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The Legislative Council
Panel on Financial Affairs

Proposed Amendments to the Current Financial Resources Rules

PURPOSE

This paper seeks Members' view on the proposals to -

(a) apply a 80% haircut on certain stocks and warrants pledged with securities margin financiers and brokerage firms as margin collateral; and

(b) include in a firm's ranking liabilities the amount of its total borrowings secured by re-pledging margin clients' securities that is in excess of 65% of the total amount of loans extended to margin clients.

BACKGROUND

Margin Financing

2. Hong Kong currently has 8 securities margin financiers and 255 securities dealers that conduct securities margin financing. Over the last year which saw keen competition for business among firms, the Securities and Futures Commission (SFC) has observed a growing market practice of aggressive lending to capture a fair share of the margin loan market which stood at $13 billion in January 2002.

3. Margin finance business involves a firm providing clients with loans or credit for the purpose of buying or continuing to hold securities. It is essentially a credit business, which subjects the firm to credit risks as well as business risks. The SFC has continuously drawn to the attention of the market and the investing public that securities margin financing involves additional risks – to the investors as well as the firms – arising from leverage, pooling arrangements and the need for ongoing and real time liquidity.

4. The SFC has reviewed the business practices of firms engaging in margin financing and has identified two practices that are considered particularly imprudent and risky. These are -

(a) accepting as collateral for margin loans a large quantity of stocks that may be difficult to liquidate quickly; and

(b) pooling securities belonging to margin clients, including “non-borrowing or low-borrowing” margin clients (i.e. those clients who borrow very little or not at all, but have a relatively large amount of securities in their margin accounts), and repledging the more liquid of such securities to banks in order to obtain bank loans. These borrowed funds are then used by the firms to finance their business operation and loans to other margin clients against collateral that may not be acceptable as collateral to banks.

5. By engaging in margin financing, a firm is exposed to the credit risk of its margin clients. A large default on a margin loan by one single margin client can potentially cause the firm to default on its bank loans if it cannot obtain funds to meet its obligations to the bank. This is possible if the securities collateral provided by the margin client to the firm cannot be readily liquidated and the firm has no additional liquidity. Once a firm defaults on its bank loan, any securities belonging to its clients which it has repledged to the bank as security for the loan would be retained by the bank pending discharge of the firm's indebtedness. A default by a firm on its bank loan would have damaging consequences not just for the firm (which might become insolvent) but also for its clients and market stability generally.

6. Compliance with the current Financial Resources Rules (FRR) safeguards a firm from insolvency risks under normal circumstances, but does not ensure that there is sufficient liquid capital to cover the scenario described, let alone large withdrawals of securities by non-borrowing or low-borrowing clients in case of a confidence crisis. The risks increase when market and economic conditions are unfavourable.

Public Consultation

7. With a view to minimizing these specific risks, the SFC released, on 4 March 2002, a set of proposed amendments (“Proposed Amendments”) to the current FRR for public consultation.

8. The objective of the Proposed Amendments is to reduce the financial risk posed to a firm’s clients as a result of the firm’s own aggressive lending and funding practices. This type of risk should not be borne by the firm’s clients, especially those non-borrowing or low-

borrowing margin clients with securities held by the firm and repledged to a bank. Instead, the firm should be using its own capital as a buffer to minimize the exposure of its non-borrowing or low-borrowing margin clients and ensure the firm's financial soundness.

9. The Proposed Amendments seek to enhance a firm’s capital buffer by two means. First, a firm that aggressively grants margin loans against securities which may be difficult to liquidate or sell (because of the size of the holdings relative to the market demand) will be required to maintain more liquid capital. To achieve this, a steep discount is applied to the value of such securities in assessing the amount of credit risk adjustment necessary on the margin loan secured by such securities. Specifically, firms that want to provide margin loans collateralised by those securities to which banks would apply a high discount or might not be willing to lend against will be required to fund much of those margin loans with their own capital, rather than with bank loans obtained through repledging their clients’ securities. Accordingly, the SFC proposed a 90% discount for such identified securities.[1]

10. Second, the SFC proposed linking the amount of borrowing by a firm (secured by repledging client securities as collateral) to the amount of margin loans it actually provides to its margin clients. Where a firm’s borrowings secured by clients’ securities exceed 50% of aggregate margin loans it made to all its clients, the firm must include the excess in its ranking liabilities for FRR calculation purposes (the gearing adjustment). In other words, firms that rely heavily on borrowings secured by their clients’ securities for their operational funding must bring in additional liquid capital

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[1] Specifically, the discount would apply to those stocks and warrants pledged as margin collateral where such stocks or warrants would:

(a) likely take more than one month to liquidate based on their respective trading volume during the previous six months; or
(b) constitute 5% or more of the market capitalization of the shares or the issue size of the warrants.

