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REVISED FINANCIAL RESOURCES RULES

AS APPLIED TO SECURITIES AND FUTURES INTERMEDIARIES

Table of Contents

I. Introduction

II. Executive Summary

III. Key Changes

- **(a) Standardization of Liquid Capital Requirement**
- **(b) Position Risk Adjustments**
- **(c) Counterparty Risk Adjustments**
- **(d) Liquidity Adjustments**
- **(e) Capital Requirements**
- **(f) Requirement for Advisers**
- **(g) Returns and Notifications**
- **(h) Transitional Arrangements**

I. INTRODUCTION

1. The Financial Resources Rules ("FRR") as applicable to securities and futures intermediaries, revamped the previously existing net capital and liquidity margin requirements for securities dealers and introduced, for the first time, financial requirements for futures dealers, securities and/or futures advisers. The FRR came into force on 1 December 1993.

2. The objective was to formulate a set of risk-based financial resources rules to ensure that dealers have, at all times, sufficiently readily realizable assets to meet liabilities as they fall due plus a "cushion" to cover unexpected market and credit risks and to set a basic solvency test for advisers.

3. In March 1997, the Commission completed a review of the FRR to cater for

    a) changes in market practices and strategies;

    b) diversification into new products, e.g. new derivative products; and

    c) anomalies and deficiencies identified in operating the rules

    and issued a consultation paper (the "1997 Consultation") on the results of the review.

4. Nineteen submissions were received from various market participants and institutions during the consultation exercise. However, the Commission did not issue its response to the submissions nor proceed to draft the necessary rule amendments given our understanding that neither the Legislative Council nor the Provisional Legislative Council were in a position to consider comprehensively the proposed amendments.

5. Separately, in the course of 1997, the Commission became concerned with the marked increase in retail participation in the securities market and in particular the substantial rise in securities margin financing by retail investors through finance companies associated with securities dealers which are largely unregulated. Following the Commission's recommendation, an inter-agency working group (the "Working Group") was established in December 1997 under Financial Services Bureau ("FSB") to study the issue of regulating securities margin financing activities, in particular, when carried out by such finance companies. The Working Group comprised representatives of the FSB, the Commission, the Hong Kong Monetary Authority, the Stock Exchange of Hong Kong Limited ("SEHK"), the Companies Registry and the Department of Justice.

6. The collapse of the C.A. Pacific Group in January 1998 added impetus and urgency to the deliberations of the Working Group which issued a consultation (the "FSB Consultation") paper on proposed regulation of securities margin financing, including FRR, in May 1998. Altogether 88 submissions were received by FSB and were considered by the Working Group.

7. These revised FRR have duly incorporated the Working Group's decisions on related matters and have been drafted on the basis that securities margin financiers (hereafter referred to as "financiers") will form a separate category of registrants under the Securities Ordinance (Cap. 333) ("SO"). To the extent that these proposed FRR address risks arising from securities margin financing, they should be read together with the proposed changes to the SO and proposed changes to the SFC's Code of Conduct. In addition, there are other changes in response to recent market events and developments, such as the collapse of the Peregrine Group which raise arguments against the use of internal valuation model of regional debt securities for assessing capital requirements and the proposal of the Hong Kong Securities Clearing Company Limited ("HKSCC") to provide a centralised stock lending and borrowing service.

II. EXECUTIVE SUMMARY

The key features of the revised FRR may be summarised as follows:

8. *standardisation of liquid capital requirement*

To standardise the approach towards setting the required regulatory capital for all securities and futures dealers and financiers

9. *required liquid capital*

a) To standardise the required liquid capital floor for all dealers and financiers at $3 million;

b) to set lower floor requirements for futures non-clearing dealers[1], introducing brokers[2] and traders[3];

c) to base the variable parameter test on total liabilities as at the computation date and to exclude segregated client money from calculation of required liquid capital;

d) to relate the required liquid capital to margin requirements on open futures/options contracts held on behalf of clients; and

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[1] Being members of the Hong Kong Futures Exchange Limited which are not members of the HKFE Clearing Corporation Limited

[2] Being dealers which satisfy the Commission that they merely relay orders, or introduce persons, to members of recognized stock or futures and options markets, do not handle clients' assets or incur any legal liability save for their own negligence etc.

[3] Being dealers which only deal in securities or trade in futures or options contracts on their own account

e) to accept approved standby subordinated loan facilities to accommodate sharp increases in total liabilities which would possibly result in a liquid capital deficiency and a consequent breach of the FRR.

