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本函檔號 OUR REF:　SUB49/99 XI

來函檔號 YOUR REF: CB1/BC/13/98

19 June 1999

Ms. Estella Chan
Clerk to Bills Committee
Legislative Council Secretariat
Legislative Council Building
8 Jackson Road
Central
Hong Kong

Dear Estella

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

Thank you for your letter of 2 June 1999. Our responses to the outstanding items are as follows (in the same order as listed in your letter) -

a. We have no objection to the suggestion to provide the exemption list in a Schedule and will follow up with the Law Draftsman accordingly.

b. Stock Exchange of Hong Kong confirms that there is no express requirement under the Exchange Rules specifying the lending ratio to margin clients vis-a-vis the borrowings from banks. The matter is more generally dealt with by the internal control and risk management measures of the brokers. We have also sought clarification with the representative of Hong Kong Stockbrokers Association and confirmed that our understanding is correct.

c. No further details have been received from the relevant authority of Singapore in relation to allowing a dealer to pledge a client's securities for a sum not exceeding the amount owed by the client. However, to the understanding of SFC, some of these arrangements might have not been written down in the form of rules to allow flexibility of implementation.

d. A copy of the requested correspondence is at Annex A. In brief, credit balances of margin clients can be used to finance other customers' margin loans. To the extent that credit balances are not used in this manner, they must be deposited in a "special reserve bank account for the exclusive benefit of customers". Broker-dealers must send each customer for whom a credit balance is held a written statement informing such customer of the amount on settlement date and that such funds are payable to the customer on demand.

e. In the UK, a firm can, with prior written consent from a customer, use the collateral as collateral for the firm's own obligations or the obligations of another customer or any person.

In respect of the Taiwanese system, as advised by the Securities and Futures Commission of Taiwan, securities dealers and finance companies are allowed to use clients' securities as collateral for obtaining re-financing from the four approved margin finance companies. Scrip held as collateral may only be re-hypothecated or used for the purposes of securities lending. The relevant rules have not specifically permitted clients' securities to be repledged with banks or other financial institutions.

In addition, we have undertaken to provide the list of constituent stocks of Hang Seng Index identifying the "related" shares as defined in the Financial Resources Rules, which is now attached at Annex B for Members' information.

Our written responses to views expressed by the deputation at the meeting on 1 June 1999 is at Annex C.

Attendance list for the meetings on 21 and 22 June 1999 is at Annex D.

Yours sincerely,

(Bryan P. K. Chan)
for Secretary for Financial Services

Att.

c.c. Mr. Andrew Procter
Mr. William Maddaford
Ms. Vicki Lee

Annex A

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON. D.C. 20549

June 1, 1999

Mr. Richard Yin
Director
Intermediaries Supervision
Securities & Futures Commission
12th Floor Edinburgh Tower
15 Queen's Road, Central
The Landmark
Hong Kong

Dear Mr. Yin:

This is in response to your e-mail dated May 21, 1999, in which you request additional information regarding customer financing and the hypothecation of customer securities. Listed below are answers to questions raised in your e-mail.

Question 1 - Can margin clients' credit balances (i.e. surplus cash under the margin clients' accounts) be applied to finance margin loans or must they be segregated?

Broker-dealers may use margin clients' credit balances to finance customers' margin loans. Under Rule 15c3-3 of the Securities Exchange Act of 1934 ("Exchange Act"), a credit balance in a client's margin account is considered a "free credit balance." Generally, free credit balances are defined under Rule 15c3-3 as liabilities of a broker-dealer to customers which are subject to immediate cash payment to customers on demand. Rule 15c3-3 permits broker-dealers to use customer free credit balances only to finance customer-related debits (e.g., customers' margin loans). Customers' free credit balances not used to finance customer-related debits must be deposited in a "Special Reserve Bank Account for the Exclusive Benefit of Customers" to the extent that the broker-dealer owes its customers more than the customers' owe the firm.

