CB(1)1599/98-99(01)

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

Administration's Response to the Submission of Mr. Leo Chiu

1. Alternative Liabilities Test

As Mr. Chiu has pointed out, the major risks of securities margin financing in present practice is the co-mingling of non-securities related business in the financier's business and this is exactly the reason why we believe the sole business requirement is essential. However, in light of the comments received from the Law Society, we have agreed that financiers should be allowed to engage in other businesses that are incidental to its normal course of business.. We will seek to amend the captioned Bill to give effect to this.

2. Securities Margin Financier's Representatives

We have explained in our earlier response to the Law Society's submission that third party arrangers do not fall within the definition of "securities margin financier", nor will it fall within that of "securities margin financier's representative". However, it is worth reiterating that those effecting the introduction may be required to be registered with the Securities and Futures Commission (SFC) as either a securities dealer or an investment adviser under the existing Securities Ordinance (Cap. 333).

Mr. Chiu has also suggested a relaxation of the definition of "securities margin financier's representatives". The definition in the Bill is essentially the same as that contained in the Securities Ordinance with respect to dealer's representatives. In our view, it is appropriate that the licensing regime should apply to those who directly participate in the provision of the services for which registration is required. We must also ensure that licensing obligations are not easily circumvented. We therefore believe that the current definition of "representative" should be retained.

3. Security Deposits with SFC

Section 121K is to allow for the deposit of security in lieu of insurance or the application of other compensation arrangements to be specified in Commission Rules. The section has an analogue under the Securities Ordinance, under which securities dealers are required to provide a deposit

with the SFC and details of how the deposit is to be used are also clearly provided. Similar provisions will be introduced by the SFC if the power under section 121K is exercised.

4. Right to be Heard

We agree that as a matter of procedural fairness, a registrant should be entitled to the right to be heard before a penalty of suspension is imposed. We are consulting the Law Draftsman as to how this could be incorporated into the Bill.

5. Misconduct

We believe "misconduct", for the purpose of the Bill, should be wide enough to cover all conduct that is "prejudicial to the interests of members of the investing public" and therefore do not propose any further change. Indeed, a similar provision already exists in the present Securities Ordinance and has not given rise to any particular problem so far. We also do not agree with the suggestion that the wide scope of the definition of "misconduct" will be tantamount to giving "unrestricted investigative powers" of the SFC. As a matter of fair administrative practice, the SFC must have proper grounds for its belief before it would exercise its powers under the law and any conduct of the SFC is subject to judicial review.

6. Section 33 of the SFC Ordinance

Under section 33 of the SFC Ordinance, even though a person under investigation is obliged to answer questions put to him by the investigator, there are safeguards and limitations as to how the information obtained may be used where a proper claim of privilege against self-incrimination is made.

We do not agree with Mr. Chiu's observations about the nature of offences under the securities law. Provisions such as section 33 of the SFC Ordinance are found in legislation in other jurisdictions and we consider them to be proper and appropriate and essential for the proper discharge of the statutory functions of the SFC as the market regulator.

7. Statement of Account

We agree that registered financiers and dealers should not be required to provide a statement of account solely for the purpose of indicating the daily

interest charges. We are now consulting the SFC as how this could be clarified in the Bill.

8. Rescission

It is our intention that the interests of a bona fide third party purchaser without notice of the relevant facts should be protected under section 121AF. We will further consult our legal adviser as to whether it is necessary and if so, how the provisions should be modified to put this beyond doubt.

9. Deposit of Trust Money

The four days period is indeed a grace period within which the securities margin financiers must deposit clients' trust money into the trust account. Similar provision applicable to securities dealers has also been given under the existing Securities Ordinance. From the experience of SFC, the position has been sufficiently clear to the practitioners and we do not think any changes are warranted.

10. Consequences of Non-approval

Mr. Chiu has rightly pointed out that following the refusal of its application as a registered securities margin financier, a financier will still be allowed to continue its business for 14 days or such longer time as specified by SFC. The purpose of this is to allow such financier to have adequate time to wind down its business without breaching the law. In any event, we do not think that the closing out of loan positions will amount to a breach of the legislation.

Administration's Response to the Submission of the Hong Kong Association of Banks (HKAB)

11. Purpose of Loans

As previously indicated, we are of the view that a financier, who is reckless as to the purpose of the loan, should be subject to the regulation to prevent possible circumvention. We will take advice on the need to amend the captioned Bill to make our intention clear.

12. Securities Collateral

Given the potential risk that may arise from pooling of clients' securities, the Administration believes that client's authority should be subject to annual renewal. It should however be noted that, as we have previously explained, the annual renewal requirement is already provided in the existing section 81 of the Securities Ordinance and has not posed any significant difficulties for the practitioners. We therefore do not see strong merit to remove the requirement.

