

LC Paper No. CB(1)103/99-00
(These minutes have been
seen by the Administration)

Ref: CB1/BC/13/98/2

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

**Minutes of meeting held on
Tuesday, 11 May 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 SIN Chung-kai
Hon FUNG Chi-kin
- Members absent** : Hon Bernard CHAN
Hon Jasper TSANG Yok-sing, JP
- Public officers attending** : Mr Bryan CHAN
Principal Assistant Secretary for Financial Services
- Ms Hanny 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 Meeting with the Administration
(LC Paper Nos. CB(1)1201/98-99 and 1293/98-99(01))

The proposed Financial Resources Rules

The Director of Intermediaries Supervision, SFC (DIS/SFC) explained the example in Annex A of the Administration's information paper which illustrated the application of haircut ratios and concentration discounting factor (CDF) under the new Financial Resources Rules (FRR) for calculating the liquid assets of securities margin financiers (SMFs).

2. Members noted that the risk-based FRR was to ensure sufficient liquid assets for SMFs to meet their liabilities and cover unexpected risks arising from market volatilities and over-exposure to specific stocks or individual clients. The proposed haircut ratios and concentrated risk thresholds applied on stock collateral were as follows -

<u>Categories of stocks</u>	<u>Haircut ratios</u>	<u>Concentrated risk thresholds</u>
Hang Seng Index (HSI) constituents stocks	15%	20%
HSI 100 constituents stocks	20%	15%
All other stocks	30%	10%

In short, higher haircut ratios would be applied to stocks which were less liquid. As regards concentrated risk adjustments, lower thresholds were set for less liquid stocks so that excessive collateral in the form of any single stocks beyond these thresholds in relation to the total stock collateral portfolio would be further discounted. As a result, a SMF who accepted less liquid stock collateral from margin clients and had a high concentration of this specific stock in the portfolio

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would be subjected to more deduction in the value of this stock and accordingly had to maintain more liquid capital to cover risks.

3. Some members opined that warrants, due to their high volatility, should not be accepted as stock collateral for obtaining margin loans.

4. The Executive Director of Intermediaries and Investment Products, SFC (ED/IIP(SFC)) stressed that notwithstanding the new FRR would tighten liquid asset requirement on SMFs, the rules were still less stringent than the credit requirements in respect of stock collateral for Authorised Institutions (AI) where haircut deduction of over 30% was common. The present proposals on haircut ratios and concentrated risk thresholds were to better reflect the characteristics of stock collateral. Categorization of stocks on the basis of constituents of HSI, HSI100 or other stocks was broadly indicative of their liquidity. As haircut ratios and CDFs were applied to share prices that were marked to market on a daily basis, they would take into account market volatilities. Moreover, market practices revealed that SMFs were conservative towards lending against warrants, and AIs providing securities margin financing service would not lend against warrants generally. Although warrants were included as collateral by SMFs, they usually applied much higher haircuts on the value of warrants to guard against risks of the higher volatility and did not repledge warrants to banks for securing credits. In fact, the volatility of warrants had been much reduced since the Asian financial turmoil as a result of the tightening up of rules on trading and settlement of warrants by SFC and the Stock Exchange of Hong Kong (SEHK). On the other hand, through the proposed revision of the Code of Conduct, SMFs would be encouraged to adopt more prudent credit policy. Besides taking greater care in granting loans against risky collateral such as warrants, SMFs were expected to assess the financial capacity of clients in meeting obligations rather than rely solely on the quality of collateral provided. As such, including warrants as collateral for margin loans would not pose additional risk to the securities margin financing business. Since there were divergent views from the industry as to whether warrants should be categorized as a distinct class for the purposes of calculating asset values under the FRR, the present proposal had already taken into account the existing market practice of accepting warrants as collateral for loans. In view of members' concern, ED/IIP(SFC) undertook to reconsider the issue and to provide information on the market volatility of warrants over the last six months for members' reference.

