

LC Paper No. CB(1)59/99-00
(These minutes have been
seen by the Administration)

Ref : CB1/SS/8/98/1

**Subcommittee on
Securities (Dealers, Investment Advisers, Partnerships and Representatives)
(Amendment) Rules 1999**

**Minutes of meeting held on
Thursday, 22 April 1999, at 4:30 pm
in Conference Room B of the Legislative Council Building**

- Members present** : Hon SIN Chung-kai (Chairman)
Hon Bernard CHAN
Hon Jasper TSANG Yok-sing, JP
Hon Ambrose LAU Hon-chuen, JP
Hon FUNG Chi-kin
- Member absent** : Hon Albert HO Chun-yan
- Public officers
Attending** : Mr Bryan P K CHAN
Principal Assistant Secretary for Financial Services
(Securities)
- Mr Wallace LAU
Assistant Secretary for Financial Services (Securities)
- Attendance by
by invitation** : Securities and Futures Commission
- Ms Lynn BAI
Senior Manager
Supervision of Markets
- Mr Anthony WOOD
Senior Counsel

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

Staff in attendance : Mr Stephen LAM
Assistant Legal Adviser 4

Ms Connie SZETO
Senior Assistant Secretary (1)1

I Election of Chairman

Proposed by Mr Ambrose LAU Hon-chuen and seconded by Mr TSANG Yok-sing, Mr SIN Chung-kai was elected Chairman of the Subcommittee.

II Meeting with the Administration (LC Paper No. CB(1)1170/98-99)

2. The Principal Assistant Secretary for Financial Services (Securities) (PAS/FS(S)) said that the purpose of the Securities (Dealers, Investment Advisers, Partnerships and Representatives) (Amendment) Rules 1999 (the Amendment Rules) was to facilitate implementation of the measure of strict enforcement of compulsory buy-in for outstanding stock positions which failed to settle by T+2 (i.e., two days after the date of the transaction). The measure was among the 30-point programme announced by the Administration for strengthening the order and transparency of the securities and futures markets following the market turmoil which took place in August 1998. In order to implement the measure, the Hong Kong Securities Clearing Company Limited (HKSCC) which operated the Central Clearing and Settlement System (CCASS) had proposed to launch a compulsory securities borrowing (CSB) mechanism, under which HKSCC would borrow, as a principal, securities to deliver to buyers in cases where sellers failed to honour their delivery obligations on T+2. PAS/FS(S) stressed that without this mechanism, buyers would have to wait until T+3 to T+5 for delivery of the securities following a default on the part of the sellers. He explained that under rule 15 of the Principal Rules, a dealer was prohibited from being a party to securities borrowing unless he first entered into a written agreement with the other party to the securities borrowing which, inter alia, required the deposit of collateral with the lender. The Amendment Rules sought to amend the Principal Rules to provide that rule 15 would not apply to securities borrowing of Hong Kong stock by a recognized clearing house i.e., HKSCC. Hence, the requirement for a written agreement with the broker lending the securities and deposit of collateral would not be applied to HKSCC resulting in a lower cost and higher efficiency for HKSCC to effect securities borrowing transactions.

3. Responding to enquiries about details of operation of the proposed CSB scheme, PAS/FS(S) clarified that the word “compulsory” within the term “compulsory securities borrowing” only referred to defaulting sellers. Lenders’ participation in CSB was entirely voluntary. The Senior Manager, Supervision of Markets, Securities and Futures Commission (SM/SM(SFC)) supplemented that lenders after joining the scheme could choose to maintain any amount and type of securities in the lending accounts at any time. Lenders could not choose to participate in a particular CSB transaction as HKSCC would be the only counterparty with which lenders would be dealing. However, they could temporarily withdraw all securities from the lending account if they so wish. Moreover, lenders could at any time demand return within five business days the securities lent.

4. As regards fees for CSB, PAS/FS(S) advised that a 3% charge on the value of the securities borrowed, to be calculated on a daily basis, would be payable to the lenders. The level was in line with that provided in other markets. SM/SM(SFC) added that the fees were calculated by HKSCC on the basis of statistics provided by the Stock Exchange of Hong Kong on stock values. PAS/FS(S) said that the Administration was confident that the CSB scheme would be attractive to participants. Apart from the economic incentive, a centralized lending scheme operated by HKSCC would encourage the development of the domestic stock borrowing and lending market as the counterparty risk involved would be low.

5. PAS/FS(S) further explained that the rule to impose a daily default fee of 0.25% of the value of outstanding positions on default brokers who failed their delivery obligations on T+2 would continue with implementation of the CSB scheme. SM/SM(SFC) added that with the strict implementation of the compulsory buy-in rule, HKSCC would buy-in from the market on T+3 for the default positions regardless of whether it had borrowed the securities. The acquired securities would be used to return to the lenders or to cover default positions of other broker participants.

6. Mr Bernard CHAN opined that while the old arrangement, under which allowance was given for outstanding positions by T+2 settlement due day, might be subject to abuse, it did provide flexibility to brokers who could not comply with the rule due to genuine difficulties. He enquired about the impact on the market and brokers after the strict enforcement of the T+2 settlement rule and compulsory buy-in on T+3.