This analysis would be applied only to those shares and warrants identified as the three largest collateral holdings (based on the securities’ respective market value) of each firm’s top 20 margin clients (those with the largest outstanding margin loan balances). However, once any shares or warrants meet either of these tests, the 90% discount would apply to all such shares or warrants held by the firm as collateral.

Note that constituent stocks of certain specified major indices, such as the Hang Seng Index, the Hang Seng Hong Kong LargeCap Index and the Hang Seng Hong Kong MidCap Index are excluded from the application of this requirement.

to better manage the financial risks brought on by pooling and repledging clients' securities.

Market Comments

11. Public consultation on the Proposed Amendments concluded on 26 March 2002. To date, 23 responses have been received. The market generally supported introducing measures to reduce brokerage firms' financial and credit risks. Some commentators supported the Proposed Amendments. Others focused primarily on the practical effects of the Proposed Amendments on the market overall. Different commentators suggested varying levels of discount as well as the gearing adjustment. Others expressed concern over the possible effect on market liquidity in general and so called "third and fourth liner" stocks in particular as well as possible negative connotations being associated with any stock or warrant subject to discounting. Concerns were also expressed as to the impact on the IPO market and a level playing field vis-a-vis banks. A summary table outlining the comments received is at Appendix A.

12. The SFC has considered all market comments expressing concern and alternative suggestions offered. To further pursue the specific comments made, the SFC met with market players to discuss possible amendments and solutions. The discussions have proved useful and the SFC has now revised the Proposed Amendments to address the market's concerns whilst tackling the specific risks at hand. The adjustments made are outlined below.

Revised Proposed Amendments

13. The discount level on those stocks and warrants that, due to the size of the holding, may not be speedily liquidated in the market will be set at 80% instead of 90% as originally proposed. This is in keeping with the percentage discount level broadly applied by banks to similar stocks. The 80% discount would also override the current discount and concentration discounting factors in the FRR that would otherwise apply to the stock or warrant, so that there will not be any "double discounting" on the same stocks or warrants.

14. In response to market comments, the gearing adjustment will be set at 35% instead of 50%. This adjustment seeks to strike a balance between protecting the investors and allowing flexibility for the brokerage firms to operate. This effectively means that if a firm's total borrowing secured by margin clients' securities exceeds 65% of the total margin loans it

lends to clients, the firm will be required to maintain an additional liquid capital buffer in the amount of such excess. Appendix B demonstrates how this gearing adjustment would operate in practice in adjusting the liquid capital requirements of a firm.

15. The combined effect of these two requirements is to require firms that adopt the lending practices described in paragraph 4 above to increase their capital to cushion themselves and their clients against the credit, liquidity and other financial business risks discussed above. This will increase protection to clients and reduce systemic market risks.

16. To facilitate compliance, the SFC proposes to exclude stocks or warrants trading for less than 7 months (i.e. IPO shares or recently launched shares and warrants) from being subject to the 80% discount and allow one month's lead time for firms to calculate the average monthly turnover of stocks and warrants.

17. The revised Proposed Amendments are at Appendix C.

Impact

18. These measures are drawn up to address specific risks arising from a particular type of business activity in light of current market conditions. They aim to achieve a targeted effect without affecting the general operation of the industry. The SFC estimates that about 95% of securities margin financiers and dealers providing securities margin financing will not need to inject additional capital because of the revised Proposed Amendments. For the remaining 5%, the SFC will work with each affected firm to ensure compliance with the new requirements. In the event that any individual firm faces genuine difficulties in complying with the new requirements when they come into effect, the SFC will consider granting temporary modifications of the new requirements where appropriate without undermining the interest of the investing public.

Legislative and implementation timetable

19. Under the current market conditions, we believe it is imperative that the revised Proposed Amendments are implemented as soon as possible, in order that the identified risks associated with those securities margin financiers and securities dealers engaging in aggressive margin financing practices can be remedied without delay. The financial and credit risks have increased during the market downturn as firms operate under financial pressure. There is an urgent need to take specific measures to tackle the

identified fault line in the operation of the industry to maintain investors' confidence and the integrity of the market system.

