# 立法會
# *Legislative Council*

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**Paper for the House Committee meeting on**
**3 March 2000**

**Report of the Bills Committee on**
**Securities (Margin Financing) (Amendment) Bill 1999**

## Purpose

This paper reports on the deliberations of the Bills Committee on Securities (Margin Financing) (Amendment) Bill 1999 ("the Bill").

## Background

2. The growing trend of securities margin financing being provided through finance companies (or called money lender companies), the financing activities of which are largely unregulated, has caused considerable concern. The bull run in 1997 revealed that a substantial number of medium-sized local brokers had provided margin financing through finance companies which were thinly capitalised and failed to take prudent risk management measures. The absence of regulation of these finance companies has led to problems such as stocks and other securities of clients being used for securing bank loans to the lender, with some clients not knowing the risk associated with the pooling and repledging of their shares, or not properly informed of the terms of their margin agreement, etc. With the large number of investors aggrieved by the collapse of a few finance companies such as the C.A. Pacific Group, the need for the regulation of such companies have become more apparent.

3. The Administration established in December 1997 an inter-agency working group to study the issue of regulating securities margin financing activities carried out by unregulated finance companies. In May 1998, the Working Group put forward its recommendations for public consultation which confirmed the need for a regulatory regime. The regulatory regime proposed by the Working Group aims to increase protection for investors through prudential regulation of the securities margin finance operators while maintaining the latter's commercial viability to meet local market needs. The key features of the proposed regulatory regime include:

(a) registration under the Securities Ordinance (Cap. 333) ("SO");

(b) prudential rules on financial resources;

(c) enhanced protection for clients' assets; and

(d) standards for business practices.

4. The Bill seeks to address the features given in (a) and (c) above. According to the Administration, the strengthening of Financial Resources Rules will take place in due course after the Bill has passed into law, while the setting of standards of business practices will be done through a revised Code of Conduct to be introduced by the Securities and Futures Commission ("SFC") for securities margin financiers ("SMFs").

**The Bill**

5. The Bill seeks to introduce a new Part to SO for regulation of securities margin financing and to provide for matters relating to -

(a) registration requirements for persons applying to be registered as SMFs and SMF's representatives, and the revocation and suspension of such registration;

(b) the conduct of securities margin financing businesses by registered SMFs;

(c) rights conferred on clients of financiers not registered with SFC;

(d) the particulars to be included in the accounting records of financiers and requirements for keeping those records;

(e) the auditing requirements applicable to registered financiers;

(f) transitional arrangements; and

(g) consequential amendments to SO, SFCO, the Money Lenders Ordinance (Cap. 163) and other relevant Ordinances.

**The Bills Committee**

6. At the meeting of the House Committee on 16 April 1999, Members

decided to form a Bills Committee to study the Bill. Hon Ronald ARCULLI was elected Chairman of the Bills Committee. The membership list of the Bills Committee is at **Appendix I**.

7. The Bills Committee has held 21 meetings to examine the Bill. Apart from discussing the content of the Bill with the Administration, the Bills Committee also invited views from four major groups in the industry and other professional organizations, and received their oral representations at one of its meetings. A list of organizations which have given views on the Bill and/or the FRR is at **Appendix II**. The Bills Committee has also dedicated two of its meetings to the scrutiny of the proposed amendments to FRR.

**Deliberations of the Bills Committee**

8. Members of the Bills Committee generally are in support of bringing securities margin financing activities under the proposed regulatory regime. Members are aware of the concern of the deputations on the need to strike a balance between enhancing investors protection on the one hand and allowing commercial viability of securities margin financing business on the other. In the course of deliberation, the Bills Committee has considered in detail concerns raised by the deputations including:

(a) applications for exemption from registration as a SMF;

(b) the stringent sole-business requirement on SMFs;

(c) the regulation of the existing practice of "pooling" clients' assets;

(d) protection for SMFs in case of default of clients'; and

(e) the onerous accounting requirements.

A gist of the deliberations of the Bills Committee is given in the following paragraphs.

