Letterhead of THE HONG KONG ASSOCIATION OF BANKS
香港銀行公會的信頭

4th June 1999

The Honourable Ronald Arculli, JP
Chairman
Bills Committee on Securities (Margin Financing)
(Amendment) Bill 1999
Legislative Council
Legislative Council Building
8 Jackson Road, Central
Hong Kong

Dear Mr Arculli

Secnrltles (Margin Financing) (Amendment) Bill 1999

We have sighted the enclosed submission by the Securities Law Committee of the Law Society of Hong Kong regarding the above. We support the concerns expressed therein generally and believe that it will be desirable that they are addressed.

Additionally, we have the following comments (following the submission's references):

2. ● "Purpose" of loans

"Securities margin financing" means *providing* accommodation *in order to* facilitate acquisitions etc. It may be reasonable to cover (a) the situation where the lender intends the accommodation to facilitate an acquisition, and (b) the situation where at the time of agreeing to provide accommodation, the lender knows, or a reasonable lender would have known given the circumstances, the borrower's purpose. The position can be made clearer.

5. Securities collateral

The requirement for securities to be registered in the client's name or deposited in safe custody with a bank or other approved institution, and the restriction on enforcement (to become dependent upon the client's consent, which must be renewed annually), are real matters of concern for dealers and exempt dealers.

A charge over shares can be taken without registering the shares in the name of the lender or its nominee, but this is a less protective security. The problem is more acute for shares held in CCASS, since the somewhat limited protection obtained from possession of the scrips does not apply to shares held in CCASS. Further, Rule 402 of the General Rules of CCASS expressly provides that HKSCC shall be under no obligation to recognise any right or interest which any person other than a Participant may have in relation to securities deposited into CCASS.

We cannot see the justification for requiring the client's consent to enforcement, after the client has been in default, when the consent may not be forthcoming at all. It defeats the purpose of the security.

Since nothing in the provisions which restrict disposal affects any lawful claim or lien in respect of the securities (Section 81B), it follows that the bank to whom securities had been pledged, without the client's authority, can dispose of the securities, if it has a lawful claim or lien. The only relevant consideration is whether the bank has a lawful collateral. However, the point can helpfully be clarified.

6. Safe custody

Similar considerations to 5 above apply. The restriction against dealing is stricter than that which applies to securities collateral, since while Section 81A permits securities subject to collateral to be lent in certain circumstances, there is no such permission in Section 81 in respect of securities held in safe custody. This will unnecessarily affect legitimate business practice which the client has agreed to.

Yours sincerely

Lorita L F Tam
Secretary

Enc.

cc: Deacons (Mr J W C Richardson)

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7 June 1999

BY HAND
Clerk to the Bills Committee
Legislative Council
The People's Republic of China
Hong Kong Special Administrative Region
Legislative Council Building
8 Jackson Road
Central
Hong Kong
Attn: Ms Estella Chan

Dear Sirs

Securities (Margin Financing) (Amendment) Bill 1999

I am a member of the Law Society Securities Law Committee.

Due to delays for which I alone am responsible, I have failed to comment on the captioned Bill until now.

Apart from adopting the comments of my colleagues in the submissions sent to you under cover of the Law Society's letter of 20 April, I have certain additional comments for the consideration of the Bills Committee. These comments are attached.

I understand that my comments may be somewhat late on this occasion, but if the Bills Committee would like to discuss any aspect of them, please let me know.

I should add that the enclosed comments are entirely mine and should not be taken as those of the Law Society or its Securities Law Committee.

Yours faithfully

Leo Chiu

Riders to submissions on Securities (Margin Financing) (Amendment) Bill

Rider 2A

Alternatively, a "liabilities" test may also useful.

The chief danger in securities margin financing, so far as clients are concerned, is that their securities collaterals are used for non clients' business, eg, the financier's own business, non securities related loans, eg, a loan to a client to acquire properties, and activities that are cloaked as hedging activities, such as speculative buying and selling of Hang Seng Index futures or options over listed securities. There is no inherent objection to a margin financier having other businesses, so long as the liabilities of such business do not flow into and become entangled with its margin financing business. Thus, if a margin financier owns an unencumbered property (its office), there is no objection to this.

