

立法會
Legislative Council

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by the Administration)

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

**Minutes of meeting held on
Monday, 27 September 1999, at 8:30 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 Jasper TSANG Yok-sing, JP
Hon FUNG Chi-kin

Members absent : Hon Bernard CHAN

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 Richard YIN
Director of Intermediaries Supervision
- Mr Leo LEE
Director of Licensing
- Mrs Yvonne MOK
Associate Director of Intermediaries Supervision
- Ms Judith YUEN
Senior Manager of Licensing
- 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
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I Discussion with the Administration

Clause-by-clause examination on the Bill

Clause 4 - Consequential amendment of the Securities Ordinance (Schedule 1 to the Bill)

The Bills Committee continued to study item 25. Members noted that proposed section 81 sought to restrict the use of cash clients' securities deposited with the securities dealers for safe custody purpose. Sections 81(4) provided that such securities could not be used for other purposes except as permitted by Commission rules. On the concern about inflexibility of the provision disallowing dealers to use securities for any other purposes even with the written authorisation of clients, the Executive Director of Intermediaries and Investment Products, Securities and Futures Commission (ED/IIP(SFC)) said that Securities

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SFC and Futures Commission (SFC) would prescribe rules to allow the use of securities held in safe custody for stock lending and borrowing. He took note of members' views and undertook to review the drafting of the provisions to put beyond doubt that flexibility would be provided in using the securities held in safe custody and to reflect clearly the rationale for SFC to make rules in this respect.

2. Members noted that section 81A was to impose restrictions on dealers in disposing securities collateral deposited by margin clients. ED/IIP(SFC) confirmed that the list provided under subsection (5), of ways a dealer could dispose of the collateral, was meant to be exhaustive. However, these uses were permitted only with written authority by clients. Moreover, whether a dealer could dispose securities collateral for settlement of clients' obligation and liabilities would depend on the contractual agreement between the dealer and the client. The Principal Assistant Secretary for Financial Services (PAS/FS) supplemented that the Administration would move appropriate Committee Stage amendments (CSAs) under section 81A(2)(a) to allow dealers to register securities collateral in the name of the dealer or his nominee to facilitate enforcement of security by the dealer in case of default by margin clients. The amendment would address the concern raised by the Law Society of Hong Kong about insufficient protection for the interest of the lender or a "bona fide third party".

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SFC 3. Under section 81A(3), the Chairman pointed out that the last word "documents" might be inappropriate. ED/IIP(SFC) undertook to consider the Chairman's suggestion to recast the last few words of the subsection as "...satisfactory facilities for such safe custody". He also noted the Chairman's
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SFC suggestion to review the drafting of sections 81 and 81A to ensure consistencies between subsections (2) and (4).

4. Upon the Chairman's enquiry, ED/IIP(SFC) confirmed that sections 81 and 81A would be applicable to exempt dealers which included an authorised institution (AI) as defined under the Banking Ordinance (Cap.155). However, persons such as lawyers and accountants where the holding of securities was only incidental to their business would not be caught by these provisions.

5. Mr FUNG Chi-kin was concerned that the requirement under section 81A(6) for securities dealers to obtain annual renewal of written authorisation from margin clients regarding the uses specified in subsection (5) would cause operational difficulties for dealers. Noting that AIs were exempted from the requirement, it was unfair that dealers and securities margin financiers (SMFs) were subject to the requirement.

6. PAS/FS said that securities dealers were subject to the same requirement already existed under section 81(3) of the existing Securities Ordinance(SO)

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(Cap 333). From the point of view of enhancing protection for investors' interest, the Administration considered it inappropriate to relax the requirement. ED/IIP(SFC) added that while recognising the industry's concern about compliance difficulty, SFC was of the view that as the authorization under section 81A(5) waived an important obligation for the dealers in the proper safeguard of clients' assets entrusted to them, explicit consent from clients should be required for the sake of better protection for investors' interest, which in turn, also ensured adequate risk disclosure and proper explanation to the clients. Notwithstanding that investors had so far not suffered any losses as a result of dealers' breaches of this requirement under the existing 81(3) of SO, SFC's inspections did reveal instances of dealers failing to comply with the provision and in some cases had resulted in disciplinary actions by SFC including private or public reprimands.

