LC Paper No. CB(1)102/99-00
(These minutes have been seen by the Administration)

Ref: CB1/BC/13/98/2

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

Minutes of meeting held on
Thursday, 29 April 1999, at 4:30 pm
in Conference Room B of the Legislative Council Building

Members present : Hon Ronald ARCULLI, JP (Chairman)
Hon Albert HO Chun-yan
Hon Bernard CHAN
Hon SIN Chung-kai
Hon Jasper TSANG Yok-sing, JP
Hon FUNG Chi-kin

Public officers attending : Mr Bryan CHAN
Principal Assistant Secretary for Financial Services

Miss Hinny LAM
Assistant Secretary for Financial Services

Mr William MADDAFORD
Senior Assistant Law Draftsman
Department of Justice

Ms Vicki LEE
Government Counsel
Department of Justice

Attendance by Invitation : Securities and Futures Commission

Mr Andrew PROCTER
Executive Director of Intermediaries and Investment Products
Mrs Yvonne MOK

Associate Director of Intermediaries Supervision

Clerk in attendance : Ms Estella CHAN
Chief Assistant Secretary (1)4

Staff in attendance : Mr KAU Kin-wah
Assistant Legal Adviser 6

Ms Connie SZETO
Senior Assistant Secretary (1)1

I Election of Chairman

Mr Ronald ARCULLI was elected Chairman of the Bills Committee.

II Meeting with the Administration
(LC Paper Nos. CB(1)1219/98-99 and 1201/98-99)

2. Mr Bernard CHAN declared interest as a director of securities firms which carried on securities margin financing business. Mr FUNG Chi-kin declared interest as a securities dealer who also operated securities margin financing business.

3. The Principal Assistant Secretary for Financial Services (PAS/FS) explained that the object of the Securities (Margin Financing) (Amendment) Bill 1999 was to amend the Securities Ordinance (SO) (Cap. 333) to bring securities margin financing activities and their operators clearly under the purview of the Ordinance, thereby subjecting them to regulation by the Securities and Futures Commission (SFC). He stressed that the proposed regulatory regime would strike an appropriate balance between enhancing market integrity and investor protection on the one hand and maintaining commercial viability of securities margin financing business on the other. The proposed regime, which was built upon the recommendations put forward by the inter-agency working group (the Working Group) in May 1998 in the "Consultation Paper on Proposed Regulation on Share Margin Financing", included the following four key features -

(a) Registration of "securities margin financiers" (SMFs) under SO. The sole business requirement would apply to restrict registrants' business to the financing of securities trading only. Existing registered securities dealers might continue to provide securities margin financing to their clients without having to obtain a separate licence but such business would be subject to the same level of regulation as SMFs;

(b) Amendments to the Financial Resources Rules (FRRs) under the Securities and Futures Commission Ordinance (SFCO) (Cap. 24) to bring in appropriate minimum paid-up and liquid capital requirements, haircut deductions, concentrated risk adjustments as well as additional reporting requirements for SMFs. All these requirements aimed at improving the risk management systems of securities margin financing operators. Existing registered securities dealers would have six months to fully comply with the new FRRs.

(c) New measures to enhance protection for clients' assets; and

(d) A revised Code of Conduct (or Code of Business Standards) introduced by SFC for SMFs, laying out the standards of business practices expected by regulators.

4. PAS/FS added that the Bill also included consequential amendments to SFCO to extend the regulatory powers of SFC to cover SMFs and their representatives; and amendments to the Money Lenders Ordinance (MLO) (Cap. 163) to exempt SMFs from certain licensing and operational requirements in order to avoid duplication of regulation. In view of the complexity of the proposed amendments to FRR, the Administration would provide the draft FRR for preliminary discussion by the Bills Committee before it would be introduced into the Legislative Council for scrutiny through the negative vetting procedure. In this connection, members noted that it had been a practice for a Bills Committee to also examine the subsidiary legislation related to the Bill.