7. PAS/FS(S) remarked that the measures of strict enforcement of the T+2 settlement rule and compulsory buy-in on T+3 had enhanced the settlement certainty of transactions and ensured a level playing field in the market. Nonetheless, the Administration recognized the concern of broker participants and would closely monitor market situations in collaboration with HKSCC, and consider conducting reviews in the light of operation of the measures whenever necessary. Despite the fact that there were few reports about difficulties in

complying with the T+2 settlement rule since September 1998 so far, there was also continuing improvement in compliance with the rule. It had been revealed that the settlement efficiency of continuous net settlement stock positions remained as high as 99% on T+2 during the past three months, with short falls occurring only on three business days. The situation compared very favourably with that before the implementation of the measure. SM/SM(SFC) added that CCASS Rules had stipulated exemptions from the compulsory buy-in arrangement where delay in securities delivery was due to certain genuine difficulties of the broker participants of HKSCC.

8. Mr FUNG Chi-kin opined that although the Amendment Rules were apparently very technical in nature, they also had policy implications. He expressed reservation over the need to set up a CSB scheme as HKSCC should be responsible for ensuring successful settlement of transactions by T+2. Moreover, as it was proposed that HKSCC as the borrower in CSB transactions would not deposit collateral with lenders of securities to avoid the risk of the lenders not being able to return the collateral to HKSCC upon closing of the CSB transactions, he was concerned that the risk originally borne by HKSCC as a clearing house would then be shared out with the lenders. In this connection, the Chairman speculated that the risk would be passed on to lenders of securities to HKSCC during the extreme situation where a defaulting seller could not deliver securities of substantial value to HKSCC which, if not backed by the Government, might also be forced to default.

9. While sharing the view that HKSCC as the settlement counterparty in securities transactions should undertake the risk involved, PAS/FS(S) reiterated that HKSCC considered it necessary to introduce a CSB scheme with a view to improving the settlement system and ensuring as far as possible that buyers would receive the securities by T+2. The measure would also pave the way for the development of the centralized stock borrowing and lending (SBL) service which HKSCC intended to provide as a measure to promote the local SBL market. He added that reference had been made to similar systems in other markets. For instance, G30 (a group of 30 economies) shared the view that the institution of a compulsory securities borrowing system was an useful measure to reduce settlement risk.

10. SM/SM(SFC) supplemented that the introduction of a CSB scheme would not pose additional risk to HKSCC nor to the overall market. Concerning risk for lenders, PAS/FS(S) said that lenders could rely on HKSCC's creditworthiness, and the risk management mechanisms that it applied to control its exposure to participants' defaults, to guarantee return of the securities borrowed. The credibility of HKSCC had been demonstrated by its ability to withstand a variety of market conditions since its establishment in effecting orderly settlement of securities transactions, particularly during the financial turmoil in recent years. Besides, there were many measures and market instruments available for controlling HKSCC and to reduce HKSCC's exposure to unsettled position, such as intra day margin calls.

11. Mr Ambrose LAU enquired whether there would be rules to govern HKSCC in returning the borrowed securities to lenders in CSB transactions. Mr FUNG Chi-kin remarked that in the absence of such rules, HKSCC could accumulate securities for other purposes. The Chairman opined that regulations should be in place to prevent improper holding of stock positions by HKSCC.

12. SM/SM(SFC) explained that CCASS Rules clearly stated that HKSCC could only effect a compulsory share borrowing transaction either to cover a defaulted stock position or to replace stock borrowing under any other compulsory stock borrowing transaction. She further advised that while lenders were entitled to recall their securities at any time and HKSCC was obliged to return the securities within five business days upon demand, HKSCC was not required to return securities to lenders immediately after acquisition in the market in the absence of recall notices.

13. As regards the concern about inappropriate holding of stock positions by HKSCC, PAS/FS(S) stressed that there would be no incentive for HKSCC to hold positions unless it had a legitimate use for them as fees would be paid by HKSCC out of the default penalty on a daily basis. Moreover, SFC was empowered under the SFC Ordinance (Cap. 24) to prohibit HKSCC from doing such acts, as SFC might deem inappropriate, for the protection of investors or the proper regulation of the clearing house.

14. In view of members' remaining concern about the availability of measures to prevent improper holding of positions by HKSCC, PAS/FS undertook to provide further information on the issue as soon as possible. The Chairman concluded that subject to the Administration's further clarifications being acceptable, the Subcommittee would not raise objection to the Amendment Rules.

(Post-meeting note: The Administration's clarifications were circulated vide LC Paper Nos. CB(1)1193 and 1228/98-99.)

15. Members noted that the scrutiny period of the Amendment Rules had been extended to 5 May 1999 and a five-clear-day notice was required for moving a motion to amend or repeal the Amendment Rules. As such, the deadline for giving the notice would be on 27 April 1999.

(Post-meeting note: The Chairman made a verbal report on the Subcommittee's deliberations at the House Committee meeting on 23 April 1999. The written report was submitted to the House Committee for its meeting on 30 April 1999.)

III Any other business

16. There being no other business, the meeting ended at 5:45 pm.

Legislative Council Secretariat

7 October 1999