Rather than restricting the business of margin financiers, a liabilities test may be more useful. The disadvantage, however, is that this will involve complicated financial resources rules. Given, however, that section 28 of the SFC Ordinance (power of SFC to impose financial resources rules on registered persons) will extend to margin financiers, a sole business requirement is not, in my view, necessary.

- *Securities margin financier's representatives*

As mentioned, the systemic risk of margin financing is that clients' securities collateral may be pledged for non client purposes, such as for borrowings that are on lent to non securities clients, the purchase of a property of the business of the financier. Essentially, therefore, the risk is that of a misuse of clients' assets. The persons who will be in a position to engage in such act will be the directors of the financier companies, not their more junior staff.

The Committee notes that accountants, clerks and cashiers are excluded from the proposed definition of "securities margin financier's representatives". The Administration is requested to consider to re-cast the definition of the phrase to cover only those officers and staff of a securities margin financier who have authority to deal with clients' securities collaterals deposited with the financier, instead of using a wide definition to cover all employees.

The proposed section 121L seeks to prohibit representatives from acting for more than one financier. If "representatives" covers arrangers, then this seems too harsh. It is, in any event, probably unnecessary to have this rule: the fact that a responsible officer owns or works for more than one financier does not pose any undue systemic risk to securities margin business either of the financiers concerned or to the industry.

Rider 2B

- *Deposit of security with the Commission*

The proposed section 121K empowers the Commission to require a financier to deposit and maintain a security with the Commission. Detailed rules will be required on the calculation of the value of the security and the right of the Commission as to the application of such security. Ideally, the grounds for requiring security to be deposited should also be set out in the enabling Ordinance.

Rider 2C

Even if, on a proper construction, arrangers are not covered by the definition of "securities margin financier", they will (and are probably intended to) fall under the definition of "securities margin financier's representatives".

Unlike the business of securities dealing and giving investment advice, the inherent dangers in securities margin financing business lie, so far as consumers are concerned, much less, if at all, with arrangers. Rather, the danger is with their securities being pledged for non-client purposes (eg, the infamous CA Pacific debacle). If it is accepted that arrangers pose little or no systemic risk, then the case for regulating this class of persons is much less compelling.

Rider 2D

- *Revocation and suspension of registration*

  The proposed sections 121R(5) and 121T(5) (suspension of registration) should be amended to make clear that a suspension may not be ordered without first giving the financier or the representative an opportunity to be heard.

- *"Misconduct"*

  "Misconduct" is defined in sections 121S(5)(d) and 121U(5)(d) as, among other matters, an act or omission that is, or is likely to be "prejudicial to the interests of members of the investing public".

  The quoted phrase is also found in section 33 of the SFC Ordinance as a ground entitling the SFC to launch an investigation.

  There is no definition or criteria in sections 121S(5)(d) or 121U(5)(d) of what might be considered to be conduct "prejudicial to the interests of members of the investing public". This creates two potential jurisprudential problems:

  (a) a subsequent ruling by the court of what constitutes conduct "prejudicial to the interests of members of the investing public" will amount to retroactive legislation, because the court ruling is not something that can be predicted beforehand. A better approach is to lay down the specific "misconduct" that the Administration has in mind. Alternatively, some criteria for determining what might constitute conducts "prejudicial to the interests of members of the investing public" should be set out;

  (b) the following is a corollary of (a). Because the investigative power of the SFC under section 33 of the SFC Ordinance will extend to "misconduct", a failure to define "misconduct" or to delineate its scope is tantamount to giving unrestricted investigative powers of the SFC. This raises one very important concern. Section 33 takes away the right of silence of persons under investigation. Given that a section 33 investigation may lead to the revocation of the registration of a registered person, this is a subject that ought to be treated with extreme care. (The traditional argument is that securities offences are difficult to detect or investigate. Bribery offences are even more difficult to detect and investigate, but it has never been suggested that the right to silence should be removed for bribery offences.)

- *Statement of account*

  Loan agreements generally provide that interest on a loan accrue daily (so that the lender need not wait until the end of an interest period to enforce payment of accrued interest).

  Section 121Y requires a statement to be given on the next business day after one of the transactions mentioned in section 121Y(1) has been entered into.

  One such "transactions" is the debiting of charges.

