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For information

Legislative Council Panel on Financial Affairs

SFC's Progress Report on Proposed Measures to Address Risks Arising from Securities Margin Financing

Purpose

This paper briefs Members on the progress of discussion between the Securities and Futures Commission (SFC) and the brokerage industry on the proposed measures to address risks arising from securities margin financing (SMF), and the follow-up work carried out by SFC since December 2004.

Background

2. On 17 December 2004, the SFC reported to this Panel the progress of its public consultation on proposed measures to address risks arising from SMF[1]. At the meeting, Members noted that the brokerage industry had different views regarding the appropriate level of the re-pledging limit. Noting that the SFC would continue discussion with the brokerage industry with a view to reaching a consensus of the appropriate measures to address risks arising from SMF, Members requested the SFC to report progress of its discussion with the brokerage industry and advise, by December 2005, on the proposed timetable for implementing complete segregation of the collateral of non-borrowing margin clients.

[1] Implementation of the proposed measures, e.g. imposing a re-pledging limit on the amount of clients' collateral that a SMF provider could re-pledge, would require amendments to subsidiary legislation under the Securities and Futures Ordinance (Cap.571).

Progress Achieved since December 2004

3. The SFC has taken a number of follow-up actions since the last Panel discussion in December 2004, which include –

(i) discussion with broker associations;

(ii) studying the viability of complete segregation;

(iii) enhancing investor education; and

(iv) monitoring of SMF providers.

Discussions with Broker Associations

4. In 2005, the SFC has conducted a number of meetings with the following broker associations to discuss the proposed measures -

(a) Hong Kong Association of Online Brokers ("HKAOB");

(b) Hong Kong Stockbrokers Association ("HKSbA");

(c) Hong Kong Institute of Securities Dealers ("HKISD");

(d) Hong Kong Securities Professionals Association ("HKSPA"); and

(e) Hong Kong Securities and Futures Industry Staff Union ("the Staff Union")

During the meetings, the SFC explored with the representatives different calibrations of the proposed key measures with an objective to agree on a package of measures that could be acceptable to the industry while according adequate protection to investors. The SFC is mindful that the proposed reforms may affect some industry players and the purpose of the exercise therefore is to find an acceptable solution that would deliver benefit to the biggest majority while keeping the impact on the industry to the minimum.

5. As of the latest meeting with the broker associations on 17 November 2005, the associations still held divergent views on the proposed re-pledging limit level. For instance, HKAOB supported that the re-pledging limit should not be lower than 150% while HKSbA and HKISD suggested setting the re-pledging limit at 180% and reviewing whether the limit could be adjusted downward to 130%-150% after a certain implementation period. Regarding HKSPA, it preferred not having any limits on brokers' right to re-pledge, but if a limit must be set, the minimum level it could accept would be a limit at 180%. As for the Staff Union, it continued to support the complete segregation proposition.

6. Not setting any re-pledging limit, as some brokers have advocated, is not a solution, nor is a 180% limit acceptable as a long term solution. As mentioned during our briefing to this Panel in December 2004, the Working Group[2] on the Review of the Financial Regulatory Framework for Licensed Corporations recommended setting the re-pledging limit at 130%-150% of the total amount of margin loans lent out by a firm. We support this recommendation and consider that the recommended range, i.e. 130%-150%, is a prudent yet acceptable level to both investors and brokers. Setting a higher re-pledging limit (e.g. 180%) may increase the risk of abuse by some SMF providers who rely excessively on bank borrowing as working capital. It may also be regarded as a rather lenient control over SMF providers who may lend aggressively with very thin capital, relying on bank loans secured by securities collateral put up by margin clients.

7. Having considered the downside of setting a high re-pledging limit, we maintain the view that the ultimate re-pledging limit should preferably be set between 130%-150% as recommended by the Working Group. We have

[2] The Working Group was formed in 2002 to identify measures to manage risks in the securities industry. It comprised senior financial and industry people, academics and the Consumer Council.

estimated the impact of imposing a re-pledging limit at 130-150% based on financial data as of September 2005 submitted by SMF providers. Assuming a re-pledging limit of 130%, 7 out of 84 SMF providers that re-pledge client collateral may be required to obtain alternative funding in order to comply with the limit.