5. On the views received during the public consultation on the proposed regulatory regime, the Executive Director of Intermediaries and Investment Products, SFC (ED/IIP(SFC)) said that comments received from a total of 88 parties were generally in support of the proposed regime. The Working Group, after careful consideration of views expressed by market participants, had revised the haircut ratios and concentrated risk thresholds. However, it maintained its original proposal on the reporting requirement of the "top 20 margin clients" noting that sufficient disclosure of the operation of SMFs, in particular their exposure, would be essential in ensuring compliance with the regulatory

requirement and enabling potential systemic risks to be identified at an early stage.

6. Mr FUNG Chi-kin questioned the need to introduce the proposed regulatory regime. He pointed out that as the vast majority of margin financing business was undertaken by securities dealers who were already under the regulation of SFC, it was doubtful whether there would be other interested parties seeking registration as "SMFs". He opined that it would be more advisable to revise FRR to improve risk management systems of securities dealers and to organise appropriate publicity and investor education programmes to enhance investors' awareness of the risks involved in dealing with independent finance companies licensed under MLO but not under the regulation of SFC. He further remarked that due to the rapid development of financial conglomerates where a financial institution would be conducting various related investment businesses, the sole business requirement on an intermediary and the requirement for it to obtain a separate licence for each type of business as well as to hold separate capital against risks would be impractical and would increase the cost of operation.

7. In response, PAS/FS stressed that notwithstanding that there had not been many reported problems associated with securities margin financing activities provided by finance companies which were largely unregulated over the past years, the absence of regulation had led to problems that became visible under adverse market conditions and volatilities following the Asian financial turmoil which needed to be addressed urgently. Although these finance companies were licensed under MLO, the principal objective of MLO was to tackle the problem of "loan sharking" and was, therefore, not the appropriate vehicle for regulating securities margin financing activities where the problems were often associated with lack of prudent management of risk exposures on the part of service providers and clients' insufficient awareness of the risks involved in these activities. At members' request, the Administration undertook to provide

FSB information on the comparison between the proposed regulatory regime on securities margin financing and corresponding legislation and level of regulation in other financial centres.

8. On the need to provide the discrete registrant class of "SMFs", ED/IIP(SFC) said that due to the more stringent FRRs, it would be likely for existing finance companies associated with securities dealers firms to find it commercially more viable to move the margin financing operation back to the securities dealing entity. SFC envisaged that only a few independent finance companies would be interested in registering as SMFs to operate the business on a stand-alone basis. Nonetheless, the Working Group considered it necessary to introduce a new category of registrants so that there would not be market barriers to the business of securities margin financing.

9. As regards the concern about the sole business requirement, ED/IIP/(SFC) explained that the purpose was to eliminate undue exposure of SMFs to non-securities related risks. This ring-fencing arrangement would prevent contagion of risks from other businesses operated by the same corporate entity exerting financial pressure on the SMF business. The Working Group had studied the industry's proposal to allow SMFs to conduct related businesses, such as trading in futures and leveraged forex contracts and bullion trading, within the same entity, but considered relaxation of the sole business requirement not advisable as it might result in higher risks. He also remarked that the sole business requirement might still be unable to prevent contagion of risks from other businesses run by a diversified group of companies. Hence, there were discrete capital requirements on businesses to reflect the risks associated with businesses of different natures.

10. On comments that the existing licensing regime for intermediaries might be too cumbersome, ED/IIP(SFC) advised that SFC was undertaking a review in the context of the market regulatory reform to be covered by the Composite Securities and Futures Bill. The review aimed at improving the current multi-licensing system on the basis of investment products or services provided by registrants. Consideration would be given to issuing a single licence to each registrant specifying the scope of permitted business and setting an appropriate capital requirement to be held against possible risks. As such, a financial conglomerate would be allowed to aggregate its capital for meeting liabilities and risks across different categories of businesses.