  If, as is believed will be the case, interest is charged on a daily basis, section 121Y will require daily statements to be generated. If this is not the intended result of the section, the Bill should be amended to clarify that a statement is not required on account of daily interest charges only.

- *Rescission*

  Section 121AD entitles a borrower who has borrowed from an unregistered securities margin financier to rescind his loan. An exercise of such right will, of course, affect third party rights. The problem may be easier to deal with if the securities have not, in the meantime, been disposed of.

  Where the securities have been disposed of to a bona fide purchaser, section 121AF(5) allows the rights of the third party purchaser to take precedence, provided that certain conditions are met. One such condition is that the purchaser made the purchase "without notice".

  In most cases, where the purchaser makes the purchase through a market transaction, this might be sufficient to enable him to rely on section 121AF(5).

  However, the position would be fraught with uncertainties if the purchase was made off market (ie, through a private agreement).

  In cases of pledges of large blocks of shares, it is often the case that the pledged securities will be disposed of privately rather than through the market.

  The rescission mechanism envisaged by section 121AF would create potential market disruption: under the common law, "notice" can take many forms - actual notice, imputed notice and constructive notice. The last of these has been the subject of litigation almost throughout the history of the equity branch of the unwritten law of England. Even if the rescission mechanism envisaged by section 121AF is to be retained, the Administration is requested to consider laying down a definition of "notice". If the word, for example, is intended to extend to "constructive notice", then at least this should be made clear.

  As to the position of "sub-lenders", please see the Securities Law Committee's views set out in the section headed "Securities collateral".

- *Deposit of money*

  Under section 121AO, money that is required to be paid into a trust account must be so paid within four business days. The Administration is requested to consider clarifying in the Bill that the money that is required to be paid into a trust account will be subject to statutory trust pending its payment into the trust account.

- *Consequences of non-approval*

  Section 121BH permits a financier who is carrying on business at the time of the Bill coming into effect to carry on his business, provided that he applies for registration within 30 days of the effective date of the Bill. If, however, his application is refused, he must cease to carry on business within 14 days of the refusal (or such longer time as the Commission may allow).

  The Administration is requested to clarify in the Bill whether the act of allow an existing loan to remain outstanding constitutes a "carrying on" of a business.

- *Amendment to section 33 of the Securities and Futures Commission Ordinance*

  Para. 10 of Schedule 2 to the Bill seeks to amend section 33 of the SFC Ordinance. The amendment will empower the SFC to investigate into whether transactions relating to securities margin financing has been might not have been in the interest of the investing public or the public interest.

  Section 33 gives extensive powers to the SFC, and takes away the fundamental right of those whom the SFC investigates or whom they believe might have relevant information (even though they are not under investigation, such as banks). The investigative powers of the SFC under section 33 are greater than that under the Prevention of Bribery Ordinance, and there is no statutory regime for any check and balance on the exercise or purported exercise of powers of the SFC under that section.

  In the context of investigation into conducts "which might be prejudicial to the interest of the investing public or public interest", section 33 does not lay down any criteria for considering what the draftsman of the section might have in mind (please also see the section above headed "Misconduct").

  In terms of legislative interpretation, the quoted phrase could be given a very wide meaning (which will further erode personal freedoms), or it may be given a very narrow meaning.

  In either case, the phrase creates great uncertainly.

  Given the context of the phrase, this is highly unusual and is undesirable.

  In the context of section 121S and 121U, the proper interpretation of the phrase will affect the registration status of a registered person. In the context of section 33, it could give overly extensive powers to the SFC and unnecessarily erode personal freedoms. It is suggested that the Bill should contain either an all-embracing definition of what constitutes "prejudicial to the interest of the investing public or public interest", or a set of statutory criteria that a judge may look to when deciding on the issue.

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Comments of the Securities Law Committee of the Law Society of Hong Kong on the Securities (Margin Financing) (Amendment) Bill 1999

1. **Introduction**

Under the Bill, a new regulatory regime for securities margin financing would be introduced.

The Securities Law Committee recognises, particularly in the light of recent events, the importance of regulating and ensuring as far as possible the proper conduct of carrying on securities margin financing business in Hong Kong. Accordingly, the Committee welcomes, in principle, the Bill. However, the Committee has a number of concerns in respect of various matters covered by the Bill, particularly the scope of the regulatory net created under it.