10. ***position risk adjustments***

a) To include all listed shares in liquid assets subject to haircut deductions ranging from 15% to 75%;

b) to introduce a third tier to shares listed on the SEHK which will attract a higher haircut deduction at 30% because of their volatility and illiquid nature;

c) to replace references to government issues in the qualifying criteria for debt securities by primarily focussing on credit ratings whilst including debt securities issued or guaranteed (except in the case of (iv)) by

   i) the central bank or the central government of the People's Republic of China ("PRC");

   ii) the government of the Hong Kong Special Administrative Region;

   iii) the Hong Kong Exchange Fund; and

   iv) the Hong Kong Mortgage Corporation;

d) to accommodate net margin requirements for futures and/or options contracts;

e) to grant capital relief to offsetting positions in shares, stock futures contracts, stock options contracts and derivative warrants issued;

f) to apply 50% of the normal haircut to net underwriting commitment (e.g. in the case of a new share pending listing on the SEHK, the net committed amount is to be multiplied by 15%) and to allow dealers two days to enter into written agreements to reduce their net underwriting commitment;

g) to streamline concentrated house position risk adjustments and to capture the risks arising from holding related stock positions; and

h) to better address risks arising from off-exchange (i.e. over-the-counter) positions.

11. ***counterparty risk adjustments***

a) To retain the existing approach whereby amounts receivable from cash clients are to be subject to deduction 5 days after the settlement day;

b) to require dealers to use the mark-to-market method in computing the deductions from amounts receivable from cash clients;

c) to allow dealers and financiers to collect margin calls from clients on settlement date;

d) to introduce concentrated risk adjustments arising from individual or related collateral received from margin clients and from individual or related margin accounts;

e) to allow netting and cross margining subject to being so authorized by clients;

f) to include outstanding margin calls in ranking liabilities, except where these margin calls are not considered to be overdue in accordance with the rules of the relevant exchange;

g) to require a dealer who introduces or gives up transactions to another dealer for execution and/or clearing to make a 5% provision if the value of transactions, added to the dealer's total liabilities, exceeds $60 million;

h) to apply the same adjustments to securities borrowing and lending and repurchase transactions due to their similarity and to provide for approved securities borrowing and lending (such as the HKSCC) in which case the Commission will waive the relevant financial adjustments; and

i) to exclude all amounts receivable which have not been specifically included in liquid assets even if they are adequately secured.

12. ***liquidity adjustments***

a) To include in liquid assets bank deposits placed with overseas banking subsidiaries;

b) to include time deposits which will mature within 6 months accrued interest on bank deposits which will mature within the forthcoming 3 months;

c) to include accrued fees, commissions etc. which are to be billed within 3 months and to include fees, commissions etc. receivable provided that they have not been outstanding for more than 2 weeks;

d) to exclude all assets in currencies which are subject to exchange controls; and

e) to exclude assets held at any overseas branch in order to obtain or maintain the necessary licence or membership for that branch.

13. *capital requirement*

a) To require $5 million paid-up capital for futures dealers and securities dealers who do not provide securities margin financing[4]; and

b) to require $10 million paid-up capital for financiers and securities dealers who provide securities margin financing.

14. *requirements for advisers*

To require net tangible assets of not less than $500,000.

15. *returns and notifications*

a) To require monthly returns to be lodged within 3 weeks together with summary on banking facilities, selected margin clients, margin loan collateral and proprietary derivative positions; and

b) to introduce additional amber light warning notification requirements on specific matters.

16. *transitional arrangements*

To set the same effective date as the Securities (Margin Financing) (Amendment) Bill 1999, but to give an additional grace period of 6 months for implementation of selected provisions.

III. KEY CHANGES

(a) Standardisation of Liquid Capital Requirement

17. The existing FRR have separate rules for securities and futures dealers due primarily to historic factors. As the vast majority of registered futures dealers have always been Members of the HKFE, when in 1993 the FRR were first

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[4] Being the provision of financial accommodation in order to facilitate the acquisition of securities listed on a stock exchange and, where applicable, the continued holding of those securities, whether or not those or other securities are pledged as security for the accommodation

applied to futures dealers, it was decided to adopt as far as possible the adjusted net admissible assets ("ANAA") requirement set by the HKFE to minimise any disruption.

18. Whilst the ANAA requirement has operated satisfactorily to ensure the financial soundness of futures dealers all these years, the 1997 Consultation proposed to standardise the liquid capital requirement for all dealers as more and more derivative products come onto the market and the delineation between activities conducted by securities and futures dealers is becoming increasingly blurred. Such standardisation would have the added advantage of eliminating the many inconsistencies and anomalies between the existing liquid capital and ANAA requirements.

19. To illustrate the extent of mixed business between securities and futures, as at 30 April 1999, of the 23 registered futures dealers who are not HKFE Members (referred hereafter as "non-HKFE Members"), 14 hold both the securities dealer and the futures dealer registration.

20. This directional move, welcomed by 5 commentators during the consultation exercise, has now been incorporated in the revised FRR.

21. The FSB Consultation considered the liquid capital requirement to be suitable for application to financiers; it will not be necessary to design a separate regulatory framework for them.

Required Liquid Capital
General

22. Under the existing FRR, both securities and futures dealers are required to maintain liquid capital or ANAA of not less than the higher of a monetary floor requirement and a variable parameter.