Exemption from regulatory measures under the Bill
(Clause 3, section 121B(2))

9. The Bills Committee notes that several kinds of business are exempted from registration, such as the provision of financial accommodation by registered dealers, mutual fund corporations, authorized financial institutions for the purposes respectively provided in the Bill. Members also note that exemptions for other kinds of activities would be dealt with on a case-by-case basis by SFC, which will have the power to grant class exemptions to specific

types of persons and waive or modify certain specific provisions of the Bill in their application to particular financiers.

10. The Bills Committee considers that the list of activities to be exempted from the proposed new part of the Bill should be exhaustive, so as to minimize the scope for SFC to deal with unusual or unpredictable cases. It is also envisaged that the proposed arrangement would add costs to operators since SFC would charge fees for considering applications for exemption. A more precise piece of legislation would facilitate market participants to conduct their business in a more proper manner. The Bills Committee notes the similar view from the Law Society of Hong Kong that the scope of the exemptions should be enlarged.

11. Members agree with the Administration that any exemption granted should be consistent with and will not undermine the policy objectives of providing better protection to investors engaged in securities margin financing and ensuring that the market is not exposed to excessive and undue risks arising from these activities. After detailed examination of the Bills Committee on the suggestions made by the Law Society of Hong Kong, the Bills Committee welcomes the Administration's decision to extend the scope of the exemptions to cover proper business activities of market participants. Nevertheless, the Administration maintains that SFC should retain the flexibility in granting exemption to specific classes of persons by way of Commission rules as there may be situations where the experience in regulation may prove it justified to exempt cases in addition to the Schedule. While SFC may waive or modify certain specific provisions on a case-by-case basis, it will not grant exemption for individual loans/transactions. The Administration however agrees to propose a Committee Stage Amendment (CSA) to clarify that while a company carrying on solely an exempted business would not be required to register as a SMF, its entire business portfolio including the exempted business would be subject to the regulatory regime and be covered by relevant requirements under the legislation once the company is registered as a SMF.

12. To allow for greater flexibility, the Administration concurs with the Bills Committee that the exempted list should be put under a new Schedule subject to the negative vetting of the Legislative Council ("LegCo").

<u>Certain unregistered persons to be permitted to carry on limited securities margin financing business</u>

13. The Administration has drawn the attention of the Bills Committee to the possibility that upon the enactment of the Bill, finance companies associated with securities dealer firms may transfer the existing well-secured margin loans back to the securities dealing entity leaving themselves with the under-secured ones. These finance companies will not engage in new securities margin financing except the recovery of outstanding margin loans and collection of interests accrued. The Administration has therefore proposed to add a new section 121BI to waive the registration requirement for such companies.

14. Members note that there is no monitoring mechanism in place to check on these companies under the proposal and therefore suggest to set up monitoring measures such as to specify a time limit for these companies to complete recovery of the loans, and to require these companies to provide periodic reports to SFC. The Administration considers that any such time limit would be impractical, arbitrary and may not satisfy the needs of individual companies. It also finds it unreasonable to require these companies to submit reports since they are not subject to the regulation of SFC. Imposing regulation on these companies will imply that SFC's power is being extended to investigate non-registered entities which may give rise to controversy.

15. The Bills Committee is aware that although these companies will not be subject to the regulatory regime for SMFs, their activities are regulated by other ordinances, such as the Money Lenders Ordinance. Under the new provision section 121BI, these companies are not permitted to provide new securities margin loans, extend margin loans, vary the terms of the outstanding loans and facilitate any further transactions for the clients. Irregularities of these companies could be detected when SFC exercises its power to investigate into securities dealer firms which usually have on-going relationship with these companies, as well as those companies suspected to have connection with breaches committed by registered persons. The Bills Committee eventually accepts the addition of the proposed new section 121BI.

16. Regarding the need to include the provision in the proposed schedule of exempted activities, the Administration has explained that the proposed section 121BI is only a transitional arrangement. It would not be appropriate to incorporate it in the schedule of exemption which is meant for on-going activities.

