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Paper for the House Committee meeting on 30 November 2018

**Report of the Subcommittee on Securities and Futures
(Financial Resources) (Amendment) Rules 2018**

Purpose

This paper reports on the deliberations of the Subcommittee on Securities and Futures (Financial Resources) (Amendment) Rules 2018 ("the Subcommittee").

Background

2. A licensed corporation ("LC") which conducts one or more types of regulated activities under the Securities and Futures Ordinance (Cap. 571) ("SFO") is required to comply with the financial resources requirements as prescribed in the Securities and Futures (Financial Resources) Rules (Cap. 571N) ("FRR").¹ Under section 6 of FRR, an LC must at all times maintain liquid capital (i.e. the amount by which its liquid assets exceeds its ranking liabilities) which is not less than its required liquid capital.

3. According to paragraph 3 of the Legislative Council ("LegCo") Brief (File Ref: SF&C/1/2/11/6/1C(2017)Pt.3), the Securities and Futures Commission ("SFC") considers it appropriate to update FRR to align with market development and streamline some of the existing requirements to facilitate the business operation of LCs.

¹ "Regulated activity" is defined under section 1 of Part 1 of Schedule 1 to SFO to mean any of the regulated activities specified in Part 1 of Schedule 5 to SFO. Examples of regulated activities are dealing in securities and dealing in futures contracts.

Securities and Futures (Financial Resources) (Amendment) Rules 2018 (L.N. 196 of 2018)

4. The Securities and Futures (Financial Resources) (Amendment) Rules 2018 (L.N. 196 of 2018) ("the Amendment Rules") are made by SFC under section 145 of SFO after consultation with the Financial Secretary to amend FRR. The main amendments are to clarify or modify certain requirements in relation to the manner in which an LC, for the purposes of calculating its liquid capital and required liquid capital, is to account for its assets, liabilities and transactions.

5. The Amendment Rules include the following amendments to FRR:

- (a) excluding from an LC's ranking liabilities the amount of liability arising from a tenancy agreement entered into by it in respect of any premises which it uses in carrying on the regulated activity concerned, up to the amount of the total value of its assets arising from that tenancy agreement, subject to compliance with the relevant requirements (sections 3(2) to (4) and 30 of the Amendment Rules);
- (b) allowing an LC to include in its liquid assets a controlled asset (for example, a currency which is subject to exchange control) that it is able to freely apply to meet its existing obligations or liabilities that are denominated in the same currency as the asset, subject to compliance with the relevant requirements (sections 3(50) and 12 of the Amendment Rules);
- (c) providing that an LC must include in its liquid assets money held by it on behalf of a client in a specified account which it has received from the client for the purposes of settling a purchase of, or subscription for, securities by it on behalf of the client (section 14 of the Amendment Rules);

- (d) introducing or revising the haircut percentages applicable to certain securities or investments, such as lowering the haircut percentage for constituent stocks of the Euro Stoxx 50 Index from 20% to 15% (for example, sections 3(17), 4 and 35 of the Amendment Rules);² and
- (e) adding to the lists of specified exchanges contained in Schedule 3 to FRR certain Mainland stock or futures exchanges such as Shanghai Stock Exchange and other stock or futures exchanges such as Taiwan Stock Exchange Corporation (section 36 of the Amendment Rules).³

6. As provided under section 1 of the Amendment Rules, sections 1, 2, 3(2) to (4) and 30 of the Amendment Rules (i.e. provisions relating to or containing the amendments described in paragraph 5(a) above) come into operation on 1 January 2019. The other provisions of the Amendment Rules come into operation on 1 April 2019.

The Subcommittee

7. At the meeting of the House Committee on 26 October 2018, Members agreed to form a subcommittee to study the Amendment Rules. Hon Christopher CHEUNG Wah-fung was elected as Chairman of the Subcommittee. The membership list of the Subcommittee is in the **Appendix**.

8. To allow time for the Subcommittee to study the Amendment Rules, a resolution was passed at the Council meeting of 21 November 2018 to extend the scrutiny period to the Council meeting of 12 December 2018.

² As stated in footnote 2 of the LegCo Brief, "haircut" is a certain percentage of the market value of securities or other investments to be deducted from the market value as 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 contained in Schedule 2 to FRR.

³ FRR prescribe more favourable treatments for assets and liabilities arising from, or related to, dealings in products traded on those exchanges.

Deliberations of the Subcommittee

9. In the course of scrutiny, the Subcommittee has examined the respective treatments of controlled assets, tenancy agreement, immovable property and standby credit under the Amendment Rules. The Subcommittee's deliberations are set out in the ensuing paragraphs.