2. **Definitions**

The Bill amends the Securities Ordinance to require that the business of securities margin financing is conducted only by "companies" which are registered securities margin financiers. However, exemptions are available for registered dealers, bankers, etc. (see below).

The definition of "securities margin financing" is clearly crucial, particularly since securities margin financiers are not allowed to carry on any business other than securities margin financing.

It means, as drafted:

"providing 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."

"Financial accommodation" means:

"a loan or other arrangement under which a person is or is to be provided with credit, whether directly or through a third party, and in particular includes an overdraft, discounted negotiable instrument, guarantee, a forbearance from enforcing a debt that in substance is a loan, and also includes an agreement to secure the payment or repayment of any such accommodation."

Com ents

- *Companies*

  It is not clear why partnerships, for example, cannot become securities margin financiers provided that they satisfy the other regulatory requirements ("fit and proper", etc.).

- *Sole business requirement*

  The sole business requirement appears to prevent registered financiers from, for example, providing funding to investors to buy <u>unlisted</u> securities (whether shares or, for instance, convertible or other bonds, funds or unit trusts), or from allowing them to enter into futures and options transactions to hedge their positions.

  It would be preferable to adopt a "principal" business test or set out in regulations certain exemptions, including the above examples, from the requirement.

> RIDER A

- *Unlisted securities*

It should also be noted that some of the provisions of the Bill will apply to securities dealers and exempt dealers who provide financial accommodation to clients and take securities collateral, regardless of whether that is done in relation to securities listed on a stock exchange.

> RIDER B

- *Third party arrangers*

"Securities margin financing" may cover a person who arranges for a third party to provide credit to an investor for the acquisition of listed securities by that investor (whether through the arranger, the third party or indeed anyone else).

This may be of concern to licensed Money Brokers, where they introduce prospective investors to authorised institutions for the purposes of funding an acquisition or financing the continued holding of listed securities.

This may also be of concern to persons in Hong Kong who introduce investors to the services of a person <u>outside</u> Hong Kong who is involved in securities margin financing. There is an exemption, as mentioned above, for registered dealers and exempt dealers where financial accommodation is arranged by the dealer to facilitate acquisitions/holding of securities by its clients. That exemption is not apparently available where the Hong Kong dealer introduces an investor to an affiliate of the dealer outside Hong Kong for the investor to become a margin client of that affiliate (for instance, in connection with investments in overseas listed securities), since it would not be the Hong Kong dealer acquiring or holding securities for the dealer's clients. Instead, it would be the affiliate who does so. The exemption should be extended accordingly.

> RIDER C

- *"Purpose" of loans, etc.*

"Securities margin financing" means providing financial accommodation <u>in order to</u> facilitate acquisitions, etc. This appears potentially to introduce the somewhat unwelcome concept of subjectivity into the question of whether a person is engaging in securities margin financing.

This raises the concern of the extent to which lenders (or arrangers) would need to make themselves aware of the purpose of any borrowings or other financial accommodation.

Personal loans from money lenders may, for example, in some circumstances be used to acquire listed shares, although that may be only part of the reason, or the disclosed reason, for the loan application. Not all money lenders will be share margin financiers and the underlying purpose of the loan may not always be disclosed or apparent.

In addition, what would the position be where a loan is obtained in order to, say, pay off another loan and thereby free up a credit line or cash to invest in listed shares?

Arrangers of such loans would also be placed in a difficult position in needing to try to find out the underlying purpose of the loan or to control the use to which the loan proceeds are put.

Derivatives/structured products are not specifically dealt with in the above definitions, but may well nonetheless be caught in certain circumstances.

It may be appropriate to ensure that the legislation expressly refers to the purpose of the lender not the borrower. Where the lender actually knows the borrower's purpose, that could be deemed to be a purpose of the lender.

> RIDER D

- *"Securities margin financiers"*

We suggest that the definition of "securities margin financier" should be *limited* to those carrying on business in Hong Kong, to be consistent with the rest of the Bill.

3. **Exemptions**

There are exemptions from the need to become a registered financier for bankers, securities dealers, etc., as discussed above.