Registration of securities margin financiers

*Purpose of loans*

17. "Securities margin financing" in the Bill is defined as "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". Members are concerned about the extent to which lenders would need to make themselves aware of the purpose of any borrowings or other financial accommodation lest they fall under the definition and be required to register as SMFs. The Administration undertakes to amend the proposed section 121C(3) to the effect that if a person who provides financial accommodation has a reasonable belief that it is not to be used to facilitate acquisition or the continued holding of securities listed on a stock

exchange, the person does not contravene the provision requiring that a business of securities margin financing cannot be carried on except by a registered financier.

*Sole business requirement*

18. Under the proposed section 121E(1)(b), a registered SMF cannot carry on any business other than securities margin financing. The Bills Committee notes the concern of those in the trade about the impact of the sole business requirement on the business development of financiers. In this respect, the Administration has clarified that the requirement would not apply to existing registered securities dealers, who, apart from being allowed to conduct securities margin financing business under the Bill, are free to engage in other non-dealing business under the regulatory regime insofar as they do not breach the licensing and financial resource requirement. Registered securities dealers who are corporate members of the Stock Exchange are already subject to the sole business requirement under the Exchange Rules. The purpose of the sole business requirement for SMF is to eliminate undue exposure of the registrants to non-securities related risks and enhancing proper regulation by SFC.

19. To address the concern about the sole business requirement, the Administration agrees to amend the proposed section 121E(1)(b) to allow SMF the flexibility to engage in other businesses which are incidental to its normal course of business, e.g. trading in futures and options for hedging purpose. However, for the sake of eliminating undue exposure of the registrant to non-securities risks, other activities such as lending to clients for acquisition of futures and leveraged forex contracts will not be allowed.

*Suspension of registration*

20. Under the proposal, a financier or its representatives are regarded as unregistered when their registration is suspended. Members are of the view that a suspended financier or its representatives should not be prevented from engaging in activities which are necessary for the continuous survival of its business and for serving the interests of its existing clients, such as unwinding positions in loan portfolios.

21. According to the Administration, the suspension of registration only prohibits a financier or its representatives from providing new financial accommodation to clients. Activities to maintain business, such as effecting security for settlement of clients obligations and liabilities may continue. In response to the suggestion of the Bills Committee, the Administration agrees to add a new section 121WA to enable SFC to suspend the registration in respect of the whole or the part of the securities margin financing business and to make an order specifying the manner in which an existing business can continue to be carried on and make it an offence for non-compliance with the order.

22. To ensure procedural fairness to registrants, members suggest that SFC should provide reasons for its decision to impose any condition and restriction

in granting application for registration if so requested by the registered financier or registered financier's representative when it is heard under section 121J(3). The Administration agrees to the suggestion and will propose a CSA accordingly. Similarly, the Administration will also amend the Bill requiring SFC to provide reasons on refusal of an application made under section 121BG for waiver or modification of requirements of a prescribed provision for carrying on securities margin financing business.

Conduct of securities margin financing businesses

*Pooling of clients' assets*

23. Under the Bill, securities dealers and SMFs, with the written authority of the clients, may deposit clients' securities with an authorized financial institution as collateral for financial accommodation provided to the dealer/financier. "Pooling" of clients' assets by financiers is the existing practice. The Administration is of the view that this practice is crucial for securities margin financing business to remain commercially viable. Subject to the requirements for SMFs to meet the minimum prudential standards set under the proposed regulatory regime and insofar as clients are adequately informed of the risks involved, the practice of pooling of clients' assets should be allowed to continue.

24. During the course of deliberation, some members expressed concern about the safeguards to protect the interest of the clients. They recognized that disallowing pooling might create an adverse impact on the commercial viability of securities margin financing business, and proposed to impose a limit on the amount of credit facilities that can be obtained upon the security of margin clients' securities collateral by a dealer or a SMF. Under their proposed condition, credit facilities obtained by pledging clients' securities collateral by a dealer or a SMF should only be available for financing the corresponding clients' margin loans. The amount which can be drawn down on the facilities lines should not exceed at any time the total gross margin loans due from clients.