Treatment of controlled assets

10. Mr James TO has expressed concerns regarding the criterion in which "controlled assets" may be treated as "liquid assets" for the purpose of fulfilling liquid capital requirements under FRR. Specifically, Mr TO is concerned that under the new section 18A(2) of the amended FRR, if an LC "reasonably believes" that it will be able to obtain the required approval from the relevant authority or regulatory organization within one week after applying for such approval, it can then include such "controlled assets" as "liquid assets". Mr TO considers that it should be SFC to approve such inclusion and he has requested that the Administration and SFC should consider removing or amending subsection (2) of the new section 18A such that SFC's explicit approval is required.

11. The Administration has advised that the abovementioned criterion is not new. Similar provisions can be found in section 18(2) of the existing FRR and have been in operation since 2003. FRR (particularly section 56) require that LCs should file periodic returns on, among others, their financial position, to SFC. It is the duty of LCs to comply with FRR requirements as a whole, and consequently it is their responsibility to ensure that all applicable FRR requirements have been complied with when adopting a particular treatment for an asset or liability in their FRR returns. In other words, LCs should "reasonably believe" that all the requirements relating to the treatment have been fulfilled in calculating their liquid assets. This is consistent with the requirement in section 18(2) of the existing FRR (or the new section 18A(2) of the amended FRR) that the LCs should "reasonably believe" that the abovementioned criterion is met before any such "controlled assets" can be included as "liquid assets". The above notwithstanding, LCs' returns are reviewed and test checked by SFC. SFC would duly take into account a wide range of objective factors (including the timeline as indicated by relevant regulatory authority, existing regulatory policies and prohibition, and past experience of the actual time required to remit such "controlled assets" to Hong Kong) before coming to a view as to whether the FRR requirements in respect of "controlled assets" have been satisfied.

12. The Administration has further advised that section 146(4) of SFO requires LCs to keep their records in sufficient detail and make their records available to SFC within five business days after notification. Section 57 of the existing FRR also requires LCs to produce records and documents upon request by SFC. Therefore, if SFC suspects any "controlled assets" have been wrongly included in an LC's liquid assets, it may request documentary evidence from the LC to allow its assessment and verification on, among others, whether any "controlled assets" should be included as "liquid assets". If SFC disagrees with LCs' returns that certain "controlled assets" can be included as "liquid assets", SFC will take follow-up actions with the LCs before assessing their compliance with FRR requirements, and take administrative or enforcement action on any FRR breach identified. Annual audits of LCs' financial statements (including LCs' FRR returns) are also conducted by independent auditors according to the Securities and Futures (Accounts and Audit) Rules (Cap. 571P). Such audit requirement provides an additional tier of checking against LCs' potential arbitrary treatment of "controlled assets". As SFC will assess the fulfillment or otherwise of the FRR requirements and will also test check LCs' FRR returns in the process, there already exists an institutional mechanism in which SFC can disagree with LCs' FRR returns (including the parts on whether certain "controlled assets" can be included as "liquid assets").

13. The Administration considers that the above existing mechanisms have, in practice, provided the same effect as Mr TO's request that the SFC's approval should be obtained in the aforementioned situation. The Administration therefore does not consider further amendments to the amended FRR necessary to achieve such purpose.

Treatment of tenancy agreement and immovable property

14. Mr Kenneth LEUNG has sought elaboration on the new treatment of tenancy agreements in respect of premises used for carrying on the concerned regulated activity by an LC upon the implementation of the new accounting standard on 1 January 2019 (as mentioned in paragraph 23 of the LegCo Brief). He also enquired about the respective treatments on liabilities arising from the LC's (i) "mortgaged" property, and (ii) "non-mortgaged" property for carrying on regulated activity.

15. The Administration has advised that the amended FRR 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 a regulated activity, up to the amount of assets arising

from the same tenancy agreement under the new accounting standard, which is not included in its liquid assets. The Amendment Rules also exclude the same amount from the calculation of an LC's variable required liquid capital.

16. The Administration has advised that under section 53(2)(b) of the existing FRR, an LC shall not include in its ranking liabilities any liability that will not fall due within the next 12 months and is secured by a first legal charge on immovable property beneficially owned by it. The immovable property must be used in carrying on the regulated activity for which it is licensed, to the extent that the net realizable value of that property equals such liability. In other words, a significant amount of liability arising from the mortgage of the property has therefore been excluded from the LC's ranking liabilities. As regards a "non-mortgaged" property owned by an LC for carrying on the regulated activity, the Administration has advised that it is regarded as a fixed asset, and will not be counted towards the liquid assets of the LC under FRR, as the property will not be able to provide immediate liquidity to the LC.

