**For discussion**
**on 4 June 2018**

**Legislative Council Panel on Financial Affairs**

# Legislative proposals to update the financial resources requirements for licensed corporations

## PURPOSE

This paper briefs Members on the Securities and Futures Commission's ("SFC") proposals to update the financial resources requirements for corporations licensed by the SFC (licensed corporations, "LC") by amending the Securities and Futures (Financial Resources) Rules (Cap. 571N) ("FRR").

## BACKGROUND

2. The FRR apply to all LCs which conduct one or more types of regulated activities to address risks arising from those activities and ensure that LCs have sufficient liquid assets to meet ongoing liabilities as they fall due. The FRR impose on LCs, among other requirements, a risk-based liquid capital requirement[1] which varies with the size and complexity of the LC's business.

[1] The applicable minimum amount of liquid capital that an LC needs to maintain, known as its "required liquid capital", comprises a base amount and a variable parameter, so the minimum amount also varies with the size and complexity of the business undertaking of the LC. For example, the base amount of required liquid capital for an LC licensed for Type 1 regulated activities which is not an approved introducing agent or trader is HK$3 million. Liquid capital is the amount by which an LC's liquid assets exceed its ranking liabilities (liquid capital = liquid assets – ranking liabilities). Liquid assets are the amount of assets that is required to be included in the calculation of liquid capital and ranking liabilities are the sum of the liabilities on its balance sheet and adjustments to cater for factors such as market risks and contingency.

**PROPOSALS**

3. The SFC proposes to make the following amendments to the FRR under sections 145 and 397 of the Securities and Futures Ordinance ("SFO") to cope with market development and streamline some of the existing requirements to facilitate business operations of LCs.

<u>Treatment for foreign currencies</u>

*Relaxation of treatment for any currency subject to exchange control or any assets of which the proceeds, upon realization, are subject to remittance control*

4. Section 18(2) of the FRR forbids LCs to include any currency that is subject to exchange control and any assets of which the proceeds, upon realization, are subject to remittance control, in their liquid assets, unless the LC reasonably believes that approval for the remittance of such currency or proceeds to Hong Kong can be obtained from the relevant authority within one week of application for such approval. In order to facilitate cross-boundary and cross-border business, the SFC proposes to relax this requirement by allowing any such assets to be treated as liquid assets, if such assets can be freely applied to meet an existing liability or obligation of the LC, which is settled in the same currency without the need to seek approval from the relevant authority. The LC will still be subject to the applicable haircut percentage[2] normally required under other provisions of the FRR.

*New treatment for opposite onshore and offshore positions in a non-freely floating foreign currency*[3]

5. Deviations between onshore and offshore exchange rates of a non-freely floating foreign currency may arise from time to time. The SFC proposes to clarify the treatment for opposite onshore and offshore

[2] Haircut percentage is a certain percentage of the market value of securities or other investments used to calculate a risk adjustment to cater for market risks of house positions or collateral for the purposes of liquid capital computation. The haircut percentages for different types of securities and investments are set out in Schedule 2 to the FRR.

[3] A non-freely floating currency means a foreign currency in respect of which an authority of the jurisdiction of which the currency is the lawful currency specifies, in respect of one or more foreign exchange markets specified by the authority: (a) the rate at which the currency is permitted by the authority to be converted into one or more other currencies; or (b) a range of rates within which the currency is permitted by the authority to be converted into one or more other currencies.

positions in a non-freely floating foreign currency and apply to such positions a new capital charge in the form of ranking liabilities at 1.5% of one side of the matched positions to cover execution and basis risks stemming from the difference in the onshore and offshore markets. The unmatched positions will continue to be subject to a 5% capital charge in form of ranking liabilities under section 52(1)(d) of the existing FRR.

<u>Updating the list of specified exchanges</u>

6. Schedule 3 to the FRR contains a list of specified exchanges to which the FRR prescribe more favourable treatments for assets and liabilities arising from, or related to, dealings in products traded on those exchanges as they are subject to comparable regulatory and prudential requirements. For example, amounts receivable from and cash deposited with their clearing houses or clearing participants of such clearing houses can be admitted as LCs' liquid assets, and shares listed on those exchanges will be subject to a lower haircut percentage.

