

**立法會**  
**Legislative Council**

LC Paper No. CB(1) 1987/99-00  
(These minutes have been seen  
by the Administration and  
cleared by the Chairman)

Ref: CB1/BC/13/98/2

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

**Minutes of meeting held on  
Saturday, 22 January 2000, at 10:30 am  
In Conference Room B 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
- Miss 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 CHUNG Hing-hing  
Associate Director of Licensing
- Clerk in attendance** : Ms LEUNG Siu-kum  
Chief Assistant Secretary (1)4
- Staff in attendance** : Mr KAU Kin-wah  
Assistant Legal Adviser 6  
  
Ms Connie SZETO  
Senior Assistant Secretary (1)1
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## **I Meeting with the Administration**

### Monitoring the activities of securities margin financiers during the application period for registration

Members noted that section 121BH(1) of the Bill provided that independent finance companies now carrying on securities margin financing business had to apply to the Securities and Futures Commission (SFC) for registration within 30 days after the commencement of the Amendment Ordinance and they would continue to operate pending the determination of the application. Moreover, existing registered securities dealers who wished to continue to provide securities margin financing business would be allowed six months to bring themselves into conformity with new capital requirements under the new Financial Resources Rules (FRR).

2. Some members expressed concern about protection for investors and the mechanism to monitor the activities of securities margin financiers (SMF) during the transitional period. In this connection, Mr FUNG Chi-kin cited the example of long-delayed approval of applications for registration under the Leveraged Foreign Exchange Trading Ordinance (Cap. 451) for some cases and expressed worries that clients dealing with non-registered financiers during the transitional period would be exposed to high risk.

3. The Executive Director of Intermediaries and Investment Products, Securities and Futures Commission (ED/IIP(SFC)) replied that it would be impractical to specify a time limit for SFC to approve applications for registration as SMFs. SFC envisaged that there would only be a few applications at the initial stage. As SFC had been monitoring the activities of existing securities margin financing service providers in the past few years and had gathered information of the potential applicants, SFC could process such applications within a reasonable period notwithstanding the possibility of a longer processing time for some exceptional cases. He added that currently delay in processing applications for registration with SFC was usually due to the need to seek further information from the applicants or comments from other regulators or the Police. In some cases, where appropriate, SFC could consider granting provisional licences to applicants pending replies from relevant parties. SFC had received complaints in very few such cases. Thus, risks in dealing with SMFs during the application period should not be a concern.

4. As regards concern about protection for investors during the transitional period, ED/IIP(SFC) said that, as provided in section 121BH(3), SFC would make orders specifying the manner in which the applicants could carry on the existing business and deal with clients' assets. In addition, SFC was closely monitoring the activities of existing service providers since the problem of securities margin financing had been exposed during the Asian financial turmoil. It had been making contacts with and inspections to finance companies with a view to better understanding their risk issues and their handling of clients' collateral. SFC would step up its efforts in this area so as to prevent misconduct of service providers during the transitional period.

Collateral interest of banks under the proposed sections 81A and 121AA of the Securities Ordinance (SO) (Cap. 333)

5. The Bills Committee had previously expressed concern that the proposed sections 81A and 121AA of SO, which required the annual renewal of clients' written authorization to deposit securities collateral with banks to facilitate the provision of financial accommodation by the dealers or SMFs, might prejudice banks' security interest if clients refused to renew the authorization.

6. ED/IIP(SFC) said that where banks had lawfully obtained collateral interest over securities from dealers or SMFs, their collateral right should not be jeopardized by the clients' actions. The Bill was neutral in respect of banks' position on the matter. The proprietary rights over securities collateral deposited by clients should be governed by the terms of the agreements between the parties concerned and the rules of common law and equity. The Administration did not intend to establish a statutory position in the Bill on the relationships among different parties. In the circumstance that clients refused to renew the authorization under section 81A and 121AA, such action should not disturb banks' lawful entitlement over the securities pledged by the dealers or SMFs. It was also expressly provided in the proposed sections 81B and 121AA(8) that a lawful claim

or lien would not be defeated. Nonetheless, banks should take action to better safeguard their collateral interest, say, to obtain warranty from the dealers or SMFs that the renewal requirement was complied with. ED/IIP(SFC) added that the Hong Kong Association of Banks (HKAB) had not raised any concern about the issue. The above interpretation of sections 81A and 121AA was well accepted when discussion was held with legal advisers of some banks.