Treatment of standby credit

17. The Chairman has suggested that the Administration and/or SFC should give favourable consideration to admitting the amount of a standby credit granted by a bank to an LC, on provision of the "non-mortgaged" property as guarantee, as "liquid assets" of the LC. This will help reduce LCs' burden in earmarking sufficient liquid capital to fulfill the FRR requirements, especially during occasions of a stark rise in business volume (such as providing initial public offering financing to clients).

18. The Administration has advised that the drawing down of a standby loan (regardless of whether or not it is collateralized) will give rise to corresponding liabilities. In other words, it cannot help in bringing up the level of liquid capital as the increase in the amount of liquid assets from the loan would be offset by the corresponding liabilities. The Administration has pointed out that the existing FRR (as well as the amended FRR) have some provisions to effectively address the Chairman's concerns, including –

- (a) bank loans with office premises as security:

Pursuant to section 53(2)(b) of the existing FRR (also section 53(2)(b) of the amended FRR), an LC using its office premises (if it is used for carrying on the concerned regulated activity) as security to obtain bank loans is

allowed to exclude such portion of the loan balance that will not fall due within the next 12 months (non-current bank loan) from its ranking liabilities. For instance, if an LC draws down a mortgage of its office premises that is repayable over a period of ten years, its liquid assets will increase by the amount of the loan drawn, while its ranking liabilities will increase by the mortgage payable in the coming 12 months (but not for the nine-year mortgage period following the first 12 months). In other words, this would provide an effective avenue for LCs to increase their liquid capital.

- (b) approved subordinated loans by shareholders/parent companies:

Approved subordinated loans are usually granted by an LC's shareholders or parent companies to increase the LC's liquid capital. Under such a loan agreement, the lender usually enters into a written agreement with SFC and the borrower (i.e. the LC) to, among other matters, subordinate its claims against the LC to those of other creditors of the LC. The LC's liquid assets will increase by the amount of the loan drawn, while, according to section 53(2)(a) of the existing FRR (also section 53(2)(a) of the amended FRR), the corresponding amount payable to its shareholders/parent companies would not be included as ranking liabilities. This provides an avenue for LCs to increase their liquid capital.

- (c) approved revolving subordinated loan facilities:

LCs may draw down subordinated loans under an approved revolving subordinated loan facility as and when a need to increase liquid capital arises. LCs may arrange with any of their lenders for such a revolving subordinated loan facility in advance to serve as a revolving credit line. Similar to the subordinated loans in (b) above, the amount drawn under the facility could be included as liquid assets of the LC, while the amount payable would not be included as ranking liabilities. This, again, provides an avenue for LCs to increase their liquid capital.

19. Notwithstanding the availability of the above mentioned means for an LC to bring up the level of liquid capital, the Administration has

advised that SFC is prepared to consider other effective suggestions in light of market development and will suitably incorporate any agreed suggestions in future amendments to FRR, after going through the necessary due process including consultation with the trade.

Haircut percentages for funds

20. Mr CHAN Chun-ying has enquired about the rationale for assigning different haircut percentages for different types of investment funds. The Administration has advised that different haircut percentages assigned for different types of funds are based on the funds' risk profiles and market volatility. For example, the haircut percentage assigned to money market and cash management funds is 5%, while that for real estate investment trusts and structured funds are 30% and 40% respectively.

21. The Administration has further advised that at present, haircut percentages are prescribed only for a finite set of investments, i.e. those investments specified in Schedule 2 to FRR. Other investments (miscellaneous investments) and certain illiquid investments as specified in FRR are not qualified as liquid assets because of their illiquidity or the difficulty in measuring their risk. In order to clarify the above policy intent, the Amendment Rules stipulate explicitly that the haircut percentage for both illiquid investments and miscellaneous investments is 100%.

Recommendation

22. The Subcommittee has raised no objection to the Amendment Rules and will not propose any amendment. The Administration will not propose any amendment to the Amendment Rules.

Advice sought

23. Members are invited to note the deliberations of the Subcommittee as set out above.

**Subcommittee on Securities and Futures (Financial Resources)
(Amendment) Rules 2018**

Membership list

Chairman Hon Christopher CHEUNG Wah-fung, SBS, JP

Members Hon James TO Kun-sun
Hon CHAN Kin-por, GBS, JP
Hon Mrs Regina IP LAU Suk-yee, GBS, JP
Hon YIU Si-wing, BBS
Hon Kenneth LEUNG
Hon Dennis KWOK Wing-hang
Hon Holden CHOW Ho-ding
Hon CHAN Chun-ying, JP

(Total : 9 members)

Clerk Mr Derek LO

Legal Adviser Ms Wendy KAN