20. Accordingly, the SFC plans to gazette the amendments to the FRR on 12 June 2002. As foreshadowed in the consultation paper, it would be desirable to allow some time for the trade to prepare for the changes. The date for the two proposals to start taking effect will accordingly be set as 1 October 2002.

21. The plan will meet the 28-day negative vetting period but the amendments would have taken effect before the expiry of the 21-day rule on extension for vetting because of the intervening summer recess. In view of the importance of the issue, we seek Members' understanding and support for this fast track arrangement.

WAY FORWARD

22. In the consultation process, the SFC has been asked to examine two potential problem areas which highlight the need for long-term solutions. These concern the practice of firms being permitted to *pool* their clients' securities and repledge the securities of even the non-borrowing or low-borrowing margin clients, and the need to tailor regulatory *capital requirements* to firms based on their line of business and the regulated activities for which they are licensed.

23. We believe these are more fundamental issues that should be addressed in the context of improving the overall regulatory framework for intermediaries and market participants. As a longer term project, the SFC will study the regulatory framework for managing brokers' financial risks in other securities market jurisdictions and review the adequacy of the existing regulatory framework. The aim is to set out the results and proposals in a White Paper to be released for public consultation later this year.

Financial Services Bureau
Securities and Futures Commission
29 April 2002

Summary of comments received on Proposed Amendments to the Financial Resources Rules

Appendix A

	Section reference	Details of the Rules/ Areas of concern	Respondent's comments	SFC's response
1	-	General comments	● Comments generally support the proposal to manage down the financial risks of margin financing intermediaries, and increase protection to investors. ● Some commentators have proposed that we should look at more fundamental issues such as capital requirements and pooling.	● We thank the market for their support and valuable comments. ● We will examine these structural issues as part of an overall review later in the year.
Specific Comments				
2.	S13(4)(b) & (10)	"Illiquid collateral" – general comments	● The haircut % should be reduced from 90% to 80% as applied by the authorized institutions.	● We agree and have amended the proposal to reduce the haircut to 80%.
3.	S13(4)(b) & (10)	"Illiquid collateral" - concern over reducing liquidity	● Some commentators were concerned that the proposal would affect market liquidity and brokers' ability to meet on-going liquidity requirements.	● The objective is to ensure that firms have adequate capital buffer in case they cannot liquidate their clients' securities collateral within a reasonable timeframe.
4.	S13(10)	"Illiquid collateral" - definition	● The definition of 'illiquid collateral' cannot address the problem because there are stocks of sound fundamentals but not frequently traded. ● There are also stocks of dubious quality but being traded actively, this haircut may encourage "manufactured" liquidity (liquidity does not define the quality of a stock). ● There are technical difficulties in applying the definition to IPO with less than 6 months track records.	● We have already excluded from "illiquid collateral" all HSI index or HSI HK LargeCap and MidCap stocks. ● Entering into wash sales (which involve the sale and purchase of stocks without any change in their beneficial ownership) is a criminal offence, as is the creation of a false market. The SFC will be vigilant in its monitoring of share movements to detect incidents involving the ramping of share prices. In relation to all such malpractices the Commission will take decisive action, including the prosecution of offences and disciplining persons guilty of misconduct. ● We agree that the illiquid collateral haircut should only apply to any share or warrant which has been listed or traded for 6 consecutive months or more immediately preceding the month in which the calculation is made.

	Section reference	Details of the Rules/ Areas of concern	Respondent's comments	SFC's response
5.	S21(2)	Ranking liabilities on repledging margin client securities – general comments	● 50% loan to bank borrowing ratio appears high.	● In response to market comments, we agree that the firm loan to bank borrowing adjustment should only be triggered when bank borrowings, secured by clients' securities collateral, exceed 65% of aggregate margin loans (i.e., two-thirds). Our major concern is over pooling where one client's collateral can be used to secure the firm's borrowings. If a firm's own practice is not to allow pooling and the bank is willing to regard each sub-account under the umbrella margin financing account on a stand-alone basis (e.g., it agrees not to combine these accounts or to effect any netting), we would be prepared to consider granting an FRR modification in these circumstances. We will work with the industry and where appropriate, be prepared to grant modifications of the FRR provided that the risks are adequately addressed by compensating controls and investor protection is not undermined.
6.		Other Comments	● Given the increasing pressure on consumers to plan for their long term financial needs, and the role that the stock market plays in this regard, every endeavour should be undertaken to ensure that investors' funds are adequately protected. The proposals are therefore a step in the right direction for HK as an international financial center. ● It was suggested that the proposals be examined in light of other regulatory capital requirements in other international markets. The concern expressed was that the regulators should be addressing concerns that are unique to Hong Kong but also being mindful of established systemic approaches in other international regimes so that the competitiveness of Hong Kong brokerage firms is not otherwise negatively impacted as compared to their counterparts in other countries.	● We thank the market for their support and valuable comments. ● We thank the market for the suggestions and will consider these concerns in the White Paper.

