Commission (SFC), under the Securities and Futures Commission Ordinance (SFCO) (Cap.24), could waive or modify any requirements specified in FRR upon application by SMFs. Moreover, some of the rules had been relaxed in response to views expressed during the public consultation.

(c) The sole-business requirement on SMFs was essential in eliminating the undue exposure of registrants to non-securities risks and enhancing proper regulation by SFC. Securities dealers were free to engage in other non-dealing business under the current regulatory regime insofar as they did not breach the licensing and financial resources requirements. On the other hand, registered securities dealers who were corporate members of the Stock Exchange of Hong Kong (SEHK) were also subject to the sole business requirement under the Exchange rules.

(d) The Administration considered it inappropriate to confine the eligibility for conducting securities margin financing business to registered securities dealers and authorized financial institutions as this would create a market barrier for finance companies that wished to provide the service on a stand-alone basis.

(e) The Administration would consider providing the exemption from the need to become a registered SMF for conducting the business under a Schedule to the Ordinance which could be amended by SFC subject to "negative vetting" of the Legislative Council (LegCo). It was considered appropriate to continue to allow SFC to grant exemption to specific classes of persons by way of Commission rules, as provided in section 146(3) of the Bill.

(*Post-meeting note*: The Administration's written responses to the industry bodies and the Law Society of Hong Kong were circulated to members vide LC Paper Nos. CB(1) 1293, 1419(02) and (03), 1543 and 1578/98-99.)

Briefing on the draft Financial Resources Rules
(LC Paper Nos. CB(1)1404/98-99(01) & (02) and 1433/98-99)

1. The Executive Director of Intermediaries and Investment Products, Securities and Futures Commission (ED/IIP(SFC)) gave a presentation on the draft revised Financial Resources Rules (FRR). He explained that the amendments aimed at introducing new rules to strengthen financial regulation of SMFs and to standardise the regulatory capital requirements for all securities and futures dealers. In respect of rules governing securities margin financing activities, key elements included the following -

(a) A SMF was required to have a minimum paid-up capital of $10 million and to maintain at all times a liquid capital not less than $3 million or 5% of his total liabilities, whichever was the higher;

(b) In the calculation of liquid capital, values of stock collateral held by SMFs were discounted to take into account price fluctuations due to market volatility. Different haircuts were applied to different categories of stocks or warrants listed on SEHK and shares listed overseas. Haircut ratios for SEHK stocks and warrants were 15% for Hang Seng Index (HSI) constituent stocks, 20% for HS100 constituent stocks, 30% for all other stocks and 40% for warrants;

(c) To address the problem of over-exposure to individual stocks or clients, concentration risk adjustments were applied in the calculation stock collateral values. In respect of risk adjustment for stock exposure, excessive collateral in the form of any single or related stocks beyond certain thresholds in relation to the total stock collateral portfolio would be further discounted. The concentration thresholds to be prescribed were 20% for HSI constituent stocks, 15% for HS100 constituent stocks and 10% for all other stocks. As to client exposure, loan receivable from any single individual or related individuals or corporate groups in excess of 10% of the total loan portfolio would be subject to additional haircuts.

(d) There would be new reporting requirements for SMFs, such as disclosure of the top 20 margin clients, summary of bank facilities and their utilization, and analysis of collateral held. The proposed rules would also increase the frequency and expedite the timing of which SMFs were required to file their FRR returns.

2. The industry was concerned that the proposal to include "related securities", in particular those that were HSI constituent stocks, in the calculation of stock collateral values for FRR purposes would drive SMFs to accept second or third line stocks as collateral, hence increasing the risk involved in the margin financing business. ED/IIP(SFC) responded that SFC and the Administration did recognise the merit in relaxing the requirement on listed securities which were HSI constituent stocks and had considered alternatives, such as stipulating a higher concentration risk threshold, say 50%, for this group of stocks. However, the industry's concern was considered to be more theoretical than real. As there were 33 stocks in HSI constituent stocks, it would be very difficult for a loan portfolio to exhaust the stocks so

that any single or related stock would reach the concentration risk threshold of 20% of the total stock collateral portfolio. SFC so far had not come across any case where a portfolio with collateral having such a high concentration of HSI stocks reaching the 20% threshold which necessitated additional deductions in asset values. To better illustrate the situation, ED/IIP(SFC) undertook to provide the list of HSI constituent stocks identifying the "related" shares as defined in FRR for members' reference. As regards shares listed overseas, the rule on "related securities" was not applicable.

