# 立法會
# *Legislative Council*

LC Paper No. CB(1) 1973/99-00
(These minutes have been seen by the Administration and cleared by the Chairman)

Ref: CB1/BC/13/98/2

**Bills Committee on**
**Securities (Margin Financing) (Amendment) Bill 1999**

**Minutes of meeting held on**
**Monday, 13 December 1999, at 2:30 pm**
**in Conference Room A of the Legislative Council Building**

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| **Members present** | **:** | Hon Ronald ARCULLI, JP (Chairman)<br>Hon Bernard CHAN<br>Hon Jasper TSANG Yok-sing, JP<br>Hon FUNG Chi-kin |
| **Member absent** | **:** | Hon Albert HO Chun-yan<br>Hon SIN Chung-kai |
| **Public officers Attending** | **:** | Mr Bryan CHAN<br>Principal Assistant Secretary for Financial Services<br><br>Miss Hinny LAM<br>Assistant Secretary for Financial Services<br><br>Mr William MADDAFORD<br>Senior Assistant Law Draftsman,<br>Department of Justice<br><br>Ms Vicki LEE<br>Government Counsel, Department of Justice |

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| **Attendance by invitation** | : | Securities and Futures Commission<br><br>Mr Andrew PROCTER<br>Executive Director of Intermediaries and Investment Products<br><br>Mr Leo LEE<br>Director of Licensing<br><br>Mr CHUNG Hing-hing<br>Associate Director of Licensing<br><br>Mrs Yvonne MOK<br>Associate Director of Intermediaries Supervision |
| **Clerk in attendance** | : | Ms Leung Siu-kum<br>Chief Assistant Secretary (1)4 |
| **Staff in attendance** | : | Mr KAU Kin-wah<br>Assistant Legal Adviser 6<br><br>Ms Connie SZETO<br>Senior Assistant Secretary (1)1 |

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## I Confirmation of minutes of meeting

(LC Papers No. CB(1)102, 103 and 104/99-00)

The minutes of the meetings held on 29 April, 11 and 20 May 1999 were confirmed.

## II Meeting with the Administration

The Administration's proposal on pooling of clients' assets
(LC Papers No. CB(1)184, 263/99-00 and 593/99-00(01))

2. The Chairman informed members that at the meeting held on 27 September 1999, the Bills Committee agreed to invite views from various

organizations which had made submissions to the Committee previously on the Administration's proposal of imposing a requirement on securities margin financiers (SMFs) and securities dealers (dealers) limiting the amount of credit facilities that could be obtained from third-party banks by pledging margin clients' securities collateral on an aggregate basis. Submissions from five organizations had been circulated to members and forwarded to the Administration for response.

3. The Principal Assistant Secretary for Financial Services (PAS/FS) briefed members on the Administration's response to the submissions. He remarked that the Institute of Securities Dealers indicated support for the proposal and the other organizations also did not object to the proposal in principle. The Hong Kong Stockbrokers Association (HKSbA) and the Hong Kong Securities Professionals Association (HKSPA) urged that flexibility should be provided in implementing the proposal. HKSbA proposed that the requirement should be non-statutory and implemented by way of guidelines or code of conduct. A buffer limit of 20% and a grace period of seven business days should be allowed. In other words, SMFs and dealers would be permitted to obtain credit facilities from banks at an amount up to 120% of the aggregate amount of margin clients' outstanding loans and have seven business days to adjust their portfolios after the clients had returned their loans. HKSPA's suggestion in respect of the buffer limit was also 20% but the grace period was two business days. PAS/FS said that after considering the organizations' views, the Administration considered that the proposed requirement could be specified by statutory rules made by the Securities and Futures Commission (SFC) and that a buffer limit of 5% and a grace period of three business days were considered sufficient to meet the practical needs of SMFs and dealers in complying with the requirement.