SFC

5. Some members were concerned about the distortion possibly caused to the liquidity and prices of stocks in the market with application of the new FRR since the rules might have the effect of encouraging or discouraging SMFs to accept specific stocks as collateral against margin loans. ED/IIP(SFC) stressed that although the new FRR would discourage the concentration of specific stocks collateral in SMFs' loan portfolio and encourage the holding of better quality stocks collateral, the rules did not restrict SMFs from holding particular stocks.

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Under the new FRR, a portfolio could still be fully collateralized against a particular stock, provided that the SMF had sufficient liquid assets to cover the risk involved. As such, the new FRR should not cause any distortion to the liquidity and prices of stocks.

6. A member opined that the new FRR could have the effect of encouraging margin clients to diversify their loans with different SMFs. While the new FRR might help addressing over-exposure of individual SMFs to risks, it might be ineffective in controlling the overall market risks.

7. In reply, ED/IIP(SFC) stressed that the requirement on SMFs to report their top 20 clients would be an effective measure to identify hidden market risks. He further explained that FRR was a long term risk management tool. In the event of an extreme market condition leading to a dramatic drop in prices of the majority of shares, haircut ratios and concentrated risk adjustments might still be inadequate in tackling the risks. Under such circumstances, SMFs' prudent credit policy in granting loans remained foremost important.

8. As regards the mechanism for reviewing the haircut ratios and concentrated risk thresholds, ED/IIP(SFC) explained that as collateral value would be marked to market on a daily basis, volatility caused by short-term fluctuations in value and quality of stocks collateral would be addressed. Furthermore, periodic reviews would be conducted on the appropriateness of the haircut ratios and concentration risk thresholds, as well as the categorisation of stocks to gauge changes in market conditions over time. Amendment to FRR would be necessary for bringing in new haircut ratios and concentrated risk thresholds.

Submission by the Law Society of Hong Kong

Companies

9. On the Law Society of Hong Kong (LSHK)'s concern about restriction on partnerships from registering as SMFs, ED/IIP(SFC) said that unincorporated business was generally not considered to be an appropriate business structure for conducting registrable activities. The problems were particularly evident in the case of sole-proprietorships. However, the some 150 sole-proprietors out of the total of about 550 members of SEHK and one dealing partnership registered with SFC which currently provided securities margin financing service would be exempted from obtaining a separate licence for their securities margin financing business but required to meet the new FRR.

10. As regards overseas incorporated companies, ED/IIP(SFC) confirmed that they would be eligible for registration as SMFs. Directors or responsible officers of these companies who took up management responsibility of the

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company in Hong Kong had to be Hong Kong residents in order to meet the requirement on residential status of directors of companies under the Companies Ordinance (Cap. 32).

11. The Principal Assistant Secretary for Financial Services (PAS/FS) supplemented that problems associated with licensing of unincorporated persons as intermediaries registrable activities would be addressed under the composite Securities and Futures Bill. The industry would be consulted on the proposal to impose corporate requirement on various classes of registrants. There would be transitional arrangements for existing sole proprietorships and partnerships.

Unlisted Securities

12. ED/IIP(SFC) said that SFC was not sure about LSHK's concern in this respect. He explained that if the concern was about SMFs securing unlisted securities as collateral, there were already rules under FRR to deal with unlisted securities and other financial products which were not traded on an exchange. Members agreed to seek clarification from LSHK regarding its concern on the matter.

(Post-meeting note: Representatives of LSHK had clarified the concern at the meeting held on 1 June 1999.)

Third party arrangers

13. ED/IIP(SFC) confirmed that the definition of "SMFs" was intended to capture only persons who "provide" the financial accommodation. Hence, third party arrangers who took the role of effecting the introduction or introducing investors to off-shore money lenders did not fall within the definition. Nonetheless, they were still required to be registered with SFC as either a dealer or an investment adviser in accordance with the Securities Ordinance (Cap 333). As regards regulation over overseas SMFs, ED/IIP(SFC) clarified that application of the new Part XA of the Bill was confined to a securities margin financing business carried out in Hong Kong. SFC would step up joint efforts with overseas regulators in monitoring overseas SMFs and organise education programme to draw investors' attention to risk involved in dealing with off-shore SMFs.