Examination of the Draft Committee Stage Amendments (CSAs) to the Bill

(LC Paper Nos. CB(1) 774/99-00(01) - sixth draft CSAs dated 30 December 1999, CB(1) 865/99-00(01) - marked-up copy of the Blue Bill, and CB(1) 872/99-00(02) - replacement sheet (000030) for the marked-up copy of the Blue Bill)

7. Members continued the examination of the sixth draft CSAs proposed by the Administration. They scrutinized CSAs for sections 121AB to 121BH and consequential amendments in Schedules 1 to 4 and the new Schedule 4.

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8. The Administration undertook to revise the sixth draft CSAs taking into account Bills Committee's views expressed in previous meetings held on 13 December 1999, 13, 19 and 21, January 2000. The revised draft would be circulated to members as soon as possible.

Draft CSAs for Division 4 of the Bill

(LC Paper No. CB(1) 872/99-00(01) - explanatory note and the first draft CSAs dated 3 January 2000 for Division 4 of the Bill)

9. Members were briefed on the draft CSAs to Division 4. Section 121AC explained the application of the Division. Section 121AD provided that the contract entered into between the client (the purchaser) and an unregistered SMF (the provider) would be unenforceable by SMF against the client. The client was entitled to recover any money or property paid under the contract and seek compensation for any loss sustained by him as a result. Section 121AE(4) gave the court discretion to allow the contract, which would otherwise be unenforceable, to be enforced against the client when it took the view that it would be "just and equitable" for the contract to be enforced or when a SMF could prove that he was not contravening section 121C by making the contract. Section 121AE(5) provided that the client would not get windfall benefits.

10. The Chairman re-iterated the concern that the new Division 4 might protect those clients who were aware that a SMF was unregistered and still entered into a contract with him. While agreed that non-innocent clients should not be entitled to seek compensation, Mr Albert HO opined that some clients entering into contracts with unregistered SMFs might have a mistaken impression that the unregistered SMF was in the process of registering with SFC. He therefore raised concern that denying all clients of unregistered SMFs the right to recover money or property paid under the contract could be unfair to the clients.

SFC 11. ED/IIP(SFC) responded that SFC would re-consider the conditions under which a client could be entitled to seek compensation for loss.

12. As regards the effect of new Division 4 on the rights of bona fide third parties, ED/IIP(SFC) said that whether the contract entered into between a client and an unregistered SMF would be enforceable or otherwise would not affect the third party. Section 121AE(6) provided that if property transferred under the contract had been passed to a third party and had become unavailable for recovery by clients, the value of the property for the purposes of sections 121AD and 121AE would be taken as at the time when the property was transferred under the contract.

13. On Mr Albert HO's suggestion to expressly provide in Division 4 that the interests of the bona fide third party would not be affected, ED/IIP(SFC) remarked that this would be unnecessary.

Admin 14. The Chairman suggested the Administration consult HKAB, the Hong Kong Society of Accountants, and the Law Society of Hong Kong on the draft provisions for Division 4. The Administration agreed to re-draft Division 4 taking into account Bills Committee's comments and consult the above three organizations on the revised draft provisions.

#### Pooling of clients' assets

15. The Principal Assistant Secretary for Financial Services (PAS/FS) informed members that HKAB supported the Administration's revised proposal to introduce the requirement which limited the amount of credit facilities that SMFs or securities dealers could obtain from pledging clients' securities collateral by way of Code of Conduct (the Code). On HKAB's suggestion to state in the Code that position of banks taking security over clients' securities would not be affected by any breach of the Code, PAS/FS said that as the Code was non-statutory, banks' collateral interest would not be unfairly prejudiced.