Under Rule 15c3-2 of the Exchange Act, broker-dealers are required to establish adequare procedures pursuant to which each customer for whom a free credit balance is carried will be given or sent a written statement informing such customer of the amount due to the customer by the broker-dealer on the date of the statement. Broker-dealers also must inform their customers that such funds are payable to the customer on demand.

<u>Question 2</u> - Can broker-dealers (or non-broker-dealers) pick and choose the stock to make up the 140% value?

Yes., Broker-dealers may decide which margin securities in a client's margin account (as defined under Regulation T) it wishes to pledge, loan, or sell under a repurchase agreement to finance customer debit balances. Although an entity to whom a broker-dealer transfers securities to obtain financing may indicate a preference for certain securities, the ultimate decision as to which margin securities will be used for financing is that of the broker-dealer.

<u>Question 3</u> - What sort of ratios are banks willing to lend on securities collateral? Do these ratios tend to be lower in which case the broker-dealers (or non-broker dealers) will have to fund margin lending with their own capital?

The amount of financing that banks are willing to provide broker-dealers in exchange for securities collateral depends on several factors, such as the type of collateral that will be pledged. Banks generally extend loans collateralized by equity securities for 70 percent of the market value of the collateral. Banks may be willing to increase the amount of financing to broker-dealers pledging securities that are historically subject to less risks, such as treasury securities.

The practice of banks lending at the 70 percent ratio underlies the 140 percent requirement in the Commission's definition of "excess margin securities" (discussed in response to Questions 3 and 4 in the May 5th letter). As a result, broker-dealers pledging margin securities with a bank are generally not required to use their own capital to finance customer margin loans. Under Regulation T, the maximum amount of credit that can be extended by a broker-dealer to finance customers' purchases of margin securities is 50 percent of the purchase price. In order for a broker-dealer to obtain the remaining 50 percent of the purchase price (which represents the client's debit balance), the broker-dealer will need to pledge securities totaling approximately 140 percent of the debit balance.

The availability of alternative methods of financing customer margin loans also limits the need for broker-dealers to use their own capital to fund margin lending. Through securities lending and repurchase agreements, broker-dealers can generally obtain more financing for margin securities than would otherwise be obtained by pledging the same securities with a bank.

<u>Question 4</u> - Will broker-dealers (or non broker-dealers) maintain sub-accounts with banks? Can banks set off or combine these sub-accounts?

The Commission's hypothecation rules (discussed in response to Questions 3 and 4 in the May 5th letter) prohibit broker-dealers from, among other things, maintaining sub-accounts with a bank in which both its proprietary securities and its customers' securities are commingled. In adopting the hypothecation rules, the Commission intended to eliminate the potential for customer losses in a failing broker-dealer by separating the broker-dealer's proprietary securities from its customers' securities in sub-accounts subject to liens covering all securities in such accounts.

However, the hypothecation rules and Regulation U permit broker-dealers to maintain sub-accounts with a bank, and receive financing from the bank for transactions in those sub-accounts, provided each sub-account contains only accounts of customers of the broker-dealer and the broker-dealer gives the bank written notice that, among other things, all securities in the sub-account will be for the account of customers and will not be subject to any lien for loans made to the broker-dealer.

As discussed in response to Question 5, larger broker-dealers do not rely on bank financing because of less expensive financing alternatives. Accordingly, large broker-dealers do not maintain sub-accounts with banks. However, smaller broker-dealers that rely on banks for financing do maintain such accounts.

<u>Question 5</u> - Do broker-dealers (or non-broker-dealers) tend to obtain financing by issuing their own papers? To what extent do they rely on financing by the banks, with what collateral?

In the U.S., larger broker-dealers generally operate within a holding company structure and may indirectly obtain financing from the commercial paper markets through their ultimate holding companies which often have access to such markets. Broker-dealer holding companies, with substantial unencumbered collateral and other liquidity backup, such as revolving credit lines, are able to raise short-term funds in the commercial paper markets at competitive rates as compared to other financing alternatives. These holding companies then provide their broker-dealer subsidiaries with financing for use in the broker-dealer's business.