8. This notwithstanding, we are prepared to adopt a two-stage approach by agreeing to set a higher level of re-pledging limit initially, and reduce the limit to 130%-150% in accordance with a mutually agreed timetable.

Study of the segregation proposition

9. At the Panel meeting on 17 December 2004, Members agreed that investors should be afforded better protection and that the interests of margin clients, in particular those who have no current borrowing from their SMF providers, should be better safeguarded. Most of the Members requested complete segregation and urged the SFC to set a timetable for its implementation. The Commission also notes that other major financial markets (such as the United States) do not allow brokers to re-pledge collateral belonging to clients who have no current borrowings from the brokers. Despite our status as an international financial centre, we are lagging behind in this respect. We are pleased to note that the Staff Union already lends its support to the segregation proposition. However, this does not have the general support of other broker associations due to cost implications. We have over the past 12 months consulted different SMF providers on this proposition and shall elaborate the implications in the ensuing paragraphs.

10. To implement segregation on a day-to-day basis under the current pooling practice, an SMF provider who re-pledges clients' collateral will need to

carry out frequent transfers of stocks between itself and its banks. As banks will levy a charge for each stock deposit or withdrawal, the SMF provider will incur substantial bank charges on an ongoing basis, in addition to employing additional resources to develop, operate and maintain the necessary computer system. Both the amount of bank charges and complexity of the process will increase with the number of margin clients and securities involved. A medium-sized SMF provider envisages that it may have to incur as much as $500,000 additional administrative costs **per month** as a direct result of the segregation requirement.

11. During our consultation with some of the brokers, they also expressed concerns that margin clients usually trade more frequently and borrow and repay margin loans on a very short-term basis and hence high administrative costs would be incurred in transferring their stocks in and out of banks. In the circumstances, the protection offered by segregation to such clients might be minimal, given their trading patterns and habits, but the administrative costs would be rather substantial.

12. Separately, some industry participants have expressed concern that additional costs arising from segregation would likely be passed on to investors, which would inevitably increase transaction costs of margin clients and ultimately drive clients to open margin accounts with other SMF providers (those do not re-pledge) or banks to avoid bearing the additional costs.

13. As a matter of principle, the SFC supports any measure / initiative that would provide the biggest protection to investors but we need to proceed cautiously if the initiative will have a material impact on the business of brokers, especially the small and medium-sized brokers. The SFC supports segregation as our long-term goal. However, in light of its potential impact on the industry

as well as investors, we need to further assess the possible consequences of the segregation proposition and how it could be implemented cost-effectively. In the short to medium term, we consider the better solution would be to adopt a re-pledging limit for clients' collateral.

Enhancement of investor education

14. Over the past 12 months, the SFC has conducted an extensive and ongoing programme to educate investors about the risk of authorizing their SMF providers to re-pledge their securities. These activities include publishing four articles in the mass media and SFC publications, conducting 15 briefings for outreach programmes, carrying out a retail investor survey, distributing over 3,600 investor education leaflets, and producing multi-media educational materials such as VCDs and radio programme series. For details of our educational efforts, please refer to Annex.

15. At the meeting on 17 November with the broker associations, the Staff Union suggested that the names of SMF providers that do not re-pledge client collateral should be made known to the public in order to help investors to make an informed decision when choosing his/her SMF provider. In this connection, the SFC supports any measures to enhance transparency and facilitate investors to make informed decisions. We will explore with the industry what more can be done in increasing the transparency of SMF providers' re-pledging practice.

Monitoring of SMF providers

16. It is part of SFC's ongoing effort to monitor the performance of SMF providers. The SFC consistently reminds the industry to remain vigilant

concerning business risks, observe good business conduct standards and exercise proper risk management. As an example, a circular was issued to all licensed corporations on 11 November 2005 reminding them, inter alia, of the need to monitor their business risks, including credit, market and liquidity risks, and exercise prudent risk management.

17. On a firm-by-firm basis, we regularly monitor SMF providers' financial conditions, hold meetings with their management to remind them to adhere to prudent margin policies, and where necessary, take regulatory actions. In June 2005, we managed down the identified risks of an SMF provider by imposing conditions on its licence to require it to adopt prudent business practices and strengthen its risk management. These conditions are public information posted on the public register maintained on the SFC website. Such transparency can help investors make an informed decision about doing business with a particular brokerage firm.