4. On the suggestion by the Hong Kong Association of Banks and the Law Society of Hong Kong to clarify in the Bill that the position of a lender's taking security over a client's securities should not be affected by any breach of the proposed requirement, PAS/FS said that the proprietary rights over securities collateral deposited by the client should be governed by the terms of the agreements between the parties concerned and the rules of common law and equity. It was not the intention of the Administration to establish in the Bill a statutory position on the relationships among different parties.

5. The Chairman expressed reservation on the need for the proposal. He opined that the proposal would offer limited protection for clients' assets. It could only limit the amount of credit facilities a SMF or dealer could draw down by reference to the total margin loans due from all of its clients at any one time but would not address the risk of a client's securities collateral being misused for meeting the liability of other clients. Moreover, he queried whether the proposal would be workable. The proposal was a modified version

of the Singaporean model the implementation of which the Administration had limited knowledge about. He pointed out that there were great discrepancies between proposals made by the Administration and the industry as regards the buffer limit and grace period. He worried that the proposal would create operational difficulties for SMFs and dealers. Given that the aggregate amount of outstanding margin loans due from clients might vary on a daily basis and that volatilities in the market would affect the value of securities collateral, the 5% buffer limit could be easily exceeded and the requirement would be difficult to comply.

6. Sharing the Chairman's views, Mr FUNG Chi-kin urged the Administration to consider permitting a larger buffer at the initial stage and review the ceiling in the light of actual implementation of the proposal. Mr FUNG Chi-kin and Mr TSANG Yok-sing also enquired about details in implementing the proposed grace period.

7. In response, PAS/FS said that the Administration's proposal had not been put forwarded as part of the Bill. The proposal was in response to the Democratic Party (DP)'s concern raised at Bills Committee meetings about the risk involved in the pooling arrangement under which SMFs or dealers might pledge clients' securities collateral for credit facilities in excess of the clients' outstanding margin loans and use the facilities for their own purposes. The Administration believed that the proposal would strike a balance between outright banning of pooling on the one hand which would adversely affect the commercial viability of SMFs and dealers, and prevention of misuses of clients' assets with a view to enhancing investor protection on the other. PAS/FS re-iterated that consultation with market practitioners indicated that the proposal would be workable and that operational difficulties could be resolved. Nonetheless, he stressed that the Administration had not taken a final position on the proposal and the Bills Committee's further deliberation was welcomed.

8. The Executive Director of Intermediaries and Investment Products, SFC (ED/IIP(SFC)) added that the proposal sought to restrict SMFs or dealers from using clients' securities collateral to secure lending to meet their development costs, daily cash flow requirement of the business and as their working capital. Upon the Chairman's enquiry, ED/IIP(SFC) informed that, as at the end of October 1999, the total amount of outstanding loans advanced by securities dealers or their associated finance companies including those obtained from banks were in the region of $10 billion to $12 billion. Under the Administration’s proposal, the ratio of the aggregate amount of clients’ outstanding loans to the total amount of credits obtained from banks with clients’ securities collateral as security would be at 1:1.05.

9. Regarding the concern about operational difficulties of SMFs or dealers in adjusting their portfolios, ED/IIP(SFC) said that as suitable software

enhancing the new operating system was available in the market, SMFs or dealers should have no difficulty in complying with the requirement. In the event of a substantial fall in share prices leading to falls in values of securities collateral, banks would require SMFs or dealers to make up the short-fall and the latter in turn would have to make margin calls on clients to maintain margin positions. Hence, market volatilities would not add to the burden of SMFs or dealers in complying with the proposed requirement.

10. On the suggestion of providing a larger buffer and a longer grace period in implementing the proposal, PAS/FS said that whilst there was no absolute science in setting the rules, the Administration considered that the proposed 5% buffer limit and three business days would be sufficient in meeting the practical needs of the industry. ED/IIP(SFC) remarked that the larger the buffer and the longer the grace period, the greater the risk SMFs or dealers would be exposed to as they might need to make up a larger potential short-fall and more likely to delay action in adjusting their portfolios.

Admin/ SFC

11. The Chairman was unconvinced of the Administration's explanation. To facilitate members' understanding, he requested the Administration to provide explanation and illustration on how the 5% buffer limit and three-day grace period could be implemented.