7. Regarding the disposition of clients' collateral in the event that renewal of the authorisation was not obtained, ED/IIP(SFC) assured members that while disposition of securities would be restricted, dealers' right to effect security for meeting outstanding loans owed by the clients concerned would not be frustrated.

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8. On item 27(a)(i), where it proposed to repeal "or any related corporation" in section 83(3)(a)(vi), the Chairman opined that the original provision should be retained so that the dealer was required to keep records of those securities which had been deposited with the dealer as collateral for loans or advances made to the dealer or any related corporation of the dealer. Such records would facilitate SFC's inspection of corporations related to a dealer in case of any suspected breaches of the relevant ordinances. The Administration agreed to review the provision.

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9. As to item 27(b), the Chairman opined that it would be unnecessary to replicate "financial accommodation" in section 83(3)(a)(viii) since the full definition would be provided under the amended section 2(1). The Administration undertook to review this provision. The Chairman also urged the Administration to re-examine section 83(5) regarding the period for which dealers were required to keep the relevant account records taking into account members' views expressed in previous meetings.

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10. On item 28(c), the Chairman requested the Administration to review the provision taking into account similar comments made on item 27(b).

11. Referring to item 36(b), PAS/FS explained that the Department of Justice was of the view that since section 94 of SO prohibited an auditor or an employee from communicating certain information which came to his knowledge in the course of performing his duties, a penalty provision should be added in the section to provide for proper sanction against contravention of the requirement.

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Admin ED/IIP(FSC) clarified that the scope of section 59 of the Securities and Futures Commission Ordinance (SFCO)(Cap.24), which concerned preservation of secrecy, was wider than section 94 of SO. The sanction for contravention of section 59 of SFCO was provided in subsection 59(7). The Chairman pointed out that the existing section 94(d) of SO was too restrictive and would prevent communication of information among employees. There were also differences in the drafting of the penalty provisions in section 94 of SO and section 59 of SFCO. He urged the Administration to review these provisions.

Admin 12. As to item 37(c), members pointed out that there were differences in the formulation of the proposed sections 95(3) and (5) which were related. They noted that the phrases "an answer that is false or misleading" and "an answer that is... materially false or misleading" which had different meanings were used inter-changeably in the two sections, whereas the phrase "to be false or misleading in a material particular" was adopted in other provisions such as sections 29A(9) and 33(12) of SFCO. The Administration was urged to review this item to avoid inconsistency in the drafting.

13. Members noted that item 42(b), which added the new subsection (aa) under section 144(1), was to subject unregistered SMFs to court orders restraining them from carrying out margin financing business. ED/IIP(SFC) elaborated that SFC was empowered under section 45 of SFCO to present petition for the winding-up of a company if it was in the public interest to do so. Such power had been invoked for the winding up of the C.A. Pacific Group.

Admin/SFC 14. Regarding item 43, members noted that the proposed subsections (1)(c), (d), (f) and (k) under the new section 146 were new provisions which empowered SFC to make rules for the regulation of SMFs or their representatives. PAS/FS confirmed that Commission rules were subsidiary legislation to SO. Members opined that due to complexity of the rules and their significant impact on the market, it would be advisable to allow a longer scrutiny period for the rules. Hence, they proposed that the Commission rules be subject to "positive vetting" of the Legislative Council. PAS/FS said that the proposal would be a fundamental departure from the current practice and might not be conducive to the regulator's ability to respond to urgent market changes. The proposal, if adopted would also affect the drafting of the Securities and Futures Bill to be introduced in due course. The Administration had to examine the issue carefully in consultation with SFC.