25. In view of the possible impact of the proposal of a credit limit might have on the industry, the Bills Committee conducted a second round of consultation to gauge the views of the organizations which had previously presented views to the Bills Committee on the Bill. After examining the views received, including those from the Administration, the Bills Committee concludes that on balancing the level of protection provided to investors and the burden that would be imposed on the dealers and financiers, the amount which can be drawn down on the facility lines by dealers and financiers should not exceed at any time 120% of the aggregate amount of clients' outstanding loans. The percentage was proposed by the Administration after taking into account

the practical operation of the securities business. A stringent requirement will be difficult for SMFs to administer and will lead to increased compliance costs. Members note that the proposed 20% buffer limit is acceptable to the industry. The Bills Committee also considers it appropriate to incorporate the proposed requirement in the Code of Conduct for SMFs to be issued by SFC. No amendment to the Bill in this regard is therefore necessary.

*Securities collateral*

26. The proposed section 121AA restricts the disposition of securities collateral by requiring SMFs to deposit collateral in safe custody. Sections 121AA(4)(b) and (c) require the financier to obtain client's written authority before it can dispose of the securities collateral to meet the client's obligation to the financier. Such authority is however subject to annual renewal. Members are concerned that the interest of SMFs will not be adequately protected since they may not be able to enforce security when their clients default. The Administration clarifies that under the provision in section 121AA(8), a lawful claim or lien in respect of securities collateral would not be defeated. It also undertakes to amend section 121AA to clarify further the right of SMF to dispose of the securities collateral in case of client default. In the proposed CSA to section 121AA(1), financiers and dealers will be allowed to register clients' securities collateral in their names or their nominees' names. Section 121AA will also be amended to the effect that with the written authority of the client, a financier may dispose of the securities collateral in case the client defaults, and such authority will not be subject to the annual renewal requirement.

*Statements of accounts*

27. Under the proposed section 121Y, a registered financier is required to provide two types of statement of accounts to clients. The first type is required to be provided to a client each time when there is a transaction in the account of the client. The second type is a detailed monthly statement to be provided to a client whether or not there have been any transactions during the month. The proposed section 121Z requires that record of the first type of statements should be kept for two years while that of the second type should be kept for six years. Since the information contained in the first type of statements should have been reflected in the second type of statements, the Administration agrees to members' suggestion to shorten the record keeping period of the first type of statements to three months.

28. In order to address the concern about onerous account requirement, the Administration agrees that a financier should not be required to provide a statement of account solely for the purpose of indicating interest charged by the financier. Appropriate amendments will be made to sections 121Y(1) and

121Y(4)(b) to that effect.

29. As regards the inconsistency of the requirement to keep record of the monthly statement for six years with the record keeping requirement of seven years under the Inland Revenue Ordinance (Cap.112), the Administration agrees to redress the anomaly, which also appears elsewhere in the existing SO, under the future composite Securities and Futures Bill.

Agreements with unregistered financiers

30. The Bills Committee supports the policy intent of the Division 4 of the Bill to render better protection to the clients of unregistered SMFs. However, members in general consider that the policy intent cannot be achieved under the proposed provision whereby a client is provided with the right to rescind his contract with the unregistered SMF, unless the rescission of the contract would prejudice the rights of bona fide third parties. The interests of the bone fide third party, including its right to apply to court for making consequential orders regarding the rescinded contract, have not been addressed in the Division.

31. To address members' concern, the Administration has re-drafted the whole Division 4 to provide that an agreement made by an unregistered SFC is unenforceable against its client, unless the court considers that it is just and equitable for the agreement to be enforced, or/and for all or part of the money paid or property transferred under the agreement to be retained. For unenforceable agreements, a client can recover any money paid and compensation for any loss. The Administration has agreed to move CSAs to the above effect. The rights of third parties, however, are not addressed in new draft.

32. Discussion on the rescission of contracts with unregistered financiers also brings out the concern about the interests of the investing public being jeopardized by activities of unregistered financiers. The Bills Committee notes that SFC has powers under the existing laws to take investigatory actions against suspected unregistered dealing and to seek injunction orders from court if circumstances warrant. Regarding the possibility of lowering the threshold for SFC to seek injunctions or the appointment of receivers over the assets of unregistered persons for greater investor protection, the Administration explains that the issue cannot be considered in isolation of other securities related regulation and would therefore be considered under the future composite Securities and Futures Bill.

