



Workshops on New Financial Resources Rules Introduction

Yvonne Mok

Associate Director of Intermediaries Supervision



Financial Resources Rules

- ◆ Liquid capital requirement
- ◆ Paid up share capital requirement
- ◆ Transitional arrangements
- ◆ Notification/reporting requirements
- ◆ Consequences of breaching the FRR
- ◆ Modification powers under s134, SFO
- ◆ Working Group on Review of Financial Regulatory Framework for intermediaries



Liquid capital requirement

- ◆ Application of one uniform risk-based methodology to all licensed corporations in support of the new single licensing regime.
- ◆ Methodology, which marries capital adequacy with liquidity, is similar to net capital rules in many other overseas jurisdictions.

Liquid capital requirement

- ◆ Liquid Assets less Ranking Liabilities must equal or exceed Required Liquid Capital at all times.
- ◆ The objective is to ensure adequate readily realizable assets to pay all liabilities with a safety buffer at any one time.



Accounting Treatment

- To adopt GAAPs
- Trade date basis
- No set-off
- Substance over form
- Need to recognise counterparty risk arising from back-to-back transaction
- State at market value and apply haircut deduction to investment/ trading positions

Liquid Assets

- ◆ Only prescribed assets can be included in liquid assets, value calculated in accordance with FRR.
- ◆ All other assets (such as fixed assets, unlisted securities, junk bonds and inter-company receivables) must be excluded in full.
- ◆ The ultimate test on amounts receivable is how the firm can recover its losses in the case of default.



Ranking Liabilities

- ◆ Ranking liabilities all on-balance sheet liabilities* + financial adjustments
- ◆ Financial adjustments include provisions made for off-balance sheet exposures or any guarantee etc. provided

* *these include redeemable shares which have not been approved, but exclude approved subordinated loans*



Required Liquid Capital

- ◆ Higher of a fixed floor requirement and a variable parameter
- ◆ Fixed floor requirement, being the single highest floor requirement and not an aggregate
- ◆ Variable parameter being $5\% \times$ “adjusted liabilities” as at computation date



Required Liquid Capital

- ◆ Underlying principle is that a firm must maintain higher regulatory capital where the regulated activity it conducts carries higher business risk and where it holds client assets.

- ◆ Examples

– Dealing in securities (RA1)	\$3M
– Dealing in futures (RA2)	\$3M
– Asset management/advisers (RA4,5,6,9)	
• Subject to specified licensing condition	\$100k
• Not subject to specified licensing condition	\$3M



Specified Licensing Condition

- ◆ The licensed corporation **shall not hold client assets**.
- ◆ Many existing advisers are already subject to similarly-worded conditions.
- ◆ These are acceptable on the premise that the SFC considers the word “handle” or “control” has the same meaning as “hold” in Schedule 1, SFO and firms should reassess ability to comply with the licensing condition with this new interpretation.
- ◆ Firms not currently subject to similar conditions have been invited to inform the Licensing Dept.

“Hold”

means, in relation to any property, includes-

- (a) Possession of the property;
- (b) Being registered or otherwise recorded, as having title to or being entitled to receive the property, in any register or other record (however compiled or stored) which is established or created for the purpose of identifying persons having title to or being entitled to receive any property;

“Hold” (Cont’d)

- (c) In the case of a person carrying on business, the person being in a position to transfer the property to himself or otherwise receive the benefit of the property-
- (i) where another person has a legal or equitable interest in the property;
 - (ii) where there is a connection between the property and the business which is carried on by the person; and
 - (iii) regardless of whether it would be lawful or unlawful for the person to transfer the property to himself or otherwise receive the benefit of the property**



Paid Up Share Capital

- ◆ This essentially serves as an entry requirement only.
- ◆ Term not defined in the FRR; to assume its generic meaning
- ◆ Examples:
 - Dealing in securities (RA1) \$5M
 - Dealing in futures (RA2) \$5M
 - Asset management/advisers (RA4,5,6,9)
 - Subject to specified licensing condition N/A
 - Not subject to specified licensing condition \$5M



Transitional Arrangements

- ◆ Six months' transitional period for exempt persons (will be deemed licensed corporations from 1.4.03) and existing advisers.
- ◆ During this time, there is no need to comply with liquid capital requirement or paid in share capital requirement, file returns, notify the Commission, except that existing advisers must
 - comply with the \$500k net tangible asset requirement; and
 - notify the Commission of non-compliance of this requirement



Notification/Reporting Requirements

- ◆ Licensed corporations must
 - notify the Commission in the case of inability to comply with the FRR or inability to ascertain compliance (s146, SFO)
 - notify the Commission upon occurrence of certain events (ss54 and 55)
 - lodge regular FRR returns (s56)
 - provide information to SFC upon request (s57)



Notification requirements under the SFO

- ◆ Licensed corporation must report in writing any inability to comply, or to ascertain compliance, with
 - the “specified amounts requirements”, i.e. the liquid capital and paid up share capital requirements (see s146(1) of SFO):
as soon as reasonably practicable
 - any other requirements within the FRR:
within one business day



Other notification requirements in FRR

- ◆ See section 55, FRR
- ◆ To notify in writing within one business day
- ◆ Examples
 - Liquid capital falls below 120% of the required liquid capital
 - Liquid capital falls below 50% of the liquid capital stated in the last FRR return
 - Information in previous FRR returns has become misleading
 - Aggregate of bank loans etc exceeds aggregate of credit limits
 - Unable to meet bank calls for 3 consecutive days
 - Lenders have informed intention to effect forced liquidation.



Form of notice

- ◆ Must include full details of
 - the matter and the reason therefor;
 - any steps, it is taking, has taken or proposes to take to redress the non-compliance or inability.
- ◆ SFC may then request any additional information and document.



In the case of non-compliance

- ◆ Under s146, SFO, besides notification, a licensed corporation that cannot comply with “specified amount requirements” or ascertain compliance must immediately cease carrying out any regulated activities, otherwise than as permitted by the Commission, subject to conditions (if any).
- ◆ Also, where the Commission reasonably believes that is the case, it may suspend the regulated activity or permit it to carry out such regulated activity, subject to conditions (if any).
- ◆ The Commission must give the licensed corporation a reasonable opportunity of being heard.

Penalty

- ◆ “specified amounts requirements”, any failure to notify and cease business is an offence
 - On conviction on indictment to a fine of \$1M and 2 years’ imprisonment + in case of a continuing offence, a further fine of \$100,000 per day.
 - On summary conviction to a fine at level 6 (\$50k to \$100k) and 6 months’ imprisonment + in case of a continuing offence, a further fine of \$10,000 per day.
- ◆ other requirements
 - On conviction on indictment to a fine of \$200k and 1 year’s imprisonment.
 - On summary conviction to a fine at level 5 (\$25k to \$50k) and 6 months’ imprisonment



Modification powers under s134, SFO

- ◆ Given the one-size-fits-all approach, some FRR requirements may be unduly burdensome for licensed corporations in particular circumstances.
- ◆ Upon application, SFC may grant modification/waiver provided that it is satisfied that to do so will not prejudice the interest of the investing public.