11. On proposals relating to managing risks of SMFs, Mr FUNG Chi-kin criticised that the proposal to require all SMFs to disclose their top 20 margin clients would be ineffective in controlling risk. He suggested the Administration considering adopting a 'risk-based' regulatory approach under which different financial resources and reporting and disclosure requirements were prescribed for SMFs according to the level and volume of business they planned to undertake.

12. In reply, ED/IIP(SFC) explained that the new FRR of a minimum paid-up capital of $10 million was considered appropriate as a set-up fund for the provision of securities margin financing service and this would be complemented by the minimum liquid capital of at least $3 million or 5% of total liabilities of the SMF, whichever was the higher. SMFs would be required to maintain this minimum liquid capital requirement at all times, which was related to the level of risks involved in running the SMF business. Furthermore, application of haircut deductions and concentrated risk adjustments in the calculation of asset values of SMFs for FRR purposes would provide additional safeguards against risks of price fluctuations in stock collateral and over-exposure to any individual clients or stock collateral. As such, FRR requirements would be consistent with the size of business of SMFs. For

instance, the haircut ratios for the three categories of stocks namely, 15% for Hang Seng Index (HSI) constituent stocks, 20 % for HS 100 constituent stocks and 30% for all other stocks, were set to reflect higher haircut percentages for stocks which were less liquid. Moreover, the risk concentrated thresholds in respect of over-exposure to individual stock collateral were set at 20%, 15% and 10% respectively for the three categories of stocks. As regards over-exposure to individual clients, loan receivable from any single client in excess of 10% of the total loan profolio of a SMF will be subject to additional haircuts. At members' request, the Administration undertook to provide examples illustrating the operation of the haircut ratios and concentrated risk adjustments in calculating asset values under the proposed FRR for members' reference.

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13. On the concern about the requirement to report the top 20 clients of SMFs, ED/IIP(SFC) said that SFC did not envisage difficulty for SMFs to provide such information as existing service providers were supplying similar information under the existing FRR requirements. The information should be easy to compile and was very useful in understanding SMFs' risk exposure, hence contributing to effective risk-based supervision by SFC. Results of previous industry surveys revealed that information on clients had facilitated the understanding of risks undertaken by service providers and enabled SFC to take timely remedial actions to prevent possible systemic risks from arising. Very often, persistent patterns of over-exposure to specific stock collateral or to individual clients were revealed from top clients' information. Otherwise, it would be beyond SFC's resources to conduct field inspections on over 21,000 registrants and some 1,600 registered firms. On the other hand, SFC would consider relaxing the reporting requirements, taking into consideration practical difficulties faced by SMFs and the level of margin activities being conducted by them.

14. Mr Albert HO Chun-yan while expressing support for the proposed regulatory regime, had reservation over the continuation of the practice of "pooling" of clients' assets for re-pledging to third party banks to secure lines of credit. He pointed out that the mingling of clients' assets had proven to be a problem in the collapse of the C.A. Pacific Group. "Pooling" always posed risks to margin clients as the funds so obtained from a client were not restricted to financing the particular client's own account but also for financing other margin clients or even the finance company's own operation. Under some circumstances, clients might be given misrepresented information and induced to sign agreements which they were not fully conversant with. He suggested that if "pooling" was to be allowed, the level of borrowing available to a client should not exceed the value of the securities collateral deposited with the SMF and the latter should only pledge a client's securities for a sum not exceeding the outstanding loan owed by the client.