Penalty levels

33. It has come to members' attention that some penalty levels are too low to have adequate deterring effect and that the relative severity of certain penalties for some offences seems inappropriate. For example, subsection 121AB(6),

which relates to the offence of a financier failing to notify SFC of any non-compliance with FRR and still carrying on business, carries lighter penalties than subsection (7) which relates to failure in producing required accounting records to SFC for the purpose of ascertaining compliance with FRR. At the Bills Committee's request, the Administration has conducted a review on all penalty levels for different offences under the Bill and proposes a number of CSAs to adjust the penalty levels to ensure that they have sufficient deterrent effect against breaches of the legislation. The result of the review and the Administration's proposed CSAs is set out at **Appendix III**.

Processing time of application for registration as a SMF

34. Members are concerned about the lack of a time limit for SFC to approve applications for registration as SMFs, because applicants may be allowed to carry on business pending registration as provided under section 121BH. The Secretary for Financial Services has agreed to consider the Bills Committee's suggestion of giving the assurance at the resumption of Second Reading debate that such applications would be processed by SFC within a reasonable time limit, notwithstanding the possibility of a longer processing time for some exceptional cases.

Future vetting of Commission rules

35. In the consequential amendment to SO where SFC is empowered to make rules for the regulation of SMFs or their representatives under section 146, members request that the rules, being subsidiary legislation under SO, be subject to "positive vetting" by LegCo. This is proposed in view of the need to have a longer scrutiny period due to the complexity of the rules and their significant impact on the market. The Administration however is of the view that the current regime of negative vetting by LegCo has been working well and it sees no strong reasons to change the present arrangement.

Financial Resources Rules (FRR)

36. The Bills Committee notes that following the amendments to the SO under the Bill, the Administration will introduce revised FRR to implement a key feature of the proposed regulatory regime namely, prudential rules on financial resources mentioned in paragraph 3 above. The Bills Committee has therefore invited the Administration to brief members on the revised FRR.

37. Members are aware that the FRR aims to provide minimum prudential standards on the financial resources of market intermediaries. The proposed revised FRR will also apply to SMFs and be strengthened to address risks arising from securities margin financing. Members also note that deputations have grave concerns about the proposed revised FRR, particularly in the

following aspects:

(a) the concentration risk adjustment requirements;

(b) the calculation of SMFs' liquid assets;

(c) monitoring of compliance with FRR requirements;

(d) timely amendments to haircut ratios and concentration risk thresholds set under FRR to keep pace with rapid changes in the market; and

(e) grace period for complying with the new FRR.

38. The Bills Committee has examined the policy concern of the revised FRR and members have put forward their views for the consideration of the Administration, in particular on the proposal regarding concentrated house position risk adjustments. It is noted that the new FRR will discourage the concentration of specific stocks collateral in SMF's loan portfolio as the concentration risk adjustment will start to apply when market value of individual positions or a group of related securities positions amount to 10% to 20% of the market value of the relevant securities received from all margin clients. Members are concerned that the new FRR will in fact encourage SMF to diversify their loan portfolios by accepting the risker second and third line stocks as collateral in order to avoid concentration risk adjustment under FRR. The Administration has undertaken to address members' concern upon the introduction of FRR.

Code of Conduct

39. The Bills Committee is aware that SFC will revise the Code of Conduct to lay out standards of business practices for SMFs. Members note that industry groups support in principle the Administration's proposal to put margin call policies and cash flow management status in the Code of Conduct.

**Committee Stage Amendments**

40. The CSAs to be proposed by the Administration are at **Appendix IV**. Members are invited to note that there may be some textural adjustments before the final version of the CSAs is proposed. The Bills Committee has not proposed any CSAs.

**Recommendation**

41. The Bills Committee recommends that, subject to the CSAs to be moved by the Administration, the Second Reading debate on the Bill be resumed on 15 March 2000.