Floor Requirements

23. Under the existing FRR,

    a) securities dealers who are sole proprietors enjoy a much lower floor requirement of $500,000 compared to $3 million required of corporate securities dealers;

    b) securities or futures dealers who have been granted the introducing broker status by the Commission are also entitled to the $500,000 floor requirement; and

    c) futures dealers are subject to different floor requirements depending on their clearing rights and whether they only trade for their own proprietary accounts.

24. The 1997 Consultation proposed to standardise the floor requirement at $3 million for all dealers, irrespective of whether they deal in securities or trade in futures/options and whether they are incorporated or otherwise, except that a $500,000 floor requirement will apply to

    a) introducing brokers;

    b) futures non-clearing dealers; and

    c) traders who only trade for their own proprietary accounts.

25. During the consultation exercise,

    a) three commentators did not favour the standardisation of the requirement for securities and futures dealers;

    b) six considered the requirement for traders to be too low;

    c) three gave support to the standardisation of the floor requirement for incorporated and unincorporated dealers despite concerns over an inadequate linkage to risk;

    d) one disagreed with the increase in the requirement for unincorporated dealers; and

    e) three considered the transitional arrangement for unincorporated dealers to meet the $3 million requirement to be too generous.

26. The Commission has decided to retain its proposal given that the existing floor requirement acts as a disincentive for sole proprietors to incorporate.

27. As for the traders, the Commission is of the view that they should be treated altogether separately because they represent a very small group of four HKFE Members who would normally not require any registration save for their being a Member of the HKFE. In the circumstances, the HKFE or the HKFE Clearing Corporation Limited ("HKFECC") can increase their own financial resources requirements as they see fit.

28. As for the futures non-clearing dealers, the revised FRR will now clarify that the $500,000 floor requirement should apply to Non-Clearing Members of the HKFE only. Again, there is a need to recognise this special group given that they have always been entitled to lower ANAA requirement having transferred their settlement risk to the General Clearing Members. Whilst they are still accountable to their clients, we can, to a large extent, rely on the other compensating controls put in place by the HKFE. As for the non-HKFE Members, they are not under the direct supervision of a self regulatory organisation, thus, they should be subject to the standard $3 million floor requirement. This should not be too onerous as only 3 non-HKFE Members

would be unable to comply with this requirement based on their March 1999 ANAA computation.

29. The FSB Consultation considered it adequate to apply the same $3 million floor requirement to financiers and securities dealers who provide securities margin financing.

Variable Parameters

30. Under the existing FRR, securities dealers have to maintain liquid capital of not less than 5% of total liabilities (including amounts payable to clients being money held in designated accounts in accordance with the SO) taken as the average of the preceding 4 quarter-ends whereas futures dealers have to maintain ANAA of not less than 4% of segregated clients' funds as at the computation date.

31. The 1997 Consultation proposed to standardise the variable parameter by requiring dealers to maintain 5% (reduced to 4% for total liabilities falling between $300 million and $1.5 billion and 3% for total liabilities in excess of $1.5 billion) of the aggregate of total liabilities (now to exclude amounts payable to clients being money held in designated or segregated accounts in accordance with the SO or the Commodities Trading Ordinance (Cap. 250) or held with a clearing house/member) and margin requirements in respect of open futures and options positions held on behalf of clients as at the computation date.

32. Realising also that dealers may have isolated transactions which can cause a sharp fluctuation in total liabilities which are to be computed on a trade date basis and may result in a breach of the FRR, the 1997 Consultation suggested the acceptance of approved standby guarantees or subordinated loans to cover these situations.

33. Of the responses received to the consultation paper:

    a) two did not endorse the progressive reduction from 5% to 4% and 3% whilst one saw this as an improvement to the existing system;

    b) one felt it more logical to use the computation date as the reference date but seven expressed concerns over the practical implications;

    c) all but two supported the use of standby guarantees or subordinated loans to meet sudden increases in required liquid capital due to fluctuations in the trading volumes; and

    d) four requested for operational details on the standby guarantees and subordinated loans.

34. In the light of the recent collapse of the Peregrine and C.A. Pacific groups, which exposes the increased volatility in our markets, the revised FRR will no longer adopt the sliding scale allowing the larger houses to maintain a smaller proportion of liquid capital than their less sizeable counterparts.

35. In other cases, the Commission has maintained its view but with further safeguards built into the revised FRR. Firstly, we have reconsidered the usefulness of obtaining standby guarantees and noted that these will only help a dealer's cashflow but not his liquid capital. Any amounts drawn under any guarantee and injected into the dealer's business will always turn into a liability in some form or another. Given the above, only standby subordinated loan facilities will be accepted for the purpose of meeting sudden increases in required liquid capital. Secondly, we need to set down clear conditions for dealers to be able to rely on these standby facilities. As they are no substitute for capital or capital equivalents, they are not suitable for sustained increase in trade volumes.

