



SECURITIES AND  
FUTURES COMMISSION  
證券及期貨事務監察委員會

## **Consultation Conclusions on the Proposed Amendments to the Financial Resources Rules made under section 28 of the Securities and Futures Commission Ordinance (Cap. 24)**

**根據《證券及期貨事務監察委員會條例》  
(第 24 章) 第 28 條訂立的  
《財政資源規則》的建議修訂的  
諮詢總結**

Hong Kong  
May 2002

香港  
2002 年 5 月

## **INTRODUCTION**

1. On 4 March 2002, the Securities and Futures Commission (“SFC”) released a Consultation Document (the “Consultation Document”) on the proposed amendments (“Proposed Amendments”) to the Financial Resources Rules made under section 28 of the Securities and Futures Commission Ordinance (Cap. 24) (“FRR”).
2. The Proposed Amendments require brokers providing securities margin financing and securities margin financiers:
  - (a) to apply a discount rate of 90% to collateral for margin loans that, because of its size compared to average monthly turnover and market capitalization, may be difficult to liquidate quickly (referred to in the Consultation Document and this Consultation Conclusion Report as the “illiquid collateral haircut”); and
  - (b) where a firm’s total borrowings, which are secured by repledging margin clients’ securities, exceed 50% (referred to in the Consultation Document as the “firm borrowings to margin loan ratio trigger”) of total amounts lent to its margin clients, the amount that exceeds 50% will be included in the firm’s ranking liabilities (referred to in this Consultation Conclusion Report as the “gearing adjustment”).
3. The consultation closed on 26 March 2002.
4. The Proposed Amendments, as modified after market consultation, have been adopted by the SFC and effected in the Amendment Rules, which are attached as Appendix 1.
5. The purpose of this report is to provide interested persons with an analysis of the main comments raised during the consultation process and the rationale for the SFC’s conclusions. This report should be read in conjunction with the Consultation Document, the Amendment Rules and the summary of comments (the “Summary of Comments”) received on the Proposed Amendments, which are attached as Appendix 2.

## **PUBLIC CONSULTATION**

### **A. Background**

6. Hong Kong currently has 8 securities margin financiers and 258 securities dealers that conduct securities margin financing. In the competition for business, the SFC has observed a tendency among some firms for more aggressive lending practices, even though the size of the market-wide margin loans has declined.
7. The SFC has reviewed the business practices of the firms and has identified two practices that are considered particularly risky and imprudent:

- (a) accepting as collateral for margin loans a large quantity of stocks that may be difficult to liquidate quickly; and
  - (b) pooling securities belonging to margin clients, including “non-borrowing or low-borrowing” margin clients (i.e., those clients who borrow very little or not at all, but have a relatively large amount of securities in their margin accounts), and repledging the more liquid of such securities to banks in order to obtain bank loans. These borrowed funds are then used by the firms to finance their business operations and loans to other margin clients against collateral that may not be acceptable as collateral to banks.
8. The Proposed Amendments were formulated with a view to minimize the risks posed to a firm’s clients as a result of the firm’s own aggressive lending and funding practices. This type of risk should not be borne by the firm’s clients, especially those non-borrowing or low-borrowing margin clients with securities held by the firm and possibly repledged by the firm to a bank. Instead, the firm should be using its own capital as a buffer against this risk to minimize the exposure of its non-borrowing or low-borrowing margin clients and to enhance the firm's financial soundness.
9. The Proposed Amendments sought to enhance a firm’s capital buffer by two means:
- (a) by introducing the illiquid collateral haircut, a firm that aggressively grants margin loans against securities which may be difficult to liquidate or sell (because of the size of the holdings relative to the market demand) would be required to maintain more liquid capital. This was to be achieved by applying a steep discount to the value of such securities in assessing the amount of credit risk adjustment necessary on the relevant margin loan secured by such securities. Specifically, firms that want to provide margin loans collateralised by those securities to which a bank would apply a high discount (or might not be willing to lend against at all) should be funding much of those margin loans with their own capital, rather than with bank loans obtained through repledging their clients’ securities. Accordingly, we originally proposed a 90% discount for such identified securities<sup>1</sup>; and

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<sup>1</sup> Specifically, the discount would apply to those stocks and warrants pledged as margin collateral where such stocks or warrants would:

- (a) likely take more than one month to liquidate based on their respective trading volume during the previous six months; or
- (b) constitute 5% or more of the market capitalization of the shares or the issue size of the warrants.

This analysis would be applied only to those shares and warrants identified as the three largest collateral holdings (based on the securities’ respective market value) of each firm’s top 20 margin clients (those with the largest outstanding margin loan balances). However, once any shares or warrants meet either of these tests, the 90% discount would apply to all such shares or warrants held by the firm as collateral.

