



# Securities & Futures Commission

## **New Requirements to Address Risks Arising from Securities Margin Financing**

Intermediaries Supervision

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# Background

- **Objectives:**
  - A balanced package of measures that would help protect the investing public, while keeping the impact on the industry to a minimum.
  - Provide a stronger foundation for the long-term development of the industry.
  - Strengthen Hong Kong's reputation as an international financial centre

# Background

- **The measures seek to:**
  - (a) introduce limits on repledging and make some moderate change to selected FRR haircut percentages.
  - (b) improve transparency by requiring SMF providers that repledge clients' collateral to provide their margin clients with more information and better disclosure about the risks of pooling and repledging; and
  - (c) provide some relaxation on certain requirements currently imposed on firms.

# Background

- On 28 September 2004, the SFC published the “Consultation Paper on the Proposed Measures to Address Risks Arising from Securities Margin Financing” to consult the public on certain proposed measures.
- A total of 24 submissions were received.
- Numerous discussions had been held with industry participants and other interested parties.

# Background

- The following Amendment Rules and amendments to the Code of Conduct were gazetted on 19 May 2006 (the Legislative Council completed its negative vetting on 12 July 2006): -
  - ✓ Securities and Futures (Financial Resources) (Amendment) Rules 2006
  - ✓ Securities and Futures (Client Securities) (Amendment) Rules 2006
  - ✓ Securities and Futures (Contract Notes, Statements of Account and Receipts) (Amendment) Rules 2006
  - ✓ Amendments to the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission

# Background

- The Gazette is available at the Government Publications Centre, and accessible on the website of the Government Logistics Department.
- The three sets of Amendment Rules are also accessible via the SFC website under “Legislation and Regulatory Handbook” – “Legislation” – “Legislation Amendments”.
- The amendments to the Code of Conduct is accessible on the SFC website under “Legislation and Regulatory Handbook” – “Regulatory Handbook” – “Code, Guidelines and Circulars”.

# Final measures

- **Two core measures:**
  1. Limit on repledging of client collateral
  2. Adjustment of FRR haircut percentages
- **Supplementary measures:**
  1. Notification requirement to the SFC
  2. Requirements on disclosure to clients
- **Relaxations of the FRR**

# Limit on repledging of client collateral

- Restricts the amount of clients' collateral that can be repledged by a firm for the purpose of securing bank facilities based on the amount of total margin loans outstanding at the previous day end.
- Irrespective of whether or not the firm utilizes its banking facilities which are secured by repledging clients' collateral.
- A higher level of repledging limit of **180%** will become effective on 1 October 2006. After a period of 12 months (i.e. 1 October 2007), the repledging limit will be set at **140%**.

## Illustrative examples of how the repledging limit operates

The following examples demonstrate how the repledging limit operates under different scenarios.

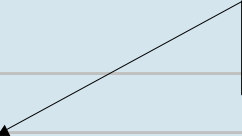
Assume the percentage of re-pledging limit is set at 140% in all the examples.

## Example 1

Aggregate market value of repledged client collateral does not exceed repledging limit

|   |     | <u>End of Day One</u> |  |  |
|---|-----|-----------------------|--|--|
|   |     | HK\$' million         |  |  |
| Aggregate margin loans outstanding (S/D)  |     | 100                   |  |  |
| Repledging limit in Value   | (A) | <u>140</u>            |  |  |
| Aggregate market value of repledged client collateral   | (B) | <u>139</u>            |  |  |
| As (B) < (A), the firm is within the repledging limit. No action will be required on Day Two. |     |                       |  |  |

**\$100 million x 140%**



## Example 2

# Aggregate market value of repledged client collateral exceeds the repledging limit

|   |     | <u>End of Day One</u> | <u>End of Day Two</u> |  |
|---|-----|-----------------------|-----------------------|--|
|   |     | HK\$' million         | HK\$'million          |  |
| Aggregate margin loans outstanding (S/D)              |     | 100                   |                       | \$100 million x 140%   |
| Repledging limit in Value                             | (A) | 140                   |                       | "Aggregate historical value" of repledged client collateral does not exceed "Repledging limit in value" of Day One |
| Aggregate market value of repledged client collateral | (B) | 149                   | = or < 140            |  |

As (B) > (A) by \$9 million, the firm is required to withdraw repledged client collateral from its lending bank(s) by the end of Day Two.

The amount of collateral to be withdrawn shall be such that the **"Aggregate historical value" of the client collateral repledged as at the end of Day Two** does not exceed the "Repledging Limit in Value" of Day One (i.e. \$140 million).

"Aggregate historical value" of client collateral repledged as at the end of Day Two shall be calculated at the market prices of those shares as at the end of Day One.



# Adjustment of FRR haircut percentages

- 100% haircut for warrants (whether held as clients' collateral or house investments)
  - 60% haircut for non-index constituent stocks\* (only applies to securities collateral provided by margin clients of firms that re-pledge client collateral)
- \* Stocks other than constituents of the Hang Seng Composite Index or the MSCI Hong Kong and China indices.