Exemptions

14. ED/IIP(SFC) advised that section 121B(2) of the Bill had stipulated exempted activities. The definition for securities margin financing activities had been drawn deliberately wide to catch those activities that would normally fall within the scope of a SMF's business. While SFC would consider the exemption list suggested by LSHK, it maintained the view that exemptions should better be dealt with on a case-by-case basis by SFC with power provided under the new section 121BG of the Bill and section 146(3) of the Securities Ordinance (SO) (Cap.333).

"Purpose" of loans

SFC/Admin. 15. On the concern about the difficulty for SMFs to find out the underlying purpose of the margin loans, ED/IIP(SFC) said that it would be sufficient for SMFs to have reasonable belief about the intended use of the loans. As indicated in the Administration's written response, SFC and the Administration would give further thoughts to and seek legal advice on points raised by LSHK.

Client information

SFC/Admin. 16. ED/IIP(SFC) stressed that the requirements for SMFs to provide statements of account to clients were necessary to ensure that clients were fully aware of their account positions and changes thereof in a timely manner. As regards suggestion of waiving the monthly statement if there was no movement in the account during the month, ED/IIP(SFC) said that the suggestion would be considered in the context of granting general waiver to requirements on client information.

Securities collateral

17. As the new section 121AA restricted the disposition of securities collateral by requiring SMFs to deposit collateral in safe custody and obtaining annual renewal of client authorisation in this respect, LSHK was concerned that the interests of SMFs would not be adequately protected since they might not be able to enforce security when their clients defaulted. Some members pointed out that there was ambiguity on the proprietary interest of securities collateral which SMFs had pledged to banks for securing credits or had deposited in the Central Clearing and Settlement System (CCASS) on behalf of their clients. Noting that the court judgement on the C.A. Pacific case had retained clients' proprietary interests in the securities deposited with the securities dealer entity despite the fungible nature of such securities in CCASS, members requested the Administration to provide a paper explaining the judgement on the C.A. Pacific case and the implications on the Bill for their reference.

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18. In response, ED/IIP(SFC) advised that the refusal of a client to renew the authorisation with a SMF on the use of his securities would not prejudice the interest of the SMF and affect the latter's right to dispose of the securities to discharge clients outstanding loans. Moreover, it was expressly provided in section 121AA(8) of the Bill that a lawful claim or lien in respect of securities collateral would not be defeated. In view of LSHK's concern, consideration was being given to amend section 121AA in the light of proposed amendment to section 81 of SO to allow clients' securities to be registered in the name of the SMF or its nominee and to clarify the right of SMF to dispose of the securities collateral in case of client default.

Admin

19. As regards implications of judgement of the C.A. Pacific case, PAS/ES said that the judgement was indeed in line with the long-held understanding of the Administration, SFC and SEHK, that as a general rule, proprietary interest of securities held in safe custody by brokers on behalf of their clients belonged to the clients. The Bill did not intend to change the principle that clients should have proprietary rights over the securities held in custody by brokers on their behalf. The issue of proprietary rights over securities collateral deposited by clients should be governed by the terms of the agreements between the parties concerned and rules of common law and equity. The Administration would provide further information on the judgement of the C.A. Pacific case for members' reference.

II Any other business

Date of next meetings

20. Members agreed to hold the next two meetings on 20 and 31 May 1999, both at 8:30 am. They further agreed to meet industry bodies and the LSHK to discuss their views on the Bill at the meeting on 31 May 1999.

(Post-meeting note: The meeting on 31 May 1999 was subsequently re-scheduled for 1 June 1999, at 8:30 am.)

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

Legislative Council Secretariat

12 October 1999