List of Respondents

Date Received	Respondent
7 March 2002	Fidelity Investments Ltd
11 March 2002	Albert Pun
14 March 2002	Anne Ng (Retail Investor)
14 March 2002	- (Retail Investor without name)
20 March 2002	POP Electronic Product Ltd
21 March 2002	Consumer Council
21 March 2002	Hong Kong Stockbrokers Association
21 March 2002	City University of Hong Kong
23 March 2002	Cho Man Sang
25 March 2002	Tai Fook Securities Group Ltd
25 March 2002	Institute of Securities Dealers Ltd
26 March 2002	- (no name)
26 March 2002	- (commentator reserved anonymity and contents of submission)
26 March 2002	Sun Hung Kai & Co Ltd
26 March 2002	OSK Asia Corporation Ltd
26 March 2002	South China Securities Ltd
26 March 2002	Albert T. da Rosa, Jr.
27 March 2002	- (commentator reserved anonymity and contents of submission)
27 March 2002	Hong Kong Society of Accountants
28 March 2002	Hong Kong Institute of Directors
28 March 2002	Survey conducted by Hong Kong Securities Institute on its members
9 April 2002	Shengyin Wanguo Group
12 April 2002	Hong Kong Securities Professionals Association

Appendix B

Illustrative example of the effect of the proposed Gearing Adjustment on captial required for securities margin financing business

In the following example, the dealer's business is mainly financed by bank borrowings secured by a pool of client securities.

	HK$ million
Assets	
Margin loans	100
Cash client receivables	25
	125
Liabilities and Capital	
Bank loan secured by client securities	95
Shareholders' fund	30
	125

Proposed Gearing Adjustment to be included in the firm's ranking liabilities

= Bank loan secured by client securities - (Margin loans x 65%)
= $95M - ($100M x 65%)
= $30M

This adjustment effectively requires the firm to maintain at least $30M liquid capital above its minimum liquid capital requirement to comply with the FRR.

Appendix C

Proposed Amendments to Financial Resources Rules

1. Commencement

These Rules shall come into operation on 1 October 2002.

13. Amounts receivable from clients and securities margin financiers arising from dealings in securities or the provision of securities margin financing

(1) A dealer shall include in his liquid assets amounts receivable from clients arising from dealings in securities which are settled on a cash-against-delivery basis and the amounts receivable have been outstanding for not more than 5 business days after the settlement date.

(2) In respect of amounts receivable from clients arising from dealings in securities which are settled on a cash-against-delivery basis, and the amounts receivable have been outstanding for 6 or more business days but less than 1 month after the settlement date, a dealer shall include in his liquid assets, calculated on a transaction-by-transaction basis, the lower of -

(a) the amounts receivable less any provision made for bad or doubtful debts; and

(b) the market value of the securities purchased by or on behalf of the respective clients.

(3) In respect of amounts receivable from clients arising from dealings in securities which are settled on a free delivery basis, a dealer shall include in his liquid assets the following amounts, calculated on a transaction-by-transaction basis -

(a) where the local clearing system settles only on a free delivery basis, amounts receivable which have been outstanding for not more than 2 weeks after the settlement date; or

(b) in all other cases, amounts receivable which are not yet due for settlement in accordance with the rules or regulations of the stock market in which the securities are traded.

(4) A dealer or a securities margin financier shall include in his liquid assets amount receivable from a margin client arising from the provision of securities margin financing, less the higher of -

(a) any provision for bad or doubtful debts; and

(b) the margin shortfall amount, calculated as the amount by which the amount receivable exceeds the aggregate of -

(i) the market value of -

(A) all illiquid collateral provided by the client, multiplied by **20%**; and

(B) any other collateral provided by the client, less the applicable haircut amount and multiplied by the applicable concentration discounting factor;

(ii) the amount of cash deposited as security by the client; and

(iii) in the case of a dealer, the maximum amount that can be drawn by him under a bank guarantee which is provided by the client to him and which is issued by an authorized institution or an approved bank formed or established outside Hong Kong.