7. The SFC proposes to include five Mainland futures exchanges (namely, China Financial Futures Exchange, Dalian Commodity Exchange, Shanghai Futures Exchange, Shanghai International Energy Exchange Co., Ltd. and Zhengzhou Commodity Exchange) and three other futures exchanges (namely, The Taiwan Futures Exchange Corporation, Thailand Futures Exchange Public Company Limited and Tokyo Commodity Exchange, Inc.) to the list of specified exchanges in order to facilitate LCs' participation in Mainland and other futures markets. Amounts receivable from and cash deposited with the clearing houses of these exchanges or clearing participants of such clearing houses can be admitted as LCs' liquid assets.

8. The SFC also proposes to add two Mainland stock exchanges (namely, Shanghai Stock Exchange and Shenzhen Stock Exchange) and four other stock exchanges (namely, B3 S.A. – Brasil, Bolsa, Balcao (the stock exchange in Brazil), National Stock Exchange of India Limited, BSE Ltd. (a stock exchange in India) and Taiwan Stock Exchange Corporation) to the list of specified exchanges, such that the haircut percentages for shares listed on these exchanges will be lowered from 50% to 30% to align with the haircut percentages for shares listed on other emerging markets.

Introducing/updating haircut percentages for certain securities/investments

9. The SFC proposes to introduce/update haircut percentages for certain securities and investments after reviewing the market volatility and liquidity of sampled securities or investments and benchmarking with securities or investments with similar risk profile, in order to better reflect their market risks.

*Updating haircut percentage for constituent stocks of Euro Stoxx 50 Index*

10. The SFC proposes to lower the haircut percentage for constituent stocks of Euro Stoxx 50 Index from 20% to 15% in order to align with the haircut percentages for constituent stocks of other major indices (such as the S&P 500 Index and the FTSE 100 Index).

*New haircut percentage for constituents of Hang Seng Composite LargeCap Index*

11. Considering the volatility, turnover and market capitalization of constituents of Hang Seng Composite LargeCap Index that are not constituents of Hang Seng Index, the SFC proposes to lower the haircut percentage assigned to those constituents from 30% to 20%, and exempt them from being classified as illiquid collateral for purposes of the FRR.

*New approach for determining the haircut percentage for equity or debt securities basket or index*

12. Currently, the FRR are silent on how the haircut percentage for a position in a basket of equities or debt securities, or an index representing a basket of equities or debt securities, is to be determined. In order to minimize LCs' computational burden and ensure prudent risk management, the SFC proposes that the highest applicable haircut percentages for the constituents of the basket or index should be chosen as the haircut percentage for the position. LCs may seek the SFC's approval to use a weighted average approach instead to calculate the basket or index haircut percentage, which may better reflect the risk of the basket or index.

*Updating haircut percentages and treatments for certain types of investment funds*

13. In light of the increased popularity of certain new types of funds in recent years, the SFC proposes to rationalize the haircut percentages for funds of different risk profiles by introducing haircut percentages for the following types of SFC-authorized investment funds and recognized jurisdiction funds[4] based on their risks –

(a) money market and cash management funds: 5%, in light of their low volatility and liquid nature;

(b) real estate investment trusts: 30%, in light of their nature being similar to listed stocks;

(c) structured funds and funds that invest in financial derivative instruments: 40%, in light of the fact that their investments may involve higher risk or use of leverage or derivatives; and

(d) index funds (including exchange traded funds (ETFs)) that track an equity or debt securities index: same as the haircut percentage for the index[5].

14. The SFC also proposes that when more than one haircut percentage applies to a fund, the highest of those haircut percentages shall prevail. Currently, funds which are SFC-authorized investment funds or recognized jurisdiction funds can be treated as liquid assets for the purposes of the FRR. In order to avoid treating illiquid funds as liquid assets, the SFC proposes to exclude funds which are not redeemable within 30 days from LCs' liquid assets. Since listed funds may also have good market liquidity, the SFC proposes to admit ETFs which are traded on a specified exchange as liquid assets, subject to similar haircut percentages as SFC-authorized investment funds.

[4] "Recognized jurisdiction fund" means a unit trust or mutual fund that (a) is regulated in a jurisdiction outside Hong Kong, regardless of whether it is also a SFC-authorized fund; and (b) falls within all of the criteria published on the SFC's website for the purposes of provisions of the Code on Unit Trusts and Mutual Funds relating to recognition of certain overseas collective investment schemes.

[5] Equals the highest of the applicable haircut percentages for the constituents of the index or the weighted average percentage applicable to the constituents subject to the SFC's approval.