15. Mr Albert HO questioned the need of the proposed section 146(3) which would have the effect of exempting "specified persons" from Commission rules. ED/IIP(SFC) agreed that the drafting of the provision was a bit unusual since exemption would usually be granted for specific class of registrants. He assured members that exemptions would only be prescribed under very extraordinary

situations and SFC would ensure that the process would be completely transparent.

16. As to the proposed section 146A under item 44, some members queried whether it was appropriate for the Chief Executive (CE) in Council to make regulations on comparatively technical matters which were of operational concern only. PAS/FS clarified that the proposed 146A sought to enable the CE-in-Council to specify the sanctions for contravention of any rules made under section 146 and was in line with existing provisions. He also advised that rules relating to the operation of securities and futures market and those concerning the interests of the investing public would usually be made by SFC or SFC in consultation with the Financial Secretary.

Clause 5 - Consequential amendment of the Securities and Future Commission Ordinance (Schedule 2 to the Bill)

17. On item 6(b), ED/IIP(SFC) explained that the purpose was to put beyond doubt the implicit power of SFC to grant, amend or revoke approvals made under section 28(2) of SFCO. SFC's decisions made in this respect were often straightforward, such as identifying rating agencies for relevant purposes and making clear classes of securities for dealing under the Financial Resources Rules(FRR). He added that the power for SFC to grant waiver or modification of FRR requirements on registrants in relation to their business was provided under section 29. Decisions of this kind were often subject to conditions as SFC saw fit. For instance, SFC could impose trading limits to restrict a firm's scope of business.

18. Members noted that item 7 was to add a new section 29AA providing SFC with the power to exempt registrants from operation of FRR. The Director of Intermediaries Supervision, SFC said that applications contemplated would include exemption from specific rules, in particular those related to risk management measures, such as haircuts on value of securities collateral. In granting an exemption, SFC would have to be satisfied that conditions stipulated in section 29AA(4) were met, i.e. the particular FRR requirements would be onerous on the applicant and the exemption would not result in any undue risk to the investing public. Some members expressed concern about the need to provide SFC with this power. In response, ED/IIP(SFC) explained that as FRR were stipulated for the entire industry covering a wide range of businesses, it would be necessary for SFC to modify these rules or to grant exemption from the requirement to certain persons in order to provide flexibility for the operation of individual businesses where appropriate. He stressed that while there would be no exemption from basic regulatory requirements, such as minimum paid-up capital, exemptions from certain risk management measures would be granted in recognition that some firms, such as multi-national financial corporations, would put in place more sophisticated risk management models to suit their own

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business conducted world-wide. Regulatory counterparts in UK and USA had also adopted a similar approach. ED/IIP(SFC) stressed that in considering applications for exemption, SFC would endeavour to strike a balance between the need to provide flexibility to facilitate operation of the business and to ensure proper management of risks by firms for better protection of interest of the investing public. He further assured members that such decisions would be made by senior staff of SFC who were at executive directorate or directorate level and published in the Gazette to ensure transparency. Exemptions would be subject to conditions and specific period of time where appropriate and SFC would continue to monitor compliance of applicants to ensure that these conditions were observed.

SFC 19. Members expressed reservation over the drafting of section 29AA(4)(a). They opined that rules which would be "unduly burdensome for the person or persons concerned" should not be a factor of consideration for granting exemptions. ED/IIP(SFC) undertook to consider the Chairman's suggestion to recast subsection (4)(a) and (b) to better reflect the intention of the provision that the exemption granted was to facilitate business operation without compromising interest of the investing public.

*Clause 6 - Consequential amendment of other ordinances
(Schedule 3 to the Bill)*

20. Members examined the items under this clause and did not raise any query.

Clause 7 - Savings and transitional provisions (Schedule 4 to the Bill)

Admin 21. Members expressed grave concern about item 1, which provided the Chief Executive in Council with the power to make regulations of a savings or transitional nature consequent on the enactment of the Ordinance. They pointed out that such regulations made would then prevail over the provisions in the principal ordinance and considered this unacceptable. PAS/FS said that the Administration and SFC did not envisage any circumstance which would warrant the use of this safety net provision. Nevertheless, the Administration would re-consider the need of item 1.