(5) In calculating the margin shortfall under subsection (4)(b), the dealer or securities margin financier may elect to exclude, for all margin clients and on a client by client basis, from the amounts receivable amounts attributable to dealings in securities which are not yet due for settlement according to their settlement date, and in which case section 5(1)(b) shall not apply to

the calculation of the balance of collateral provided by clients.

(6) If a dealer or a securities margin financier elects to calculate margin shortfall in accordance with subsection (5), he is not allowed to change his election except with the prior approval of the Commission.

(7) Amounts receivable from a securities margin financier, other than amounts included in liquid assets under subsection (8), shall be included in the liquid assets of a dealer at the lower of -

(a) the amounts receivable less any provision made for bad or doubtful debts; and

(b) the aggregate of -

(i) the amount of cash deposited as security by the securities margin financier;

(ii) the market value of any collateral provided by the securities margin financier less the applicable haircut amount; and

(iii) the maximum amount that can be drawn by him under a bank guarantee issued by an authorized institution or an approved bank formed or established outside Hong

Kong and provided by the securities margin financier.

(8) A dealer shall include in his liquid assets net amount receivable from a securities margin financier arising from dealing in securities by their common clients, to the extent that such amount represents receivables from dealings which are not yet due for settlement according to their settlement date.

(9) Where a dealer subscribes for securities on behalf of clients, he shall include in his liquid assets, calculated on a transaction-by-transaction basis, the lower of -

(a) 90% of the total costs of subscribing for the securities; and

(b) the amounts receivable from the respective clients in respect of such subscription for securities.

(10) In this section –

"average monthly turnover" (…) in relation to a listed or traded share or warrant, means one sixth of the aggregate value of transactions in the share or warrant, as the case may be, on the stock market on which it is listed or traded for a period of 6 consecutive calendar months (including any period during which the share or warrant is suspended from trading) immediately preceding the month prior to the month in which the calculation is made;

"illiquid collateral" (…) in relation to collateral given to a dealer or securities margin financier by his margin clients, means any listed or traded share or warrant which is identified as the top 3 collateral where the aggregate value of shares or warrants comprising the collateral is equal to or greater than –

(a) the average monthly turnover of the share or warrant, as the case may be; or

(b) in the case of shares, 5% of the total market capitalization of the issued shares of that class of the issuer as at the end of the month immediately preceding the month prior to the month in which the calculation is made; and

(c) in the case of warrants, 5% of the value of the warrant issue as at the end of the month immediately preceding the month prior to the month in which the calculation is made,

but does not include –

(i) any share or warrant which has been listed or traded for less than 6 consecutive calendar months (including any period during which the share or warrant is suspended from trading) immediately preceding the month prior to the month in which the calculation is made;

(ii) any listed share which is a constituent stock of any of the following indices -

(A) Hang Seng Index;

(B) Hang Seng Hong Kong LargeCap Index;

(C) Hang Seng Hong Kong MidCap Index;

(D) FTSE-100 Index;

(E) Nikkei 225 Index; or

(F) Standard & Poor's 500 Index; and

"top 3 collateral" (…) in relation to collateral given to a dealer or securities margin financier by his margin clients, means the listed or traded shares and warrants included in such collateral which are identified as being the 3 highest in terms of market value given by each of the 20 margin clients with the largest outstanding margin loan balances with the dealer or securities margin financier.

21. Provision of securities margin financing

(1) A dealer or securities margin financier shall include the following amounts in his ranking liabilities -

(a) amounts payable to margin clients except where they represent amounts payable to clients out of monies held by that dealer or securities margin financier in a designated

trust account in accordance with the Securities Ordinance (Cap. 333); and

(b) in the case of securities margin financier, net amount payable to a dealer by him arising from dealings in securities by their common clients through that dealer.

(2) Where a dealer or securities margin financier obtains financial accommodation wholly or partly secured by collateral provided by a margin client, he shall include in his ranking liabilities the amount by which such borrowings exceed 65% of the aggregate amount receivable from his margin clients arising from the provision of securities margin financing.