36. The FSB Consultation considered it appropriate to apply the variable parameter requirement to securities margin finance providers and securities dealers who provide securities margin financing and to extend to them the same flexibility over the use of the standby subordinated loan facilities.

(b) Position Risk Adjustments

37. These can be broadly analysed into adjustments in relation to shares, debt securities, futures and options positions, offsetting positions, underwriting commitment, concentrated house positions and off-exchange positions.

Shares

38. Under the existing FRR, only shares listed on the SEHK or any stock market listed in Schedule 2, or traded on the National Association of Securities Dealers Automated Quotations - National Market System (NASDAQ-NMS) or the Japanese Association of Securities Dealers Automated Quotations (JASDAQ) qualify as liquid assets subject to haircut deductions ranging between 15% and 30%.

39. The 1997 Consultation proposed to

    a) reduce the maximum haircut deduction for listed shares to 75% (from 100% for shares which are currently excluded in full);

    b) add an interim tier at a 50% haircut for shares listed on markets not included in Schedule 2 but which are Members of the Federation Internationale Des Bourses De Valeurs (FIBV);

c) reduce the existing haircut deduction for shares which are constituents of the Hang Seng Index, FTSE-100 Index, Nikkei 225 Index or Standard & Poor's 500 Index from 15% to 10%;

d) to reduce the haircut deduction for other shares listed in Hong Kong, UK, Japan and US from 20% to 15%; and

e) to recognise shares traded on the Stock Exchange Automated Quotations International (SEAQ International) on the same footing as shares traded on NASDAQ - NMS and JASDAQ.

40. During the consultation exercise, one commentator was of the view that the regression scale for listed equities might not have taken liquidity into account. This was not considered to pose a major problem given that the 50% and 75% haircut deductions should be steep enough to provide against any lack of liquidity.

41. The FSB Consultation proposed to introduce one new tier to shares listed in Hong Kong so that only shares which are constituents of the Hang Seng 100 Index, or which are eligible for a derivative warrant issue, would attract the 15% haircut; all others would be subject to a 25% haircut in view of their lack of liquidity.

42. The Working Group had since reconsidered the position and concluded that the haircuts suggested in the FSB Consultation would still not be adequate given the recent volatility in the market. As a result, it had decided to further increase the haircut percentages as follows:

SEHK listed shares	Haircut %
a) constituents of the Hang Seng Index	15
b) constituents of the Hang Seng 100 Index	20
c) any others	30

43. The reference to eligibility for a derivative warrant issue has been deleted given that there is no readily available list in the market naming these shares. Whilst the qualifying criteria are stated in the SEHK's Listing Rules, it will be difficult for dealers to identify which shares are eligible given the constantly changing public float.

44. Given the above, the revised FRR will retain the existing percentages, subject to adding this third tier to SEHK listed shares.

Debt Securities

45. Under the existing FRR, debt securities can be included in a dealer's liquid assets if they can meet a set of qualifying criteria. A dealer can either apply a blanket 10% haircut to selected government issues and 20% to all other qualifying debt securities or alternatively he can stratify his positions and apply lower haircuts. All positions must be valued at market value and there is no special mention of structured notes and the likes which have the characteristics of a derivative product rather than a debt security.

46. The 1997 Consultation proposed to

    a) relax the qualifying criteria;

    b) accept dealers' own valuation of debt securities at fair value by adopting generally accepted pricing models;

    c) remove the choice to apply the 10%/20% haircuts; and

    d) introduce a 5-tier haircut system whereby haircut percentages are analysed into two separate components, namely issuer and remaining term to maturity.

47. During the consultation exercise, one commentator suggested to further lower the qualifying criteria for regional corporate bonds whilst two others were concerned about the acceptance of fair value where the debt securities are not actively traded and wanted details on the types of models which would be acceptable to the Commission. However, the recent market turmoils expose the illiquidity of such instruments and after careful deliberation, we have decided to retain the existing capital charges towards debt securities.

48. The revised FRR now revert to the 3-tier system and refine the qualifying criteria to include only those debt securities which are:

    a) issued or guaranteed by the central government or central bank of the PRC;

    b) issued or guaranteed by the government of the Hong Kong Special Administrative Region;

    c) issued or guaranteed by the Hong Kong Exchange Fund;

    d) issued by the Hong Kong Mortgage Corporation;

    e) issued or guaranteed by a corporation with issues currently rated at or above investment grade either by Moody's, Standard & Poor's or any

other credit rating agency which the Commission may approve in the future; or

f) listed on the SEHK.

49. The consequence of this change is that we will no longer be accepting dealer's own fair value, and bearing in mind that most debt securities are not traded on an exchange or have an automatic quotation, the revised FRR have made a special provision in that debt securities shall be valued at the average of quotations obtained from at least 2 market makers.