Follow-up on issues raised at previous meetings

22. Members noted that the Administration had provided a master list of issues (i.e. Enclosure A of LC Paper No. CB(1)1959/98-99(01)) which had been raised at previous meetings and their latest positions. They agreed that the Bills Committee would examine the list together with draft CSAs to be provided by the Administration in due course.

The Administration's response to the Democratic Party's proposal on "pooling arrangement"

(Enclosure B of LC Paper No. CB(1)1959/98-99(01))

23. PAS(FS) said that in response to the Democratic Party (DP)'s concern about the risk involved in the pooling arrangement under which a SMF or securities dealer might pledge clients' securities collateral for credit facilities in excess of the clients' margin loans and used the facilities for any purposes, the Administration had considered and was prepared subject to further deliberation at the Bills Committee to accept DP's proposal as set out in the Administration's information paper. He explained that the proposal, in essence, sought to impose a condition that credit facilities obtained through pledging of margin clients' securities collateral should only be available for financing clients' margin loans. The Administration would propose CSAs to sections 81A and 121AA of the Bill to give effect to the proposal if adopted.

24. Mr FUNG Chi-kin pointed out that there would be operational difficulties for SMFs and dealers to comply with the condition which would also add costs to their business. The Chairman, while not opposing the principle of the proposal, expressed concern about the ensuing operational problems for the registrants and enforcement difficulties for SFC. He opined that apart from the impracticability of implementing the proposal on overseas based registrants or those which had overseas branches, the proposal would only limit the amount of credit facilities a SMF or dealer could draw down to the total margin loans due from all of its clients at any one time. Thus, the proposal would not address the risk of a client's securities collateral being misused for meeting the liability of other clients. Furthermore, the proposal seemed to put local SMFs and dealers in a comparatively disadvantageous position.

25. Mr Albert HO, on behalf of DP, said that notwithstanding that the proposal had limitations, it would render better protection to investors if pooling of clients assets was allowed to continue. To address the industry's concern, he agreed that flexibility should be given in implementing the proposal, such as prescribing a percentage limit which a SMF or dealer could draw down on total amount of credit facilities available.

26. PAS(FS) responded that although there had not been an extensive industry consultation on the proposal, the SFC had discussed with market practitioners about the implementation of the proposal. While the Administration was sympathetic to the industry's concern about compliance costs, it considered that this would not necessarily require extensive modification of their present operating systems. Having considered the possible merits and demerits of the proposal, the Administration believed that the proposal would strike a balance between outright banning of pooling, thus adversely affecting the commercial viability of SMFs and dealers, and preventing misuses of clients' assets with a

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view to enhancing investor protection. ED/IIP(SFC) supplemented that although SFC was not aware of any abuse of clients' assets by dealers, in the absence of any restriction, the present arrangement did expose clients' assets to higher risks. As regards the concern about operational difficulties, recognising that credit lines for financing the operation of a firm were often not separated from the credit facilities which were secured by clients' securities collateral or the firm's own assets, he agreed that a buffer could be set by specifying a % cap which a SMF or dealer could draw down on the total credit facilities available in order to allow flexibility in meeting daily cashflow requirement of the business of the SMF or dealer.

27. Noting that the Singaporean model on pooling on which DP's proposal was based had proven to be rather impractical and that similar rules on pooling were not found in major financial markets elsewhere, the Chairman considered that the Bills Committee should take a prudent approach on the matter. He suggested and members agreed to invite those deputations which had made submissions to the Bills Committee previously to give views on the Administration's present proposal.

(Post-meeting note: The organizations concerned have been invited to give views on the proposal regarding pooling of clients' assets as presented by the Administration and respond to the Bills Committee by 16 October 1999.)

II Any other business

Date of next meeting

28. Members agreed that the next meeting should be held to consider draft CSAs proposed by the Administration when they were ready. Members would be notified on the details of the meeting in due course.

29. The meeting ended at 12:30 pm.