**Advice Sought**

42. Members are invited to note the deliberations of the Bills Committee and support the recommendation in paragraph 41 above.

Prepared by
Council Business Division 1
Legislative Council Secretariat
1 March 2000

**Appendix I**

**Legislative Council**
**Bills Committee on**
**Securities (Margin Financing) (Amendment) Bill 1999**

**Membership List**
**(**as at 29 April 1999)

Hon Ronald ARCULLI, JP (Chairman)
Hon Albert HO Chun-yan
Hon Bernard CHAN
Hon SIN Chung-kai
Hon Jasper TSANG Yok-sing, JP
Hon FUNG Chi-kin

Total: 6 Members

**Appendix II**

## Organizations which have given views on the Bill and/or the Financial Resources Rules

1. Chiu & Partners Solicitors
2. Hong Kong Securities Professionals Association;
3. Hong Kong Stockbrokers Association Limited;
4. The Hong Kong Association of Banks;
5. The Institute of Securities Dealers Limited; and
6. The Law Society of Hong Kong.

**Appendix III**

**Review on the Penalty Levels of the Bill**

| Section | Offence | Penalty level | | Justifications |
|---|---|---|---|---|
| | | **Original proposal** | **CSAs to be moved by the Administration** | |
| 121C(2) | Acting or holding out as a securities margin financier without registration | Indictment: $200,000 and imprisonment for 2 years<br><br>Summary: Level 5 (i.e. $50,000) and imprisonment for 6 months | Indictment: $1,000,000 and imprisonment for 5 years<br><br>Summary: Level 6 (i.e. $100,000) and imprisonment for 6 months | To increase deterrence and to be in line with the penalty levels provided for in the Banking Ordinance (Cap. 155) |
| 121F(4) | False representation for the purpose of obtaining the certificate of registration | Indictment: Imprisonment for 5 years | Indictment: $1,000,000 and imprisonment for 5 years<br><br>Summary: Level 6 (i.e. $100,000) and imprisonment for 6 months | To be in line with the penalty level for section 121C(2) |
| 121AA(7), 81(6), 81A(8) | Disposition of clients' securities without clients' authorization | Indictment: $200,000<br><br>Summary: Level 5 (i.e. $50,000) | Indictment: $200,000 and imprisonment for 2 years<br><br>Summary: Level 6 (i.e. $100,000) | To increase deterrence |

| Section | Offence | Penalty level | | Justifications |
|---|---|---|---|---|
| | | **Original proposal** | **CSAs to be moved by the Administration** | |
| 121AB(6) | Failure to notify SFC of non-compliance of the Financial Resources Rules | Level 4 (i.e. $25,000) (a fine of $250 per day for continuing offence) | Level 6 (i.e. $100,000) (a fine of $1,000 per day for continuing offence) | To increase deterrence |
| 121AK(4) | Failure to lodge auditor's report/annual financial statement before a specified time | Level 2 (i.e. $5,000) | Level 3 (i.e. $10,000) | To increase deterrence |
| 121AS(1) | Unlawful disposition of money deposited in trust account | Level 3 (i.e. $10,000) | Level 5 (i.e. $50,000) | To increase deterrence |
| 121BE | Destroying, concealing or altering of records, or send records or other property outside Hong Kong | Level 5 (i.e. $50,000) | Level 6 (i.e. $100,000) | To increase deterrence |
| 121BF | Obstructing the conduct of audit | Level 5 (i.e. $50,000) | Level 6 (i.e. $100,000) | To increase deterrence |

| Section | Offence | Penalty level | | Justifications |
|---|---|---|---|---|
| | | **Original proposal** | **CSAs to be moved by the Administration** | |
| 121BH(4) | Failure to comply with the order made by SFC in relation to the application of registration by existing financiers during the transition period | Level 6 (i.e. $100,000) | Indictment: $1,000,000 and imprisonment for 5 years<br><br>Summary: Level 6 (i.e. $100,000) and imprisonment for 6 months | To match the penalty for contravention of section 121C(2) for conduct of unregistered securities margin financiers |

Legislative Council Secretariat
1 March 2000