50. As for the treatment of structured notes, the revised FRR have clarified the accounting policies and computation basis which dealers must adopt for FRR purposes, with special reference to the need to observe substance over form and to treat structured notes as a derivative product.

Futures & Options Trading

51. The existing FRR require all long and short positions to be included separately in liquid assets and ranking liabilities and do not accommodate the net margin requirements for futures or option positions permitted by some clearing houses and their members.

52. The 1997 Consultation proposed to provide for net margin requirements and the revised FRR have effected the necessary change to allow for net margining.

Offsetting Positions

53. The existing FRR assume that all house positions are unhedged positions and only provide limited hedging allowances on positions held in SEHK traded options. Dealers have to apply to the Commission for relief which will be granted based on the merits of each application.

54. The 1997 Consultation proposed to give allowances where a dealer carries offsetting positions in relation to the same underlying shares.

55. During the consultation exercise,

a) four commentators supported an expansion of the allowances provided;

b) one expressed concern over the added risk faced by the clearing houses;

c) another cautioned the Commission to impose stricter control and supervision over such activities; and

d) one commentator suggested that the Commission should allow dealers with adequate risk management systems to use their own value-at-risk models to calculate capital requirement.

56. The Commission is of the view that dealers should still apply for relief on a case-by-case basis so that we could first be satisfied with their risk management systems before giving any allowances. In the meantime, the proposals made in the 1997 Consultation have been translated into detailed provisions in the revised FRR, covering different specific scenarios where a dealer holds a long/short position in the shares, stock futures and/or stock options. In addition, the revised FRR recognise the reduction in risk where a dealer issues collateralised warrants and where he holds the shares underlying non-collateralised warrants which have been issued by him.

Underwriting Commitment

57. The existing FRR apply a 10% haircut to net underwriting commitments in respect of shares (to be) listed on a stock market listed on SEHK and the OECD Stock Markets as listed in Schedule 2 and 50% in all other cases.

58. The 1997 Consultation made clear the original intention to set the financial adjustment at 50% of the normal haircut. Also it proposed to give dealers two days to put in writing any previous agreements they might already have for other persons to take up sub-underwriting commitment or to subscribe for shares through them.

59. During the consultation exercise, one commentator considered it illogical to give an extra two days to underwriters and sub-underwriters and two commentators asked for a clarification of the meaning of “normal haircut”.

60. The Commission has maintained that underwriters should not need to put up large sums of regulatory capital just to tide them over for the two days when they attend to the paperwork. Thus the revised FRR have adopted the proposal made in the 1997 Consultation whilst making it clear that by “normal haircut”, we mean “haircut which would apply to the various classes of securities being underwritten”.

Concentrated House Positions

61. The existing FRR impose concentrated position risk adjustments where a dealer has a large exposure to a particular issuer compared to the issue size and/or the dealer’s liquid capital. The exposure is computed by taking the net position in shares and debt securities held, adjusted by any obligations, or options likely to be exercised, by the dealer to buy or sell such shares or debt securities.

62. The 1997 Consultation suggested streamlining the existing adjustments so that a dealer will only need to bear an additional haircut of 5% or 10% where his exposure to any one issuer exceeds 25% or 50% of his required liquid capital respectively.

63. Whilst this proposal has been retained in the FRR, this has been further simplified by applying the concentrated position risk adjustment to shares of individual companies and related companies which will be in line with the concentrated risk adjustment in respect of securities collateral.

Off-Exchange Positions

64. The existing FRR have prescribed a number of financial adjustments in respect of off-exchange positions; dealers are not required to make provisions or financial adjustments for positions which are not covered by the FRR. Some dealers have overlooked the remaining default risk in effecting back-to-back transactions where they interpose as the principal in both transactions. The FRR are also deficient in their treatment of swap transactions by not requiring them to be marked to market.

65. Under the 1997 Consultation,

    a) dealers would be required to inform the Commission of off-exchange positions and exposures which are not covered by the FRR so that we could discuss the appropriate capital requirement with them; and

    b) they would be required to mark swap transactions to market but could set off profits and losses so arising under specified circumstances.

66. During the consultation exercise, three commentators made various comments on the proposed treatment of swap transactions, including the interpretation of swaps, the fixing of risk adjustment as a percentage of notional value and limited profit recognition.

67. Overall, the Commission has decided to retain its proposals subject to minor modification so that the revised FRR now require

    a) notification by dealers of off-exchange positions which are not covered by the FRR;

    b) all off-exchange positions to be marked to market and a financial adjustment to be made by taking a prescribed percentage of the notional value of interest rate swap agreements and foreign exchange agreements;

    c) back-to-back transactions to be treated as two separate transactions; and

    d) inclusion in ranking liabilities of floating losses in relation to off-exchange derivative positions to the extent that they have not been set off by floating profits in relation to other off-exchange derivative positions maintained with the same person under a bilateral netting agreement.