WAY FORWARD

18. Given that a solution for pooling risk has been due for more than seven years since the C.A. Pacific case, the SFC shall press on with the discussion with the brokerage industry on the proposed re-pledging limit and assess further the viability and impact of implementing complete segregation. We believe that, until such time when the market is ready for complete segregation, it is of paramount importance that we have in place the re-pledging limit as soon as possible to manage the risks and bring us closer to international standards. The re-pledging limit may not be welcomed by every SMF provider. However, as regulator, our duty is to identify risks and prevent, where we can, damage to investors' interest and market confidence. We will therefore seek to conclude the consultation and put in place a re-pledging limit and other

measures as soon as practicable. In the meantime, the SFC will continue its close monitoring of SMF providers and will not hesitate to apply existing regulatory tools should signs of poor risk management and financial distress are identified.

19. We will also continue with our on-going investor education efforts and where appropriate and legally feasible, increase the transparency of the re-pledging activities of SMF providers.

Securities and Futures Commission
December 2005

Annex

SFC's Investor Education Work on Pooling Risks (Dec 2004 – Dec 2005)

(i) Articles

Date	Media – *Article*
Mar 2005	Monthly Focus on the eIRC – *Are My Securities Pledged?*
Aug 2005	Metropolis Daily – *Pooling risk*
Oct 2005	FAQs on SFC Alert – *How does a licensed brokerage handle the securities in my margin account?*
Nov 2005	Monthly Focus on the eIRC – *Pooling Risk of Margin Accounts*

(ii) Outreach Activities

Date	Event (Attendants)	No. of Attendants
Dec 2004	Teachers Workshop 2004: Stocks - Intermediate Module	45
	School Talk – Investment vs. Speculation (Sing Yin Secondary School)	440
Feb 2005	School Talk – Personal Finance Management (CMA Choi Cheung Kok Secondary School)	350
	School Talk – Introduction to Securities Market in Hong Kong (SKH Bishop Baker Secondary School)	150
Apr 2005	School Talk – Operations of HK Stock Market & Risk Management (CCC Heep Woh College)	40
	School Talk – Getting Started in Stock Investing (YCH Tung Chi Ying Memorial Secondary School)	170

April 2005	Seminar to retiring civil servants – Managing Your Money After Retirement	500
Jun 2005	Teachers Workshop : Stock - Elementary Module	117
	Teachers Workshop : Stocks - Intermediate Module	97
Jul 2005	Teachers Workshop : Stocks - Intermediate Module	35
Sep 2005	School Talk – SFC and the Securities Market in Hong Kong (CUHK)	24
Oct 2005	University Course – Lingnan General Education Course: *Foundations of Financial Investing*	182
	School Talk – Demystifying Share Trading (SKH Tang Shiu Kin Secondary School)	400
	School Talk – Stock Market Infrastructure and IPO (Lok Sin Tong Ku Chiu Man Secondary School)	44
	School Talk – Get Ready to Invest (The Hong Kong University Students' Union)	110
Nov 2005	School Talk – Various Investment Products and Market Misconduct (CCC Kung Lee College)	(Not available yet)
Dec 2005	Public Lecture – Open University of Hong Kong - SFC Public Lecture Series	
	School Talk – SFC and IPO Process (Good Hope School)	
	School Talk – Intermediaries, Stock Trading and Investor Protection (Vocational Training College)	
	Total	**2,704**

(iii) Leaflets

Date	Leaflet	No. of copies distributed
Dec 2004 - Oct 2005	"What is Pooling Risk?", distributed through Consumer Council's Advice Centres, public libraries and Financial World Exp 2005, etc.	3,640

(iv) Other Initiatives

Date	Event & Brief Description
Feb 2005	Started distribution of VCDs of "*All about Stock Investing*", an RTHK-SFC TV drama series, and uploaded the series on the eIRC for public viewing. Episode 2 of the programme is *Pooling Risk of Margin Accounts.*
	Uploaded the RTHK-SFC radio segment series, "*Invest Wisely for Seniors*", on the eIRC for public access. Episode 3 of the series is *Margin Accounts*.
Sep – Dec 2005	SFC Retail Investor Survey 2005. One of the objectives of the survey is to gauge investors' understanding of pooling and re-pledging of securities in stock trading.