16. Mr Albert HO remarked that the concern of the Democratic Party was whether SFC would exercise adequate monitoring over SMFs and securities dealers for compliance of the relevant Code. Unlike FRR which was subsidiary legislation to the Securities and Futures Commission Ordinance (SFCO) (Cap 24), the Code did not have the force of law. Mr HO therefore enquired about sanctions against breaches of the Code.

17. ED/IIP(SFC) responded that in monitoring compliance with the Code, SFC had put in place a combination of measures including routine inspections and complaint-driven inquiries. At present, SFC made on-site visits to securities dealing companies annually to examine, inter alia, their risk management systems, cash flow management, margin lending policy etc. In addition, specific risk-based programmes were conducted to companies from time to time to address

particular risk issues, such as margin financing. Inspections to companies which were members of the Stock Exchange of Hong Kong were currently carried out jointly with the Exchange. In anticipation of implementation of the new regulatory regime on securities margin financing, SFC and the Exchange were prepared to conduct a series of inspections into the margin financing operation of over 100 finance companies. SFC would take over the responsibility from the two exchanges to monitor compliance of exchange participants with the Code and various requirements under FRR after the merger reform. With the new FRR coming into force, SMFs and dealers would be subject to new reporting requirements. More information on the companies' margin financing business would be available which would facilitate SFC in monitoring their compliance with the Code.

18. On sanctions against breaches of the Code, ED/IIP(SFC) said that notwithstanding that the Code was non-statutory, it laid down the standards of business practices expected by regulators. The Code helped to identify and remedy risks of SMFs and dealers. As such, the Code was effective in preventing breaches of related ordinances and statutory rules. Persistent breaches on the Code would lead to query over the "fitness and properness" of SMFs or dealers for continued registration. In the absence of satisfactory explanation or appropriate remedial actions by SMFs or dealers, SFC would consider these persons no longer fit and proper for conducting the registrant business and could take disciplinary actions, such as private reprimand and revocation of licence as appropriate.

#### The rule making power of SFC

19. Members noted that section 146 of SO empowered SFC to make rules for the regulation of registrants with SFC. SFC was also empowered under section 28 of SFCO to make the FRR. Commission rules made under section 146 of SO and FRR under section 28 of SFCO were subsidiary legislation, the making and amendment of which were subject to "negative vetting" by the Legislative Council (LegCo).

20. The Chairman re-iterated some members' suggestion to subject Commission rules and FRR to "positive vetting" by LegCo or to provide in the Bill option for the Administration to introduce these rules by way of subsidiary legislation or to subject them to "positive vetting" of LegCo. The suggestion would provide LegCo with more time to scrutinize complicated rules and those with significant impact on the market.

21. PAS/FS stressed that the current regime of making Commission rules by negative vetting had been working well and there seemed to be no strong reason to change the present arrangement. As regards scrutiny of FRR, recognizing the complexity of the rules and the various concerns raised by the industry during the consultation period, SFC had already made changes to the draft addressing the concerns and presented it at a meeting of the Bills Committee. ED/IIP(SFC) supplemented that following the passage of the Bill by mid March 2000, SFC

could approve the draft FRR within a short period of time so that the Administration could submit the subsidiary legislation within March. The revised FRR would come into effect on the date it was gazetted. However, there would be a six-month transitional period for registered dealers to comply with certain new capital requirements.

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22. As regards the proposal providing the Administration with flexibility in introducing Commission rules and FRR, PAS/FS remarked that it involved fundamental change to the existing regime of subsidiary legislation. The proposal was unprecedented and would have implications which required prudent examination. He undertook to refer the proposal for consideration by the Department of Justice and the Director of Administration and revert to the Bills Committee at the next meeting.

### **III Any other business**

#### Resumption of Second Reading debate on the Bill

23. As the Bills Committee would need to scrutinize the revised draft Division 4 and, if necessary, the finalized draft CSAs for the remaining parts of the Bill, members decided that the Bills Committee would report to the House Committee on 3 March 2000 and recommend resumption of the Second Reading debate for the Bill on 15 March 2000.

#### Date of next meeting

24. Members agreed to hold the next meeting on 17 February 2000 at 2:30 p.m.

25. There being no other business, the meeting ended at 12:05 p.m.

Legislative Council Secretariat

2 August 2000