15. ED/IIP(SFC) said that the "pooling" arrangement was not only a common practice among local SMFs but was also central to their operations. The total

banning of the arrangement might have serious adverse impact on the profitability of service providers. The concern about commercial viability was evidenced in the industry-wide surveys and submissions received during the public consultation on the proposed regulatory regime. On the other hand, there were margin clients who were fully aware of the risks associated with "pooling" and were still prepared to assume the risk, thus illustrating that market demand did exist for such service. While noting the risks posed to clients, the Working Group considered that in order to strike an appropriate balance between commercial viability of SMFs and investor protection, "pooling" should only be allowed to continue provided there were adequate safeguards under the proposed regulatory regime. Besides having new FRRs for better risk control, there were also proposed measures to enhance protection for clients' assets, which included requirement on SMFs to obtain clients' written authorisation to use their stocks for specific purposes and clear segregation of cash and margin accounts. Furthermore, clients' written authorisation had to be prepared in plain language in both Chinese and English with clear risk disclosure provisions. The authorization had to be renewed on an annual basis and could be withdrawn by clients with five days' advance notice. The Code of Conduct to be introduced for SMPs would also specify requirements on service providers in respect of areas including risk management, margin lending policy, margin call policy, cash flow management and disclosure of account status to clients on a regular basis to facilitate continuous monitoring. The Bill also stipulated criminal sanctions on non-compliance of SMFs with certain provisions in relation to pooling arrangement. The Working Group considered that with the proposed regulatory regime in place, coupled with close monitoring and supervision by regulators, risks involved in "pooling" of assets should be contained and regarded as tolerable.

16. As regards problems associated with "pooling" which had been revealed in the C.A. Pacific case, <u>ED/IIP(SFC)</u> clarified that the margin financing business of C.A. Pacific Group had not directly attributed to its collapse, which was rather caused by the Group's exposure to two major non-securities related loans. This had demonstrated the need to impose the sole business requirement on SMFs. To address the concern that margin clients might be misled to enter into agreements to their disadvantage, standard securities margin contracts/agreements with clear warnings of the associated risks would be prescribed. There would also be standardised procedures in dealing with margin accounts specified in the Code of Conduct. Moreover, SMFs would have to take personal responsibility for failure in explaining margin agreements to clients and there would be requirement on the account executives to sign off to show their compliance in this respect.

17. On the concern that the proposed regulatory regime would not cover SMFs incorporated overseas and securities margin financing activities conducted outside Hong Kong, <u>PAS/FS</u> acknowledged that cross jurisdication regulation of

financial activities had been a problem which would need to be addressed internationally in the long term. However, the proposed legislation would serve to address the more urgent problem of local regulation of securities margin financing. ED/IIP(SFC) also advised that SFC had maintained joint inspections and regular exchange of information with overseas regulatory counterparts. It could step up joint efforts with regulatory authorities of other jurisdictions in combating mal-practices of SMFs.

18. In respect of compensation arrangement for securities margin financing activities, PAS/FS advised that SEHK members who provided securities margin financing service would be covered by the Unified Exchange Compensation Fund and the Broker's Fidelity Insurance Scheme. The Working Group recognised the difficulties for the small group of non-Exchange member SMFs to establish a separate compensation fund and for them to obtain insurance coverage. Hence, the Bill had included provisions requiring these registrants to provide an amount of security deposit to SFC as obligation held against risks. ED/IIP(SFC) supplemented that the details on the level, operation, etc. of the securities deposit were yet to be set out in regulation under the Bill. On the other hand, SFC had consulted the public on a new investor compensation arrangements for Hong Kong. The new compensation scheme would have a three-tier financing structure including insurance coverage and back-up credit facility. Although the new scheme would initially be applicable to SEHK members, it would be developed in a modular fashion to enable other classes of registrants, such as SMFs, to be covered in due course.

III Any other business

FSB 19. Members noted that the Law Society of Hong Kong had provided a submission on the Bill and requested the Administration to provide a written response to the submission.

Dates of next meetings

20. Members agreed to hold the next two meetings of the Bills Committee on 10 and 11 May 1999, both at 8:30 am.

(*Post-meeting note*: The meeting scheduled for 10 May 1999 was subsequently cancelled.)

21. There being no other business, the meeting ended at 6:40 pm.

Action

Legislative Council Secretariat
12 October 1999