- (b) by introducing the gearing adjustment, where a firm's borrowings secured by clients' securities exceed 50% of aggregate margin loans made to all its clients, the firm must include the excess in its ranking liabilities for FRR calculation purposes (the gearing adjustment). The net result is that firms that rely heavily on borrowings secured by their clients' securities for their operational funding must bring in additional liquid capital, the better to manage the financial risks brought on by pooling and repledging clients' securities.
10. We believed that the combination of these two requirements would effectively require firms that adopt the practices described in paragraph 7, above, to increase their capital to cushion themselves and their clients against credit, liquidity and other financial business risks. In the process, these firms would be more financially sound and their clients would have a reduced risk of loss arising from the firms' defaulting on their borrowings.

## **B. Consultation Process and Comments**

11. In addition to the public announcement inviting comments, the Consultation Document was sent to all registered securities dealers and securities margin financiers via the FinNet communication network, distributed to the Financial Services Bureau, various industry representative bodies and professional associations. The Consultation Document was also published on the SFC website.
12. 23 responses were received from the public as well as market practitioners including securities dealers, legal firms, industry representative bodies and professional associations. One of the submissions consisted of a survey of its members conducted by the Hong Kong Securities Institute.
13. Comments varied considerably in range and depth, with some focusing on broad principles and others on points of detail and clarification. On the whole, the market generally supported introducing measures to reduce financial and credit risks. Some commentators supported the Proposed Amendments. Others focused primarily on the practical effects of the Proposed Amendments on the market overall. Different commentators suggested varying levels of discount as well as changing the gearing adjustment. Others expressed concern over the possible effect on market liquidity generally as well as on specific 3<sup>rd</sup> and 4<sup>th</sup> liner stocks and on the proposal not differentiating between the perceived "quality" of the securities that may be discounted. Concerns were also expressed as to the impact on the IPO market and ensuring a level playing field with banks.
14. We have considered all market comments expressing concern over the proposal as well as those that have offered alternative suggestions. After the public consultation closed, we met with different commentators to discuss possible amendments and solutions that would be acceptable to the market generally. After much discussion and weighing all comments and investor considerations, we have made the Amendment Rules to balance the concerns (please see paragraphs 17 to 23).

15. There were also comments recognizing the need to address various financial risk issues in the long-term and possible alternative approaches. These issues, such as the pooling of clients' securities and the required capital level for firms conducting different business activities, are fundamental issues that Hong Kong should address in the context of the overall framework for intermediaries and market participants. As these will require considerable time for the necessary review, discussion, consultation and consensus building, they will be addressed separately in due course.
16. In the meantime, we believe it is imperative to introduce some interim measures to address the identified risks posed to firms, their clients and potentially to the systemic stability of the market. This we mean to achieve by making the Amendment Rules effective as soon as practicable.

## **AMENDMENT RULES**

17. Taking into account the submissions received and following discussions with commentators, several revisions to the Proposed Amendments were considered appropriate.
18. First, we have reduced the "illiquid collateral haircut" percentage from 90% to 80%. This is in keeping with the percentage discount level broadly applied by banks to similar stocks. The "illiquid collateral haircut" would also override the current discount and concentration discounting factors in the FRR that would otherwise apply to the stock or warrant, so that there will not be any "double discounting" on the same stocks or warrants.
19. Second, in response to market comments, we have relaxed the gearing adjustment from 50% to 35%. This effectively means that if a firm's total borrowings secured by margin clients' securities exceed 65% of the total margin loans it lends to clients, the firm will be required to maintain an additional liquid capital buffer in the amount of such excess. This liquid capital buffer should, to a large extent, manage down both insolvency risks as well as liquidity risks.
20. Third, we note the concerns over practicality of applying the Proposed Amendments in the situation of IPO and newly listed shares without a 6 month trading period, as well as practical difficulties in tracking average monthly turnover and market capitalization.
21. To address these concerns, we have now revised the Proposed Amendments so that effectively the illiquid collateral haircut would not apply to shares or warrants that have been listed or traded for less than 7 consecutive calendar months (including any period during which the share or warrant is suspended from trading) immediately preceding the month in which the calculation is made. We have also allowed more lag time for firms to calculate the average monthly turnover of stocks and warrants.

22. Fourth, it has been brought to our attention that the definition of “illiquid collateral” would inadvertently affect shares that have been subject to a recent stock split. To overcome such technical problem, we have now changed the reference point from “number of shares or warrants” to “value”.
23. As revised, we believe that the Proposed Amendments are sound and offer the most reasonable means of reducing currently identified credit risk. While the Amendment Rules do not necessarily address all of the concerns expressed by the industry, we believe that they strike an acceptable balance between the interests of the industry and the protection of investors.

#### **EFFECTIVE DATE**

24. The effective date of the Amendment Rules will be 1 October 2002.

**FINANCIAL RESOURCES (AMENDMENT) RULES 2002**

(Made by the Securities and Futures Commission under section 28 of the Securities and Futures Commission Ordinance (Cap. 24) after consultation with the Financial Secretary)

**1. Commencement**

These Rules shall come into operation on 1 October 2002.