The HKAB has also expressed its view that securities collateral should be permitted to be registered in the name of the lender or its nominee for the purpose of providing better protection to the lender. In this connection, Members may wish to note that in our previous response to the submission of the Law Society, we have agreed to expand the scope of sections 81A and 121AA to allow securities dealers and margin financiers to register the securities collateral in their own or their nominees' names. We have also indicated our view that securities interests of the lenders should be protected and they must be free to enforce security if their client default. We will give further consideration as to whether the current drafting of section 81A and 121AA should be modified.

13. Safe Custody

Under section 81(4) (as amended by the captioned Bill), a dealer must ensure that securities are not deposited, transferred, lent, pledged, repledged or otherwise dealt with except as provided by that subsection or as permitted by Commission Rules. The SFC will introduce a new piece of subsidiary legislation under this subsection to permit securities dealers, subject to putting in place adequate safeguards, to do what is permitted under section 81A(d) to (f). We believe that HKAB's concern will be addressed.

Administration's Response to the Further Submission of the Law Society

14. Principle for Granting Exemption

The main purpose of the present Bill is to provide better protection to investors engaged in securities margin financing and to ensure that the market is not exposed to excessive and undue risks arising from the activity. As a general principle, therefore, any exemption granted under

the Bill should be consistent with and will not undermine these policy objectives. In implementing the proposed regulatory regime, the SFC will in the interest of market certainty and transparency and as a matter of good regulatory practice, clearly explain to the industry and the market of how applications should be made and what information is required. In addition, SFC will also observe procedural fairness and notice of concerns and reasons will be given to the parties involved.

15. Areas of Exemption

As pointed out in our previous responses, we have agreed to put the types of activities which are clearly not intended to be covered by the present regime and therefore to be exempted from the registration regime, under a Schedule, as opposed to the present approach of listing them in section 121B. The Schedule can be amended by the SFC subject to the negative vetting of the Legislative Council. However, there may be situations where the experience in regulation may prove it justified to exempt cases in addition to the Schedule. We therefore see merit to continue to provide the flexibility to SFC to grant class exemption to specific types of persons by way of Commission rules, as provided for in section 146(3) in the Bill. Such exemptions may be subject to terms and conditions as prescribed by the SFC as deemed appropriate. SFC will also be empowered to waive or modify certain specific provisions on a case-by-case basis under the Bill upon application.

16. Exemption Suggested by the Law Society

Keeping the above general principles in mind, we have carefully considered the further suggestions made by the Law Society. In general, we are agreeable to extending the exemption list to include -

- Loans to a company with paid up share capital of $1 million or foreign currency equivalent and to a listed company or the subsidiary of a listed company;

- Loans to its directors or employees from a company to purchase securities in that company;

- Loans to registered securities margin financiers, authorised institutions under the Banking Ordinance and securities dealers;

- Loans to facilitate the acquisition of 5% or more of the issued share capital of a listed company;

- Loans to associated company; and

- Loans by individuals to companies in which they have substantial shareholdings of 10% or more and vice versa.

It should however be clarified that once a company is registered as a securities margin financier, all relevant activities carried on by it should be covered by the relevant requirements under the law.

For the remaining cases, we consider it more prudent to consider them individually and grant exemption by way of class exemption or on a case-by-case basis -

- Loans to professionals. Apart from the difficulty of how "professionals" should be defined, we are concerned of the possibility of circumvention.

- Loans to investment advisers and insurance companies. We do not believe that investment advisers and insurance companies will be affected in any way under the present Bill.

- Transactions of which the provision of financial accommodation is not the principal or dominant purpose. From its past experience, SFC is not aware of the practice of providing financial accommodation in the form of vendor financing or sales on deferred terms. In addition, it would be difficult to attempt to determine the principal or dominant purpose of a particular transaction.

- Loans to finance off-exchange transactions. The similar problems now encountered in unregulated securities margin financing activities will still prevail and therefore we believe off-exchange transactions should not be exempted from regulation.

17. Costs of Exemption

We concur with the view that we should try to keep costs to a minimum. This is precisely the reason for including an exemption list in the Bill itself and for giving a general class exemption power to the SFC. It is not our

general intention that the SFC should grant exemption to single loans and to the extent possible, the SFC will seek to do so by way of class exemption. Generally speaking, the SFC will expect the applicant to describe its nature of business in considerable detail and provide any other explanation necessary for it to assess whether such business should be regulated, on the basis of the general principles set out above.

Financial Services Bureau
25 June 1999