# Adjustment of FRR haircut percentages

|   | Margin Financing |                | Other purposes |
|---|------------------|----------------|----------------|
|   | Repledging       | Non-repledging |                |
| Hang Seng Index constituents            | 15%              | 15%            | 15%            |
| Hang Seng Hong Kong MidCap constituents | 20%              | 20%            | 20%            |
| MSCI HK & China constituents            | 30%              | 30%            | 30%            |
| Other HSCI constituents                 | 30%              | 30%            | 30%            |
| Non-index constituents                  | 60%              | 30%            | 30%            |
| Illiquid collateral                     | 80%              | 80%            | N.A.           |
| Warrants                                | 100%             | 100%           | 100%           |

# Notification requirement to the SFC

- Notify the SFC when the firm has used 80% or more of the firm's total credit limit with banks for a continuous period of 2 weeks.
- This requirement applies only to firms that have repledged clients' collateral.

# Requirements on disclosure to clients

- Disclose to clients whether the firm has repledged clients' collateral upon opening of new margin accounts.
- Inform all its existing margin clients as soon as practicable if the firm changes its status from non-repledging to repledging.
- Include a risk disclosure statement about pooling risk upon each and every annual renewal of the client authority to repledge clients' collateral.
- Disclose to the margin clients in the monthly client statements whether the client authority to repledge clients' collateral is still valid and whether the firm has repledged clients' collateral.

# Relaxations of the FRR

- Abolition of CDF.
- Abolition of the ad hoc notification requirement on the amount of concentrated margin client adjustment.
- Gearing adjustment relaxed to 80% from 65% once the repledging limit is fixed at 140%.

# Summary of measures

|  | <b><u>Firms that conduct SMF but do not repledge clients' collateral</u></b> | <b><u>Firms that repledge clients' collateral to banks</u></b>  | <b><u>Firms that do not conduct SMF</u></b> |
|--|--|---|---|
| Repledging limit                             | - N/A  | - 180% (commencing 1 October 2006 for a period of 12 months)<br>- 140% (1 October 2007)                             | - N/A                                       |
| Revised haircut percentage                   | - 100% haircut for warrant   | - 100% haircut for warrant<br>- 60% haircut for non-index constituent stocks (for margin financing only)            | - 100% haircut for warrant                  |
| Notification to SFC on bank line utilisation | - N/A  | - Notify SFC when 80% or more of the total credit limit with banks has been used for a continuous period of 2 weeks | - N/A                                       |

## Summary of measures (cont'd)

|                       | <u>Firms that conduct SMF but do not repledge clients' collateral</u> | <u>Firms that repledge clients' collateral to banks</u>   | <u>Firms that do not conduct SMF</u> |
|-----------------------|---|---|--------------------------------------|
| Disclosure to clients | - N/A   | <ul style="list-style-type: none"> <li>- Disclose to clients whether the firm has repledged clients' collateral upon opening of new margin accounts.</li> <li>- Inform all its existing margin clients as soon as practicable if the firm changes its status from non-repledging to repledging.</li> <li>- Include a risk disclosure statement about pooling risk upon each and every annual renewal of the client authority to repledge clients' collateral.</li> <li>- Disclose to the margin clients in the monthly client statements whether the client authority to repledge clients' collateral is still valid and whether the firm has repledged clients' collateral.</li> </ul> | - N/A                                |

## Summary of measures (cont'd)

|                | <b><u>Firms that conduct SMF but do not repledge clients' collateral</u></b>   | <b><u>Firms that repledge clients' collateral to banks</u></b>   | <b><u>Firms that do not conduct SMF</u></b>  |
|----------------|--|--|--|
| FRR relaxation | <ul style="list-style-type: none"> <li>- Abolition of CDF</li> <li>- Abolition of ad hoc notification on concentrated margin client adjustment</li> <li>- 65% gearing adjustment does not apply</li> </ul> | <ul style="list-style-type: none"> <li>- Abolition of CDF</li> <li>- Abolition of ad hoc notification on concentrated margin client adjustment</li> <li>- Gearing adjustment will be relaxed to 80% from 65% once the repledging limit is fixed at 140% (i.e. 1 October 2007)</li> </ul> | <ul style="list-style-type: none"> <li>- CDF does not apply</li> <li>- Ad hoc notification on concentrated margin client adjustment does not apply</li> <li>- 65% gearing adjustment does not apply</li> </ul> |

# Effective date & transitional period

| Proposed measures  | Existing licensed corporations  | Firms licensed on or after 1 October 2006              |
|--|---|--|
| Repledging limit   | 180% (commencing 1 October 2006 for a period of 12 months)<br><br>140% (with effect from 1 October 2007)  | 140% (with effect from 1 October 2006)                 |
| Revised haircut percentage<br><br>Requirement on notification to SFC<br><br>Requirements on disclosure to clients<br><br>Abolition of CDF & ad hoc notification on concentrated margin client adjustment | 1 October 2006  | 1 October 2006   |
| Gearing adjustment   | Existing requirement (65%) continues to apply until and including 30 September 2007<br><br>80% gearing adjustment with effect from 1 October 2007 | 80% gearing adjustment with effect from 1 October 2006 |

# Q & A