(c) Counterparty Risk Adjustments

68. These can be broadly analysed into adjustments in relation to cash clients, margin clients, netting of balances and cross margining, treatment of margin calls, introduction of transactions, stock borrowing and treatment of non-itemised receivables.

Cash Clients

69. Under the existing FRR, a dealer is given 5 bank trading days to collect from cash clients after which these receivables will be subject to adjustments computed by adopting the ageing or the mark-to-market method.

70. The 1997 Consultation proposed to extend the grace period from 5 bank trading days to 2 weeks. Given that it has always been the Commission's intention to disallow the ageing method as it does not reflecting the true default risk, the 1997 Consultation also proposed to disallow the use of the ageing method in the future.

71. During the consultation exercise, two commentators welcomed the use of the mark-to-market method but one felt that the two weeks' grace period might be seen to endorse lax risk management controls towards unsettled balances whilst the other considered it necessary to have a lead time for implementation of up to 12 months.

72. The FSB Consultation proposed to revert back to the original 5 days in order to minimise the incentive to treat margin clients as cash clients.

73. The revised FRR have adopted the proposals made in the 1997 consultation save that dealers would only have 5 days to collect amounts due from their cash clients.

Margin Clients

74. The existing FRR

    a) require amounts receivable from margin clients to be calculated on a client-by-client basis, taken as the lower of each amount receivable and the discounted value of securities collateral received (i.e. market value less haircut deduction) from the client;

    b) do not stipulate whether such amounts receivable should be accounted for on a trade or settlement date basis; and

    c) lay down restrictions on the use of the collateral received from margin clients.

75. The 1997 Consultation proposed to stipulate the use of the trade date basis (which means that dealers must collect collateral, or have sufficient collateral, on trade date in order to avoid having to fund the shortfall with their own regulatory capital) and to strictly enforce the restrictions on the use of the collateral which effectively disallow pooling of assets.

76. The FSB Consultation proposed to allow dealers and financiers up to settlement date to collect collateral from their clients and to withdraw the restrictions on the use of the collateral (on the ground that this should better be addressed by the relevant section in the SO on protection of clients' securities) On the other hand, it proposed to introduce new concentrated risk adjustments to include any excess of concentrated securities collateral or margin loan balances in the dealer's or the financier's ranking liabilities, whereby excess is defined as the excess of the value of any individual shares (or shares of related companies) over 10% of the total value of securities collateral or the excess of an individual margin loan (or margin loans of related margin clients) over 10% of total margin loans outstanding.

77. The concentration risk adjustments have attracted substantial market comments during the consultation period. As a result, the Commission has worked closely with the SEHK in designing an alternative model to address seeming anomalies whereby:

    a) a dealer or financier might need to make a concentrated risk adjustment for collateral received but not used to secure any margin loan; and

    b) total concentrated risk adjustments could exceed the total amounts receivable from margin clients.

78. The alternative model involves computing a concentration discounting factor for each securities collateral or each group of related securities collateral received as collateral. This factor will then be applied to the market value less applicable haircuts of collateral received from each margin client. By making this adjustment, the revised FRR will effectively impose an exposure limit on securities collateral or groups of related securities collateral as follows:

    a) for Hang Seng Index constituent stocks, the exposure limit is 20% of the total market value of all collateral received from all margin clients;

    b) for Hang Seng 100 Index constituent stocks, the exposure limit is 15% of market value of all collateral received from all margin clients; and

    c) for all other listed shares or warrants, the exposure limit is 10% of market value of all collateral received from all margin clients

79. The same numerical example which has previously been submitted to the Bills Committee when it considered the Securities (Margin Financing)(Amendment) Bill 1999 can be found in the Appendix. Whilst the model is quite

comprehensive and will require enhancement made to existing computer applications, we consider this a necessary cost to pay for better risk assessment and controls.

80. As for the concentration risk adjustment arising from receivables from related margin clients, we have substantially trimmed the original definition of related persons so that dealers or financiers should be able to identify such relationship by performing due diligence.

Netting of Balances & Cross Margining

81. The existing FRR do not allow netting of receivables from and payable to cash clients unless they relate to the same person and the same securities.

82. The 1997 Consultation proposed to allow cross margining whereby a dealer can apply surplus cash or securities collateral held by a client in one margined account (essentially all accounts except cash accounts), to another margined account of the same client, provided that the dealer is so authorised by the client.

83. In addition to the above, the revised FRR now clarify that netting between amounts receivable from and payable to the same person which are non-trade related would be permitted subject to the dealer being so authorised.

Margin Calls

84. The existing FRR do not recognise the risk when a margin deposit falls below the amount of margin called and allow futures dealers 3 days to collect overlosses from clients.

85. The 1997 Consultation proposed to require dealers to provide for any margir shortfall and to exclude overlosses from liquid assets.