12. On whether the third-party banks would be liable for lending over 105% of the aggregate amount of clients' outstanding loans to SMFs or dealers, PAS/FS re-iterated that only SMFs or dealers would be liable for breaching the proposed requirement. He added that segregation in the credit facilities which were secured by clients' securities collateral from those obtained with the own assets of SMFs or dealers would facilitate implementation of the proposal. In this connection, the Chairman and Mr FUNG Chi-kin pointed out that there would be problems in implementing the proposal as the industry practice was that clients' securities collateral and own assets of SMFs or dealers were often pooled together for obtaining credit facilities from banks and that even where there were separate bank accounts, banks would off-set loans due from SMFs or dealers with returns received from other accounts of SMFs or dealers. Thus, it would be very difficult for SFC to enforce the relevant rules.

13. As regards the appropriateness of prescribing the proposed requirement in the form of SFC rules which would be subject to the negative vetting of the Legislative Council instead of implementing it by way of non-statutory guidelines or code of conduct, ED/IIP(SFC) explained that guidelines or code of conduct would only lay down the standards of business practices expected by regulators and would not specify detailed rules concerning daily operation of SMFs or dealers. Moreover, guidelines or code of conduct specifying the proposed requirement would be difficult to police. Breaches of guideline or code of conduct would not automatically give rise to disciplinary actions on

SMFs or dealers. They only described the circumstances of which SFC might consider disciplinary actions appropriate. Whether sanctions for breaches would be imposed would depend upon SFC successfully demonstrating that failure of SMFs or dealers in observing the relevant guidelines or code inferred that they were not "fit and proper" persons for conducting the registrant business. Hence, to ensure effective enforcement, it was considered necessary to provide legislative backing to the proposed requirement.

14. Responding to the Chairman's comment that the Hong Kong Monetary Authority (HKMA)'s guideline requiring banks to limit their exposures in property lending was very effective, ED/IIP(SFC) said that while he did not have details about HKMA's enforcement of the guidelines, he understood that HKMA did have power under the Banking Ordinance (Cap. 155) to direct banks to observe the guidelines.

Outstanding issues arising from previous meetings
(LC Papers No. CB(1) 576/99-00(02), (03))

15. Members deliberated on the list of outstanding items (the list) provided by the Administration. They noted that the Administration had prepared draft Committee Stage Amendments (CSAs) covering 46 items out of the total of 78 outstanding items. CSAs for another 16 items were under preparation. The Administration had reviewed the rest of 16 items and considered that no CSA was necessary.

*Item 2 - Section 2*

16. PAS/FS explained that since the interpretation of the word "audit" for the purposes of the Securities Ordinance (SO) (Cap. 333) included the meaning of "examine", it was therefore considered appropriate to retain the definition. References to "audit" were found in section 9 of the existing SO and the proposed section 121 AY of the Bill.

17. The Chairman opined that the term "audit" was a widely-used term and the proposed definition of "audit" might cause confusion as it had a broader meaning. ED/IIP(SFC) said that one possible option to address the concern was to pick out those sections in the existing SO and the Bill where "audit" was meant to include "examine" and replace them by "audit and examine" so as to save the need of providing a definition of "audit". He agreed to explore the feasibility of such option.

Admin/ SFC

*Item 12 - sections 121C(3) and D(3)*

18. PAS/FS explained that sections 121C(3) and D(3) (i.e. SMFs or SMFs' representatives under suspension would be deemed as unregistered) were

consistent with sections 121S and 121U concerning SFC's power to order suspension of registrants. Sections 121C(3) and D(3) only applied where suspension had been ordered under sections 121S(3) and U(3). If the persons carried on a securities margin financing business or act or held themselves out as a SMF's representatives during the suspension, they would commit an offence under 121C and 121D.