However, there are no exemptions for:

- financing to assist in a take-over offer for a listed company
- financing to acquire substantial stakes in a listed company (the threshold could be defined by reference to a specific amount, say HK$20 million, or a percentage of issued share capital, say 2% or 3%)
- financing of all off-market transactions
- prime brokerage or global custody arrangements which may involve the provision of financial accommodation to a major institutional investor
- money brokers (see above)
- vendor financing or share sales on deferred terms (although that may well not amount to a "business" in any event)
- loans to shareholders which do not amount to intra-group arrangements
- financing for employees to purchase listed shares (note: this type of arrangement is currently uncommon in Hong Kong, although it is likely to become more common, for instance in respect of Hong Kong based participants in overseas companies' schemes)
- exempted loans under Schedule 1, Part 2 of the Money Lenders Ordinance (including, for example, loans to listed companies)
- "non-retail" securities margin financing (that is, in the context of, say, financing to "professionals" as is covered in the Securities Ordinance and Protection of Investors Ordinance, given their ability to evaluate the relevant risks, etc.)
- subsidiaries of authorised institutions (as provided for under Schedule 1, Part 1 of the Money Lenders Ordinance). Note: The Money Lenders Ordinance also has an exemption for insurance companies and for persons whose ordinary business does not primarily or mainly involve (for these purposes) securities margin financing. We assume that these exemptions have not been adopted to ensure that lenders to persons who will use the funding to acquire listed shares will be caught. This will be of concern to, say, insurance companies who, as part of a "one stop shopping" service, may introduce clients to their affiliates where clients wish to acquire listed shares
- loans to securities margin financiers for the purposes of their business.

It may be appropriate to refine the definition of "financial accommodation" or to extend the exemptions (on a restricted basis) accordingly.

The Committee requests that LegCo looks into the scope of the exemptions to be included in the final form of the legislation to ensure as far as possible that the scope is sufficiently wide to cover proper business activities of market participants.

The Committee recognises that the SFC, under the Bill, would be able to waive or modify requirements for registered financiers (or applicants), and to make rules exempting certain classes of person, transactions, etc. from the provisions of the Ordinance, and if it is the SFC's intention to extend the exemptions list in that manner, then that is to be welcomed.

However, in the Committee's view, it is important that any such waivers, modifications or additional exemptions are kept to a minimum to maintain consistency as far as possible in the regulation of the market, so as to avoid piecemeal and arbitrary treatment of situations arising.

4. Client information

Each time there is any movement on the account of a client of a registered financier, such as a deposit or withdrawal of collateral or a deduction of charges, or whenever there is a change in the terms on which financial accommodation is provided (such as a change in interest rates or a change in the level of margin cover required) the client must be sent a statement of account by the end of the next business day. A detailed monthly statement of the account is also required, whether or not there have been any movements during the month.

The same onerous requirements apply to a securities dealer who provides financial accommodation to a client to facilitate the acquisition of securities (whether or not those securities are listed on a stock exchange).

We suggest that these provisions are reviewed in order to ensure that a balance is struck between client protection and the need to control the compliance burden and cost of doing business. Is it necessary, for instance, for the full range of information specified in section 121Y(3) (especially (d) to (f) and (i)) to be given in respect of all the transactions mentioned in sub-section (1)? We also suggest that the time requirement should be relaxed to (say) two business days and that it should be made clear that posting materials within this time frame satisfies the requirement to "give" them.

There is a concern that this could apply where the dealer does not intend to give the client a credit facility but financial accommodation is provided on an *ad hoc* basis, for example where the dealer has to settle a trade where a client has failed to provide cleared funds in time. We assume that this is not intended.

5. Securities collateral

Where securities are taken as collateral by a lender, it is of critical importance that the lender has a valid and enforceable security interest over those securities. A legal charge over shares would normally involve registering the securities in the name of the lender or its nominee (rather than the securities being registered in the name of the client or held in a safe custody account). In respect of shares held in CCASS, effective security would require those shares to be held in the chargee's CCASS account, or that of its nominee or in an account of another person but in such a way so as to ensure that those shares are controlled by, and the CCASS interests in those shares are "owned" by, that other person. (Holding shares in CCASS accounts in the names of individual clients is not practicable.) Any other forms of security than those described above (e.g. in accounts in clients' names) will provide less effective security as far as the chargee is concerned. This is an important structural point which could affect the securities financing industry generally. It is also essential to the lender that the charge can be readily enforced by disposing of the securities to meet the liabilities of the borrower.