*Specifying haircut percentages for illiquid investments and miscellaneous investments*

15. Currently, haircut percentages are prescribed only for a finite set of investments, i.e. those investments specified in Schedule 2 to the FRR. Other investments (miscellaneous investments) and certain illiquid investments as specified in the FRR do not qualify as liquid assets because of their illiquidity or the difficulty in measuring their risk. In order to clarify the policy intent, the SFC proposes to state explicitly in the FRR that the haircut percentage for illiquid investments and miscellaneous investments is 100%.

*New treatment for financial instruments with leverage*

16. In order to ensure financial products with embedded leverage are properly capitalized, the SFC proposes to require the haircut percentage for a product to be scaled up according to the leverage embedded in the product, subject to a cap of 100% of the market value of the product if the maximum possible loss on the position is capped at its market value.

<u>Refining treatments for amounts receivable in respect of dealings in securities</u>

*Amounts receivable arising from third party clearing*

17. The SFC proposes to allow an LC to include as liquid assets non-past due receivables arising from third party clearing of securities transactions with the Hong Kong Securities Clearing Company Limited ("HKSCC"), in order to facilitate the use and provision of third party clearing services by LCs.

18. The SFC also proposes that the amounts receivable from a General Clearing Participant ("GCP") of the HKSCC may be set off against amounts payable to the GCP in exceptional situations where the settlement risk is considered to be low, subject to the SFC's approval.

19. In addition, in order to facilitate LCs' dealings under Stock Connect, the SFC proposes to allow LCs to include as liquid assets any amount receivable from a China Connect Clearing Participant of the HKSCC in respect of Mainland Settlement Deposit or Mainland Security Deposit paid.

*New treatment for client prepayments for securities transactions*

20. Under the existing FRR, any prepayment received from a client to settle a purchase of or subscription for a stock is not allowed to be included in the LC's liquid assets, but the corresponding amount payable to the clearing house or issuer is required to be included in the LC's ranking liabilities. Since client prepayments for securities transactions can reduce the settlement risk of the LCs, the SFC proposes to allow LCs to include client prepayments in their liquid assets.

*Relaxing the treatment for underwriting fees receivable*

21. An LC which acts as a securities underwriter may only be required to pay the sub-underwriting fees to the sub-underwriters after the receipt of the underwriting fee from its client. In order to reduce the capital burden of LCs under such circumstance, the SFC proposes to allow LCs to include any underwriting fee accrual or receivable which remains outstanding beyond the normal time limit prescribed in the FRR in their liquid assets, up to the amount of the corresponding sub-underwriting fee liability to sub-underwriters, if the settlement of the latter is contingent upon the collection of underwriting fees by the LCs.

<u>New treatment for liabilities arising from tenancy agreements for business premises</u>

22. Under a new accounting standard coming into effect on 1 January 2019, a tenant may be required to recognize its rights and obligations under certain tenancy agreements as on-balance sheet assets and liabilities. In order to alleviate the additional capital burden on LCs as recognized assets are non-liquid assets while recognized liabilities are counted towards ranking liabilities under the FRR, the SFC proposes to allow an LC to exclude from its ranking liabilities the amount of liability arising from a tenancy agreement entered into by it in respect of any premises used for carrying on regulated activity, up to the amount of assets arising from the same tenancy agreement under this accounting standard, which is not included in its liquid assets. The SFC also proposes to exclude the same amount from the LC's variable required liquid capital calculation.

Other technical changes

23. The SFC proposes other technical changes to the FRR which aim to enhance the transparency of the rules, to align with current accounting and market practices and to better reflect the underlying policies. The key proposed changes include the following –

(a) allowing an LC to exclude from its ranking liabilities amounts payable to clients in respect of client money held by it in a segregated account maintained with a person approved by the SFC;

(b) recognizing credit ratings issued by Fitch Ratings in order to ensure a level playing field with other jurisdictions; and

(c) rationalizing certain definitions to better reflect policy intent and current market practices, for example, to exclude highly complex or risky products from the definitions of "qualifying debt securities" and "special debt securities".

## PUBLIC CONSULTATION

24. The SFC conducted a public consultation on the proposed amendments to the FRR from July to August 2017. Eight submissions were received from various market practitioners, professional firms and industry associations. Respondents who provided comments generally welcomed and supported the proposed changes. The SFC has taken into account their responses in finalizing the above proposals.

## WAY FORWARD

25. The SFC aims to table the relevant subsidiary legislation before the Legislative Council in the fourth quarter of 2018 for negative vetting.

26. Members are invited to note the content of this paper.

**Financial Services and the Treasury Bureau**
**Securities and Futures Commission**
**25 May 2018**