SFC

3. In respect of concentration risk adjustments for client exposure, ED/IIP(SFC) said that while the 10% threshold might pose a genuine problem for small scale SMFs having a few clients, SFC would consider granting a class exemption to provide relief for these SMFs. The threshold would not cause operational difficulty for typical SMFs which usually have numerous clients.

4. On the concern about the difficulty in identifying "related" clients, ED/IIP(SFC) remarked that SMFs should put in place adequate risk management systems and follow prudent margin lending policy to make proper assessment of clients' financial capacity in meeting obligations and to limit lending to related clients. These standards of business practices would be included in the Code of Conduct for SMFs. In addition, inter-company loan receivable as well as loan receivables due from particular clients whose financial capability had been adversely affected by volatility in the market would not be included in calculation of the SMFs’ liquid assets under the FRR.

5. Regarding reporting requirements for SMFs, ED/IIP(SFC) stressed that disclosure of the top 20 margin clients was essential for recongnizing systemic risks. The information on bank lines would facilitate SFC's regulation over pooling arrangement. He also advised that under existing legislation, SFC already had power to inspect the full margin books of SMFs and request for information concerning particular clients. He assured members that SFC was obliged under SFCO to keep the commercial and personal information obtained in the performance of its functions strictly confidential. On the other hand, SFC, in collaboration with SEHK, had been discussing with computer system service providers with a view to developing the necessary software for computing the various information required in FRR returns.

6. On monitoring of compliance with FRR requirements, ED/IIP(SFC) advised that SFC adopted a combination of measures for such purpose. FRR returns were analysed in detail. The returns from Exchange members were analysed by SEHK and referred to SFC if there were any apparent breach of the FRR. SFC would compile sensitivity analyses with information on stock collateral held by finance companies. There would be intelligence generated inquiries under situations where companies' FRR returns revealing areas of concern, sensitivity tests indicating that the companies might be affected by

price fluctuations in particular stocks, or Exchange reports showing unusual activities of members. Inquiries would also be initiated in response to complaints which might give rise to adverse impacts on a company's financial position necessitating reconciliation of liquid capital to ensure that it was available and realisable to meet liabilities. Besides, SFC ran a routine surveillance programme making on-site visits to companies annually, and subjecting each company to a detailed inspection covering its internal control systems and verification of FRR returns at least once every three years. There was also specific risk-based inspection programmes conducted to companies from time to time to address particular risk issues, such as securities margin financing and problems related to Year 2000 computer bugs.

7. As regards SFC's enforcement against non-compliance with the FRR requirements, ED/IIP(SFC) said that a period of 48 hours would usually be allowed for companies to remedy the situation. Failure of rectifying the problem within the period would result in disciplinary actions by SFC including restriction of business. In the event of a severe breach of requirements, SFC would consider suspending the company's registration. SEHK had complementary power in this regard in respect of its members. ED/IIP(SFC) also advised that apart from filing routine FRR returns, companies were required to report to SFC on any breaches of FRR requirements as soon as they occurred. Failure to report breaches might result in disciplinary action by SFC since this demonstrated the company's inadequate internal control system.

8. On the resources implications on SFC in monitoring the compliance of SMFs with the new FRR, ED/IIP(SFC) said that the new regulatory regime on securities margin financing would entail additional resource strain on SFC. While SFC had been deploying resources to work on monitoring of securities margin financing activities, in anticipation of implementation of the new regulatory regime, SFC had budgeted for the required resources in the 1999-2000 budget.

9. Members noted that the FRR should be able to cope with rapid changes in the market and practices of practitioners. For instance the list of "related securities" had to be up-dated whenever there were changes in cross-ownership of shares, or haircut ratios and concentration risk thresholds might need to be raised in case of extreme market volatilities. Mr FUNG Chi-kin was concerned that it might not be possible to make timely amendments to FRR, which was subsidiary legislation to SFCO, in response to such rapid changes. He enquired about the possibility of delegating the power to make the FRR to SEHK and SFC.