19. As regards members' concern that a suspended SMF would be precluded from engaging in activities which were necessary for the continuous survival of its business and the protection of the interests of its existing clients, PAS/FS referred members to item 29 of the list and said that a new section would be added to enable SFC to suspend the registration in respect of the whole or part of the securities margin financing business and to specify the manner in which the business could continue to be carried out. Non-compliance with the suspension order would constitute an offence. In this connection, the Chairman opined that sections 121C(3) and D(3) might become obsolete as sanction for breaching suspension order would be provided under the proposed new section.

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The Administration noted the Chairman's view and agreed to review the need of sections 121C(3) and D(3).

*Item 16 - section 121F(4)*

20. On the Bills Committee's concern about the absence of pecuniary penalty for contravention of section 121F(4) relating to the making of false statements upon an application for registration, PAS/FS said that section 121F(4) was analogous to section 62 of the existing SO which dealt with false representation for the purpose of obtaining a certificate of registration and under which no pecuniary penalty was prescribed. The apparent gap was filled by the Magistrate's Ordinance (MO) (Cap. 227). According to section 62 of the SFC Ordinance (SFCO) (Cap. 24), SFC could, in its own name, bring a prosecution for any offence under the relevant ordinances but the offence would be tried summarily before a Magistrate. Sections 91 and 92 of MO allowed Magistrates to hear indictable offences summarily and empowered them to impose penalties including imprisonment and fines on the convicted.

21. The Chairman pointed out that there were some inconsistencies between the penalty levels prescribed under sections 121C(2)(a) and 121F(4). In section 121C(2)(a), carrying on a securities margin financing business without registration would be liable to imprisonment for two years whereas breach of 121F would be liable to five years' imprisonment. He urged the Administration to review the penalty levels for the two offences by reference to the other offence clauses in the Bill and other relevant ordinances. The Administration undertook to do so.

Admin/SFC

*Item 23 - sections 121R(5) and T(5)*

22. Concerning the Bills Committee's suggestion to amend sections 121R(5) and T(5) with a view to providing a SMF or a SMF's representative an opportunity of being heard before the imposition of a suspension order, ED/IIP(SFC) explained that as the same language had been used in section 55 of the existing SO, for the sake of consistency it was proposed not to amend the two sections. He stressed that notwithstanding the absence of statutory requirement for a hearing in this respect, registrants would be entitled to such right as a matter of procedural fairness. Moreover, section 121W of the Bill provided that SFC had to give the registrants a written notice of the decision and an explanation of the grounds that led to the decision. In addition, SFC's decisions concerning licensing or disciplinary matters were subject to appeal under the Securities and Futures Appeals Panel.

*Item 24 - section 121S(1)*

23. PAS/FS said that the Administration's legal advice had confirmed that given section 121S(1)(a)(iv) which enabled SFC to conduct inquiries to ascertain whether a SMF remained fit and proper and in that connection, SFC could have regard to SMF's financial integrity and reliability, the scenarios listed in section 121R(2) should have been covered. In other words, SFC would have sufficient power to inquire into any of the matters listed in 121R(2)(a)-(h). Hence, no amendment for section 121S(1) was considered necessary.

24. The Chairman opined that it would be arguable whether all of the matters listed in section 121R(2) were connected with "fit and proper" criteria of SMF. Hence, he was concerned that section 121S(1) might not provide SFC with the power to inquire into all matters listed in section 121R(2)(a)-(h). In response to the Chairman's suggestion, the Administration agreed to consider proposing CSAs to put it beyond doubt that SFC's inquiry power covered the matters listed in 121R(2)(a)-(h).

Admin/ SFC

## III Any other business

Date of future meetings

25. Members agreed to schedule the following four meetings to continue discussion with the Administration on the draft CSAs -

| Date | Time |
|---|---|
| 10 January 2000 | 10:45 am |
| 13 January 2000 | 8:30 am |

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| 17 January 2000 | 8:30 am |
| 18 January 2000 | 10:45 am |

(*Post-meeting note:* The meetings scheduled for 10 and 18 January 2000 were subsequently cancelled and re-scheduled for 19 and 21 January 2000, both at 10:45 am.)

26. The meeting ended at 4:40 pm.

Legislative Council Secretariat
21 July 2000