Under the new provisions (sections 121AA and 81), which will apply to registered financiers and to dealers and exempt dealers, the lender will have to register the securities in the client's name or deposit them in a designated account with a bank or other institution which provides safe custody services. These requirements are not consistent with the needs for effective security described above. Further, they do not address effectively the fact that most shares will be held in CCASS and therefore in dematerialised form. Registration of those shares in any particular name will not be an option, and the concept of "deposited in safe custody" is not really consistent with how shares are held in dematerialised form in CCASS.

The lender will only be able to dispose of the securities with the client's written consent, which must be renewed annually, or in accordance with SFC rules, which have not yet been produced. The Committee is concerned that the operation of these provisions will affect the lender's security, for example if the client refuses to renew the annual consent at a time when the client owes money to the lender. A lender must be free to enforce security once a default has occurred on the part of the borrower. Such a provision would also have the undesirable effect of forcing lenders to liquidate security as the annual time limit approaches to avoid taking the risk of not obtaining renewal of client consent, in circumstances where they may otherwise have given the borrower more time. It may be that SFC rules will address this issue. We recommend that this legislation is not brought into effect until such rules have been produced.

The new provisions also mean that the lender will only be able to use the securities (even with the client's written consent) for certain specified purposes, and not generally for its business purposes.

The position of a third party who received the securities from the lender in circumstances where the lender was in breach of any of the above provisions is somewhat unclear. The Bill states that nothing in these provisions affects any lawful claim or lien that a person has in respect of securities collateral, but it is not clear whether, for example, if a lender had pledged client securities with a bank as collateral for a loan, but did not have authority from the clients to do so, the bank would have the right to dispose of the securities to discharge the loan. We recommend that "bona fide third party" provisions, similar to those in section 121AD, could be introduced to clarify this issue.

6. Safe custody

Amendments have also been made to Section 81 of the Securities Ordinance, which will apply to dealers and exempt dealers who provide custody of securities for clients to whom no financial accommodation is provided. Such securities must not be pledged, lent or dealt with except as permitted by rules made by the SFC, even if the client has given its consent to this. Similar concerns to those described in 5. above arise in this respect. In addition, read literally, this would appear to prevent the dealer from returning the securities to the client, or effecting stock lending for the client with the client's authority. Presumably this will be addressed in rules to be made by the SFC?

7. Miscellaneous

- The Bill talks throughout in terms of "margin" financing. This is inaccurate, as it relates to all securities acquisition financing and we recommend that this could helpfully be clarified.

- The Bill does not seek to regulate futures financing, although this must be an area of concern.

- The provisions of Section 121F (false or misleading information to the SFC) need to be considered in the context of the SFC proposals concerning false reporting on which the Committee has previously provided comments.

- The Hong Kong Stock Exchange rules, including the uniform client agreements, will need to be updated to take into account the proposed changes, including for example the Section 81 amendments.

- Presumably the Hong Kong Money Authority will publish guidelines or other guidance in relation to their treatment of exempt dealer banks in the context of the new legislation, to ensure as far as possible a "level playing field" in the market?

- Please see the attached extracts from the Bill on which we have marked, in manuscript, some drafting comments. In addition, we have the following miscellaneous comments on the Bill:

  - Section 121C(1) is wider in its scope than section 121B(1), and should be narrowed to make it consistent.

  - Section 121S(4) and similar provisions: the words "impose a penalty under this section" are unclear. We suggest these should read "take any action under sub-section (3)" (or the equivalent).

  - Section 121AK(1)(a): it may not be possible for a financier to comply with this requirement, in particular because it cannot control its auditors and what qualifications they may make.

  - Section 121AW(2)(a)(i): we suggest that this is too wide: for instance, a significant drop in profits is an adverse financial event but does not necessarily affect a financier's ability to perform its obligations. We suggest this sub-section focuses on the latter and the financier's balance sheet.

  - Schedule 1, item 1(c): we suggest that this exclusion should be widened, as the definition of "dealing in securities", on which the definition of "dealer" is based, in particular the words "making......an agreement......with a view to acquiring ......securities", is wide and could apply to most activities of a financier, including lending and taking security.

Securities Law Committee
The Law Society of Hong Kong

20 April 1999