86. During the consultation exercise, three commentators suggested that some grace period should be given before providing against margin calls. It was also brought to our attention that the HKFE margin guidelines allow Members to collect margins from certain clients until the next business day and that similar allowances should be provided in the FRR.

87. In view of the above, the revised FRR only require provision for margin calls in ranking liabilities where the relevant exchanges deem such margin calls to be overdue.

Introduction of Transactions

88. The existing FRR do not address the risks which arises from the introduction of transactions by a dealer to another where the client settles directly with the latter broker. The market practice is for the former broker not to account for any trade receivables or payables or to recognise any risks arising therefrom Yet, the rights and obligations of the parties are rather opaque and it is possible that the former broker may be subject to recourse of the client and/or the latter broker.

89. Under the 1997 Consultation, it was proposed that

    a) wherever a dealer is a contracting party, he should always account for such receivables and payables for FRR purposes even though settlement is not effected through him; and

    b) wherever a dealer is not a contracting party but where clients or other brokers have recourse to him in the event of default, he should subject the receivables and payables so arising to the counterparty risk adjustments.

90. During the consultation process, one commentator suggested that, even with recourse, a dealer who introduces the transactions should only make provisions for trade defaults based on claims received. At the same time, it was brought to our attention that the above proposal would affect some HKFE Members who give up trades effected for clients to other HKFE Members for clearing. Whilst such give-up arrangement may vary from Member to Member and currently there is no express agreement between the parties involved, the HKFE is of the opinion that the rules and procedures of the HKFE Clearing Corporation Limited make it sufficiently clear as to when a give-up broker or the clearing broker should be responsible for which transaction.

91. The Commission has reconsidered the situation and concluded that it would not be necessary to establish whether a dealer is, or is not, a contracting party The test should be whether the clients or the execution broker would have recourse to the dealer. Also, it would be desirable to change the proposed specific risk adjustment to a general provision in order to reduce the amount of compliance work required of the dealer.

92. Given the above, the revised FRR now require dealers to provide in their ranking liabilities the aggregate of:

    a) any outstanding claims received; and

    b) 5% of the amount by which the sum of the following exceeds $60 million:

i) the value of transactions introduced (less transactions covered in the claims received) which have not been fully settled, calculated on a gross basis; and

ii) the total liabilities of the dealers.

93. This, in effect, will be equivalent to capturing such outstanding trade payables (unless they have already resulted in a claim) in the dealers' total liabilities and increasing the required liquid capital where such payables exceed $60 million (being the amount of liabilities which can be supported by the floor requirement of $3 million).

94. This requirement is further relaxed, in view of the representations made by the HKFE, in that this should only apply to dealers who do not have express agreement or clear market practice to support their exemption from this requirement.

Stock Borrowing & Repurchase Transactions

95. The existing FRR apply different financial adjustments to stock borrowing and repurchase transactions despite their similarity, are harsh on borrowers providing cash as collateral and require dealers to make adjustments even with the slightest movement in price of the underlying securities or collateral.

96. The 1997 Consultation proposed to redress the above by generally waiving financial adjustments to be made by borrowers unless the value of collateral deposited exceeds 110% of the value of the shares borrowed.

97. The revised FRR have modified the above approach by further reducing the borrower's financial adjustments by the haircut deduction on the collateral provided to the lender. The reason is because the borrower, who provides his own securities as collateral in a stock borrowing, will have been subject to haircut deductions for these securities, thus even if the lender defaults and does not return these securities to the borrower, the borrower's loss should be limited to the market value less haircut deduction.

Non-Itemised Receivables

98. The existing FRR allow receivables by a securities dealer which arise outside his ordinary course of business provided that they are adequately secured by collateral subject to haircut deductions and are receivable within 2 months. Similarly, futures dealers are allowed to include secured receivables in their ANAA computations.

99. The 1997 Consultation proposed to exclude all receivables which do not arise from the ordinary course of business. The particular concern was to exclude

receivables from finance companies associated with securities dealers which could snowball and become the key component of a dealer's liquid assets.

100. Of the responses to the consultation exercise,

a) one disagreed with the proposal to exclude secured receivables;

b) two requested clarification of the meaning of "ordinary course of business"; and

c) two others suggested transitional concessions be given,

with most of the reservations expressed having been directed to the proposed exclusion of receivables from finance companies.

101. This has ceased to be a concern with the proposed regulation of finance companies. As a result, the revised FRR can adopt the original proposal and exclude all non-itemised receivables. As regards receivables from finance companies, since these entities will, under the proposed regulation, need to be registered with the Commission as financiers, such amounts are to be included in liquid assets provided that they are adequately secured (i.e. subject to haircut deduction but not subject to the concentrated risk adjustment in respect of securities collateral and margin loans).

(d) Liquidity Adjustments

102. The 1997 Consultation had suggested a number of amendments to the liquidity adjustments in respect of bank deposits, fees and commission receivables and accruals, assets held in currencies subject to exchange controls and assets maintained at overseas branches to meet local requirements.