10. In response, PAS/FS said that the FRR had significant implications on the market and the Administration had been prudent in amending FRR. So far the rules had only been amended in 1995 since it was introduced in 1993. He

stressed that due to the importance of FRR on the operation of SMFs and for the sake of enhancing transparency in making the rules, the Administration considered it appropriate to continue with the present practice of that any amendments to FRR should be subject to prior consultation with the Financial Secretary and "negative vetting" by LegCo.

11. The Chairman expressed support for continuation of the existing arrangement for making amendments to FRR. He remarked that LegCo would be able to scrutinise amendment rules catering for urgent situations without delay.

12. ED/IIP(SFC) remarked that notwithstanding the extreme market volatilities in the recent Asian financial turmoil, FRR had proven to be a robust set of rules and performed its task satisfactorily in ensuring sufficient capital adequacy of securities dealers for meeting their liabilities. In view of the rapidly changing market, SFC recognised that it should not apply certain rules too stringently. While recognizing that market practitioners did manage their risks prudently, he stressed that they should be required to address problems expeditiously. Giving fair opportunities for practitioners to respond, SFC would monitor FRR compliance and take appropriate disciplinary actions against any breaches. On the question of up-dating the list of "related securities", ED/IIP(SFC) advised that agreement had been made with SEHK for the latter to compile and make public the updated list whenever necessary for industry's reference.

13. On the timetable of introducing the proposed amendments to FRR, PAS/FS said that the Financial Resources Rules 1999 would be introduced into LegCo in due course after the Bill was passed. ED/IIP(SFC) added that the new FRR would be effective on the same date when the amended ordinance came into operation. However, there would be a six-month grace period for registered securities dealers to bring themselves into conformity with certain requirements including the new paid-up capital and liquid capital requirements as well as concentration risk adjustments. Others, including reporting and disclosure requirements, would become effective once the new FRR was enacted.

14. As to the suggestion of extending the grace period for complying with the new FRR, PAS/FS said that given the prior consultation on the new regulatory regime for securities margin financing and the legislative lead time during which any serious business operators would have already been assessing their commercial prospects and viability and preparing themselves for compliance with the new rules, the Administration considered the six-month grace period sufficient.

Follow-up on outstanding issues arising from previous meetings

SFC
SFC

15. On the arrangements of pooling of client assets in Taiwan and the United States, ED/IIP(SFC) agreed to provide members with more detailed information obtained from respective regulatory authorities in due course. As regards the pooling situation in Singapore, he said that SFC had made further enquiries with the Singapore authority on the arrangement of allowing dealers to pledge clients' securities for a sum not exceeding the amount owed by the client and would provide further details in due course.

(*Post-meeting note*: The information was conveyed to members vide LC Paper No. CB(1)1543/98-99 dated 16 June 1999.)

Clause-by-clause examination of the Bill

Clause 1

16. Members noted that the enacted legislation would come into operation on a day to be appointed by the Secretary for Financial Services. While recognising that it was necessary to allow the industry sufficient time to prepare for the new regulatory regime, PAS/FS advised that the effective date would also need to tie in with successful enactment of and/or amendments to relevant subsidiary legislation that were necessary for the administration and operation of the regulatory regime. On transitional arrangements, he advised that existing registered securities dealers carrying on securities margin financing business would have 30 days to indicate to SFC their interest to continue to provide the business and existing unregulated entities could also submit application for registration during this period. Registered securities dealers would have six months to bring themselves into conformity with certain requirements under the new FRR including minimum paid-up capital requirement. All other parties were required to apply for necessary registration as SMFs, and to fully comply with the regulation once their licence was granted by SFC. During the processing of application for registration as SMFs, existing finance companies might be allowed to continue with their business subject to conditions imposed by SFC. They were required to fully comply with the regulation once their registration was granted.

Clause 2

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17. The Chairman questioned the need to provide definitions for 'agent' and 'audit' under section 2(1) as the meaning of the words were explicit. The Administration agreed to review the provisions.

II Any other business

18. The Chairman reminded members that the next two meetings had been scheduled for 21 and 22 June 1999, both at 8:30 am.

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

19. The meeting ended at 10:30 am.

Legislative Council Secretariat
20 January 2000