Larger U.S. broker-dealers do not rely on bank financing because of less expensive financing alternatives such as the indirect access to the commercial paper markets described above, as well as access to the securities lending and repurchase markets. Smaller U.S. broker-dealers rely on bank financing to the extent that they do not have access to other less expensive financing markets.

<u>Question 6</u> - Are there a lot of small, retail margin clients in the US? How many broker-dealers and non-broker-dealers which currently provide margin financing to clients?

No statistical information is compiled by the Commission as to the number of retail margin clients in the U.S. However, a reasonable estimate of such clients would likely range between two and five million. Statistical information on customer financing at broker-dealers, available from the Board of Governors of the Federal Reserve System, indicates that such financing totaled approximately $151 billion as of February 1999. For comparison, the total market value of all U.S. corporate equities at year-end 1998 exceeded $15 trillion.

In 1998, the Commission supervised approximately 8,300 broker-dealers, approximately 10 percent of which are broker-dealers that carry customer accounts and are permitted to provide margin financing. No statistical information is compiled by the Commission as to the number of non-broker-dealers providing financing to customers.

Please contact me by telephone at (202) 942-0766 or by e-mail at AttarM@sec.gov if you have any additional questions.

Sincerely,

Mark M. Attar
Staff Attorney

Annex B

Cross-ownership of HSI constituent shares

Code No.	HSI Constituent	Shareholdings in another HSI Constituent (%)[1]	Related Collateral?
0001	Cheung Kong Holdings	Hutchison (49.9%)	Yes
0002	CLP Holdings	-	-
0003	HK & China Gas	-	-
0004	Wharf Holdings	-	-
0005	HSBC Holdings	Hang Seng Bank (62.14%)	Yes
0006	HK Electric	-	-
0008	HK Telecom	-	-
0010	Hang Lung Development	Amoy Properties (58.66%)	Yes
0011	Hang Seng Bank	-	-
0012	Henderson Land evelopment	Henderson Investment (64.28%)	Yes
0013	Hutchison	Cheung Kong Infrastructure (85%) HK Electric (30%)	Yes
0014	Hysan Development	-	-
0016	SHK Properties	-	-
0017	New World Development	-	-
0019	Swire Pacific A	Cathay Pacific (45.10%)	Yes
0020	Wheelock And Co.	Wharf Holdings (48.0%)	Yes
0023	Bank of East Asia	-	-
0041	Great Eagle Holdings	-	-
0045	HK & Shanghai Hotels	-	-
0054	Hopewell Holdings	-	-
0069	Shangri-la Asia	-	-

[1] Source of information: ETNet, information posted as of 2 June 1999

0083	Sino Land	-	
0097	Henderson Investment	HK & China Gas (32.01%)	Yes
0101	Amoy Properties	-	
0142	First Pacific	-	
0267	Citic Pacific	CLP Holdings (20.30%) Cathay Pacific (25.4%)	No No
0270	Guangdong Investment	-	
0291	China Resources	-	
0293	Cathay Pacific Airways	-	
0363	Shanghai Industrial Oldings	-	
0511	Television Broadcast	-	
0941	China Telecom	HK Telecom (13.0%)	No
1038	Cheung Hong Infrastructure Holdings	-	-

Groups of Related Securities

1. Cheung Kong Holdings, Hutchison, Cheung Kong Infrastructure and Hong Kong Electric;

2. HSBC Holdings and Hang Seng Bank;

3. Hang Lung Development and Amoy Properties;

4. Henderson Land Development, Henderson Investment and Hong Kong & China Gas;

5. Swire Pacific A and Cathay Pacific; and

6. Wheelock and Co. Ltd. and Wharf Holdings.

Ends.