103. During the consultation exercise, five commentators found the treatment of fees and commissions unclear.

104. The revised FRR have fine-tuned some of the proposed treatments in various aspects. For example, the definition of authorized institutions has been revised so as to give value to deposits held with wholly owned banking subsidiaries (but not merchant banking or investing banking subsidiaries) of fully licensed banks or in the case of restricted licence banks and deposit-taking companies, their Hong Kong office or branch. For deposits held outside Hong Kong, the revised FRR have added flexibility to the Commission by permitting it to approve banks which would otherwise not qualify as prescribed overseas banks under the existing regime.

105. As to accrued interest, the Commission has decided not to give value to accrued interest for deposits which will not mature within the coming 3 months. This takes into account the fact that dealers may need to use the

money in a hurry and incur penalty charges etc. for early withdrawal or arranging borrowing secured on such deposits.

106. In view of the reservations expressed over the proposed treatment of fees and commissions, the provision has been fine-tuned so that only accrued fees due to be billed in the coming 3 months and fees billed but not outstanding for more than 2 weeks will qualify as liquid assets.

107. The Commission has decided to retain the proposed treatment of assets held in currencies which are subject to exchange controls or the proceeds of which upon realisation or liquidation are not freely remittable to Hong Kong - these are to be excluded from liquid assets unless the dealer or the financier has reason to believe that remittance approval can be obtained within one week.

108. The Commission has reconsidered its proposed treatment of assets maintained in order to obtain or maintain the necessary licence or membership for an overseas branch and decided to streamline it so that these assets will be excluded from a dealer's liquid assets under the revised FRR.

(e) Capital Requirements

109. Under the FSB Consultation, financiers and securities dealers who provide securities margin financing would be required to maintain a minimum of $10 million paid-up capital compared to $5 million required of other dealers. As paid-up capital would only be applicable to corporate dealers, we had to set a similar requirement on sole proprietors and partnerships to have injected not less than $10 million or $5 million, as the case may be, into their respective businesses.

110. For the purpose of ensuring a level playing field, the $5 million paid-up capital would also be required of futures dealers. This requirement would however not apply to introducing brokers, futures non-clearing dealers and traders.

(f) Requirement for Advisers

111. Under the existing FRR, advisers are required to maintain net tangible assets of not less than zero. The 1997 Consultation proposed to change the requirement to the minimum of $500,000 shareholders' funds.

112. Again, bearing in mind that the term "shareholders' funds" cannot be applied to unincorporated businesses, we proposed to require sole proprietors and partnerships to maintain "total assets less total liabilities" at not less than $500,000. To ensure that these businesses would not recognise intangible assets such as goodwill which could be quite common amongst partnerships, the revised FRR specifically exclude intangible assets from total assets and rename the requirement as net tangible assets requirement. This is however not the existing net tangible assets requirement as the new one should be simpler to compute.

(g) <u>Returns and Notifications</u>

113. The existing FRR require dealers to submit quarterly returns within 28 days from the quarter-end except for those who have already submitted returns to the SEHK or the HKFE. The 1997 Consultation proposed monthly returns to be submitted within 3 weeks which would be compatible with the reporting requirements of the SEHK and the HKFE. Also, the 1997 Consultation referred to the Commission's Survey on the Over-the-Counter Derivatives Activities by Registered Persons in April 1997 which suggested regulat returns be obtained from dealers about their proprietary derivative positions based on IOSCO reporting.

114. The FSB Consultation proposed a number of new ad-hoc notification requirements related to cashflow problems and signs of concentrations in collateral collected and margin accounts.

115. The revised FRR have extended the notification requirements about cashflow to all dealers and added some other notification requirements about guarantees, indemnities and claims received/lodged.

<u>Reformatting of Computation</u>

116. The existing FRR treat assets and liabilities separately, item by item, under different provisions governing liquid assets and ranking liabilities. This makes it difficult for dealers to identify all the relevant provisions in respect of a particular transaction.

117. The 1997 Consultation proposed to reformat the computation accordingly.

118. The revised FRR have not adopted the proposed reformat but have rearranged the provisions in such a way as to make the rules easier to follow.

(h) <u>Transitional Arrangements</u>

119. The 1997 Consultation proposed different grace periods for compliance with different provisions. For example, it suggested allowing up to 2 years for sole proprietors to increase their liquid capital to the required level which was criticised for being too lenient.

120. The FSB Consultation also proposed different grace periods for compliance with different provisions.

121. Bearing in mind that financiers are not subject to the existing FRR, it is essential for the revised FRR to be effective at the same time as the Securities (Margin Financing) (Amendment) Bill 1999 in order to eliminate any regulatory gap. The above notwithstanding, we shall allow an extra 6 months for dealers and financiers to comply with the minimum capital requirement

and the concentration risk adjustments in relation to securities margin financing.

Securities and Futures Commission
28 May 1999