SECURITIES (MARGIN FINANCING) (AMENDMENT) BILL

Further submission of Law Society's Securities Law Committee re: exemptions

1. Scope of legislation: focus of exemptions

The proposed legislation is primarily aimed at providers of retail margin finance. This in turn is likely to involve mainly on-market acquisitions of listed securities, normally in relatively small quantities.

The purpose of the exemptions which the Law Society is proposing to add to the proposed Section 121B is to ensure that activities which should not be treated as within the scope of the legislation (and thus subject to registration and other requirements) are excluded so as to ensure that only persons carrying out retail margin finance fall within the registration and other requirements.

Once a person is registered, all relevant activities carried on by it (whether retail or not) should be covered by relevant parts of the legislation, such as financial resources requirements.

2. Importance of appropriate clearly stated exemptions

The Law Society is strongly of the view that the Administration's proposal to deal with the exemptions on a "case-by-case" basis is inappropriate, although we support a residual power for the SFC to grant waivers on a case-by-case basis.

Our reasons for this are the following.

(a) Cost

We assume that the SFC would charge for considering applications for case-by-case exemption, as it does under, for instance, Section 4(2)(g) of the Protection of Investors Ordinance. Added to these costs would be the often substantial legal and other costs and management cost involved in making the applications.

It is in Hong Kong's long term interest to maintain its competitiveness by minimizing the cost of doing business, and a comprehensive, clear set of exemptions in this regard will be of assistance.

It is particularly worth noting that, whereas the sort of advertisement for which applications are made under Section 4(2)(g) of the Protection of Investors Ordinance tends to involve a substantial underlying transaction, involving a substantial amount of money, this may not be the case with case-by-case applications which may be required to be made regularly in connection with possible margin financing activities. It would be unlikely to be cost effective, for instance, to apply for an exemption for a specific single loan.

(b) Clarity/consistency

It is essential that the law be as clear and consistent as possible, and that market participants and advisers know where they stand and can predict the outcome in relation to specific issues as much as possible. Giving extensive discretions to the SFC in this regard will definitely work against these important considerations. While we are sure that the Administration and the SFC would be sincere in wishing to ensure transparency regarding case-by-case exemption and the applicable criteria, there is in practice no substitute for clear exemptions embedded in the legislation.

(c) Quality of legislation

As a general point of principle, good legislation would involve setting out as extensive a list of exemptions as practicable, leaving a residual administrative discretion to deal with unusual or unpredictable cases.

3. Misuse of exemptions

We note the Administration's comments at the recent hearing of the Legislative Council Committee that it is concerned that exemptions could be abused through structuring transactions which should be treated as securities margin financing so that they do not fall within the scope of the Ordinance.

While we accept that it is always a concern to make sure that the exemptions are appropriately drafted so as to cover precisely what they are intended to cover, the Committee does not accept that such fears should prevent exemptions being implemented.

As experienced advisers to intermediaries in the securities business, we spend time examining relevant exemptions already in Ordinances such as the Leveraged Foreign Exchange Trading Ordinance and the Securities Ordinance. Our experience is that it is not practicable to structure transactions artificially so as to fall within relevant exemptions. Adverse effects on business of a dispute with regulators in respect of an artificial structure of which they disapprove, and the attendant publicity which could be to be generated, are disincentives even were it possible to find such a structure.

4. Suggestions for more clearly defining the exemptions

In our previous submission, we set out a list of possible exemptions based on type of transaction and/or type of borrower. As requested, we set out below suggested exemptions which would, we consider, be relatively clear to apply and would not create undue risk of abuse.

(a) Exemption for loans to any "professionals" i.e. a person whose business involves buying, selling or holding securities, whether as principal or agent. This is consistent with many of the provisions of the Securities Ordinance and Protection of Investors Ordinance, which exclude from those provisions marketing to, or effecting transactions with, such "professionals". Such an exemption would go a substantial way towards addressing our concerns as to unnecessary (or inadvertent) regulation of securities margin financing business, since such "professionals" are well able to recognise and guard against the risks involved, and are outside the principal intended focus of the proposed legislation, which we understand is aimed more at providers of retail margin finance.

(b) Exemptions for loans to a company with a paid up share capital of HK$1 million or foreign currency equivalent (and, we suggest, their subsidiaries), and to a listed company or the subsidiary of a listed company (as in the Money Lenders Ordinance).

(c) Exemptions for loans to directors or employees to purchase securities in the company of which they are directors/employees (or in a related company).

(d) Exemptions for loans to registered securities margin financiers, authorised institutions under the Banking Ordinance (and their subsidiaries), securities dealers and investment advisers and insurance companies.

(e) Exemptions for loans to facilitate the acquisition of 5% or more of the issued share capital of a listed company (whether in a single transaction or a series of transactions).

(f) Exemptions for transactions of which the provision of financial accommodation is not the principal or dominant purpose. This is intended to protect bona fide non-margin financing transactions which may on a strict reading fall within the definition of "securities margin financing", such as vendor financing or sales on deferred terms. This concept can also be found in Section 47C(1) of the Companies Ordinance, which provides exemptions from restrictions on "financial assistance".

(g) "Associated company" loans, being loans by companies to their associated companies, being their holding companies, subsidiaries, subsidiaries of the aforesaid and associated companies of the aforesaid (the definition of "associated corporation" in the Securities (Disclosure of Interests) Ordinance could be useful in this respect). This is wider than the exemption in Clause 121B(2)(e) of the Bill.

(h) Loans by individuals to companies in which they have shareholdings of (say) 10% or more, and vice versa.

(i) Exemptions for loans to finance off-exchange transactions (other than applications by retail investors in public offers of securities): generally, retail customers would not be involved in such transactions. [Note: this is not such an important exemption, and should be omitted if the Administration is concerned about the possibility of abuse of this exemption.]