Annex C

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

Administration's Responses to Comments Made
By the Deputation of the Industry
At the Meeting on 1 June 1999

This short note summarises the Administration's responses to the comments raised by the representatives of the industry[1] on the Securities (Margin Financing)(Amendment) Bill 1999.

Pooling of Client Assets

2. The industry reiterated their view that pooling of client assets should be permissible under the Bill for the sake of market viability, which is in line with Administration's position. We believe that the introduction of the regulatory regime, under which securities margin financiers are subject to more stringent paid-up and liquid capital requirements, reporting and disclosure requirements as well as sole business restriction, would help ensure the capital adequacy of these companies and render better protection to the margin clients. On that basis and taking into account the market demand for the margin financing services, we believe it is appropriate to continue to permit pooling of client assets.

Concentration Risk Adjustment

3. It was commented that the concentration risk adjustment requirement should be relaxed to allow more flexibility for doing business. However, as the Administration has previously explained, we believe that the present proposal is necessary and appropriate to encourage securities margin financiers/securities dealers who engage in securities margin financing to diversify their client/collateral portfolio.

4. As regards client exposure, judging from the past experience of the Securities and Futures Commission ("SFC"), we believe that the present 10% threshold is appropriate to encourage diversification of client risks. It

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[1] Including representatives of the Hong Kong Stockbrokers Association. Hong Kong Securities Professional Association, Hong Kong Institute of Securities Dealers and Law Society.

would however be worth noting that SFC is empowered under the SFC Ordinance (Cap. 24) to waive or modify any requirements specified in the Financial Resources Rules upon the application of any person if it is considered that compliance with such requirement will be unduly burdensome for that person. In other words, a financier/dealer who only has ten margin clients as suggested in the hypothetical scenario may apply to SFC for a waiver of the client risk adjustment.

5. Concerning stock concentration risk adjustments, the present proposal has taken into account the comments received during the public consultation and has been relaxed to address the industry's concern. We believe that the revised proposal would allow adequate flexibility for the registrants and meanwhile, remain effective for confining the risk exposure on individual stocks.

Sole Business Requirement

6. As we have previously pointed out, securities dealers are free to engage in other non-dealing business under the current regulatory regime insofar as they do not breach the licensing and financial resources requirement. However, registered securities dealers who are corporate members of the Stock Exchange are also subject to the sole business requirement under the Exchange Rules (except activities which are normally ancillary to dealing in securities). Insofar as securities margin financiers are concerned, the Administration takes the view that a sole business requirement is essential in eliminating the undue exposure of the registrants to non-securities risks and enhancing proper regulation by SFC. We believe it is prudent to keep this rule as proposed.

Only Dealers Can Conduct Securities Margin Financing

7. Most of the existing margin finance companies are associated with registered securities dealers. Under the present Bill, these finance companies may register with SFC as a securities margin financier and continue to provide securities margin financing on a stand-alone basis or they may transfer their businesses back to the dealer entities. Whether or not they would choose to exist on a stand-alone basis is purely a commercial decision and as a matter of policy, the government does not believe it appropriate to confine the eligibility for conducting securities margin financing businesses to securities dealers and authorized financial institutions.

Exemption

8. It has been suggested that the exemption list should be placed under a Schedule which can be amended by the SFC subject to the negative vetting of the Legislative Council. The Administration has no objection to the approach as this would indeed provide more flexibility to SFC when administering the law. We will seek to move the types of activities which are clearly not intended for the present regime to the new Schedule. For other borderline cases, however, we see merit to continue to allow SFC to grant exemption to specific classes of persons by way of Commission rules, as provided in section 146(3) in the Bill. This is to prevent any possible regulatory loophole and exemption made under the section may be subject to terms and conditions as prescribed. Members may also wish to note that SFC will be empowered to waive or modify certain specific provisions on a case-by-case basis under the Bill upon application.

Financial Services Bureau
17 June 1999