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

written response following the discussion at the meeting on 13 November 2018

This paper provides responses of the Government and the Securities and Futures Commission ("SFC") to the concerns / suggestions in relation to the *Securities and Futures (Financial Resources) (Amendment) Rules 2018* as raised by Members of the Subcommittee at its meeting of 13 November 2018.

Treatment of controlled assets

2. The Hon. James TO raised at the Subcommittee his concerns regarding the criterion in which "controlled assets" may be treated as "liquid assets" for the purpose of fulfilling liquid capital requirements under the *Securities and Futures (Financial Resources) Rules* ("FRR"). Specifically, the Hon. James TO was concerned that under the new s.18A(2) of the amended FRR, if a licensed corporation ("LC") "reasonably believes" that it will be able to obtain the required approval from the relevant authority or regulatory organisation within one week after applying for such approval, it can then include such "controlled assets" as "liquid assets". The Hon. James TO considered that it should be the SFC to approve such inclusion and he requested that the Government and the SFC should consider removing or amending ss.(2) of the new s.18A such that the SFC's explicit approval is required.

3. As mentioned at the Subcommittee meeting, the abovementioned criterion is <u>not</u> new. Similar provision can be found in s.18(2) of the existing FRR which have been in operation since 2003.

4. The FRR (particularly s.56) require that LCs should file periodic returns on, among others, their financial position, to the 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 s.18(2) of the existing FRR (or the new s.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".

5. The above notwithstanding, LCs' returns are reviewed and test checked by the SFC. As explained at the meeting, 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) would be duly taken into account before coming to a view as to whether the FRR requirements in respect of "controlled assets" have been satisfied.

6. S.146(4) of the *Securities and Futures Ordinance* (Cap. 571) requires LCs to keep their records in sufficient detail and make their records available to the SFC within five business days after notification. S.57 of the existing FRR also requires LCs to produce records and documents upon request by the SFC. Therefore, if the 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 the SFC disagrees with LCs' returns that certain "controlled assets" can be included as "liquid assets", the 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".

7. As the 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 the SFC can disagree with LCs' FRR returns (including the parts on whether certain "controlled assets" can be included as "liquid assets"). These have, in practice, provided the same effect as the Hon. James TO's request that the SFC's approval should be obtained in the aforementioned situation. We therefore do not consider further amendments to the amended FRR necessary to achieve such purpose.

Treatment of standby credit

8. At the Subcommittee meeting, the Hon. Christopher CHEUNG suggested that the Government / the 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. We understand from the discussion at the meeting that the Hon. Christopher CHEUNG's objective was to 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).

9. The drawing down of a standby loan (regardless of whether or not it is collateralised) 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. We would, however, wish to point out that the existing FRR (as well as the amended FRR) have some provisions to effectively address the Hon. Christopher CHEUNG's concerns, including -

(a) **<u>bank loans with office premises as security</u>**:
Pursuant to s.53(2)(b) of the existing FRR (also s.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) **<u>approved subordinated loans by shareholders / parent companies</u>:**
Approved subordinated loans are usually granted by an LC's shareholders or parent companies to increase the LC's liquid capital. Under such loan agreements, the lender usually

enters into a written agreement with the 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 s.53(2)(a) of the existing FRR (also s.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 their lenders for such 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.

10. We fully appreciate the Hon. Christopher CHEUNG's concerns on the capital burden of LCs in fulfilling FRR requirements. We believe the provisions in the existing FRR and the amended FRR as mentioned under paragraph 9 above should have effectively addressed the concerns. The SFC is prepared to consider other effective suggestions in light of market development and will suitably incorporate any agreed suggestions in future amendments to the FRR, after going through the necessary due process including consultation with the trade.

Financial Services and the Treasury Bureau
Securities and Futures Commission
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