**2. Amounts receivable from clients and securities margin financiers arising from dealings in securities or the provision of securities margin financing**

Section 13 of the Financial Resources Rules (Cap. 24 sub. leg.) is amended -

(a) in subsection (4)(b) -

(i) in subparagraph (i), by adding ", other than illiquid collateral," after "collateral";

(ii) by adding -

"(ia) the market value of all illiquid collateral provided by the client, multiplied by 20%";

(b) by adding -

"(10) In this section, "illiquid collateral" (非速動抵押品), in relation to collateral provided to a dealer or securities margin financier by a margin client, means any listed or traded share or warrant which is of the same description as that identified as the top 3 collateral where -

(a) if it is a share, the aggregate market value of all shares of the same description as that share provided to the dealer or securities margin financier by his margin clients as collateral is equal to or greater than -

(i) the average monthly turnover of that share; or

(ii) 5% of the total market capitalization of that share as at the end of the month immediately preceding the month prior to the month in which

the calculation is  
made; or

(b) if it is a warrant, the  
aggregate market value of all  
warrants of the same  
description as that warrant  
provided to the dealer or  
securities margin financier by  
his margin clients as  
collateral is equal to or  
greater than -

(i) the average monthly  
turnover of that  
warrant; or

(ii) 5% of the warrant  
issue as at the end  
of the month  
immediately preceding  
the month prior to  
the month in which  
the calculation is  
made,

but does not include -

(c) any listed or traded share or  
warrant which has been listed  
or traded for less than 6  
consecutive months (including

any period during which the share or warrant is suspended from trading) immediately preceding the month prior to the month in which the calculation is made; and

(d) any listed share which is a constituent stock of any of the following indices -

- (i) Hang Seng Index;
- (ii) Hang Seng Hong Kong LargeCap Index;
- (iii) Hang Seng Hong Kong MidCap Index;
- (iv) FTSE-100 Index;
- (v) Nikkei 225 Index; or
- (vi) Standard & Poor's 500 Index.

(11) In this subsection and subsection (10) -

"average monthly turnover" (平均每月成交額), in relation to a listed or traded share or warrant, means one sixth of the aggregate value of transactions in that share or warrant on any stock market on which it is listed or traded for a period of 6

consecutive months (including any period during which the share or warrant is suspended from trading) immediately preceding the month prior to the month in which the calculation is made;

"calculation" (有關計算) means a calculation made for the purposes of subsection (4);

"market capitalization" (市場資本值), in relation to a share, means the total number of shares of the same class as that share issued by the issuer of that share, as multiplied by their market price;

"top 3 collateral" (首3位抵押品), in relation to a top margin client of a dealer or securities margin financier, means any of the 3 highest listed or traded shares or warrants in terms of market value among all shares or warrants provided by him to the dealer or securities margin financier as collateral;

"top margin client" (佔首位的保證金客戶), in relation to a dealer or securities margin financier, means -

- (a) where he has less than 20 margin clients, each of his margin clients; or
- (b) where he has 20 or more margin clients, each of the 20 margin clients with the largest outstanding margin loan balances;

"traded" (買賣), in relation to any share or warrant, means traded on a stock market."

### **3. Provision of securities margin financing**

Section 21 is amended -

- (a) By renumbering it as section 21(1);
- (b) by adding -

"(2) Where a dealer or securities margin financier obtains financial accommodation wholly or partly secured by collateral provided by his margin clients, he shall include in his ranking liabilities the amount by which such financial accommodation exceeds 65% of the aggregate amount receivable from his margin clients arising from the provision of securities margin financing."

### **4. Liquid capital computation**

Schedule 7 is amended -

(a) in item 21, in column 3, by repealing "21(a)" and substituting "21(1)(a)";

(b) in item 22, in column 3, by repealing "21(b)" and substituting "21(1)(b)";

(c) in item 29, in columns 2 and 3, by adding -

" gearing adjustment		21(2)"
before -		
" short selling of		24(6)".
securities on behalf		
of clients		

Andrew Len Tao SHENG  
Chairman,  
Securities and Futures Commission

29 May 2002

#### **Explanatory Note**

The purpose of these Rules is to amend the Financial Resources Rules (Cap. 24 sub. leg.) ("the principal Rules") to limit the main financial and credit risks arising from the

provision of margin loans by securities dealers and securities margin financiers.

2. Section 2 amends section 13 of the principal Rules to require the application of a steep discount to the market value of certain securities held by the securities dealers and securities margin financiers as collateral, for the purpose of calculating their liquid assets.

3. Section 3 amends section 21 of the principal Rules to require securities dealers and securities margin financiers to compare the total value of their margin loans to clients with the total value of borrowings they have obtained by re-pledging securities received from their margin clients. If the borrowings obtained by any securities dealer or securities margin financier exceed 65% of the total margin loans extended by him, the excess must be included in his ranking liabilities.

4. Section 4 amends Schedule 7 to the principal Rules by introducing consequential renumbering of references to section 21 of the principal Rules, and adding a new item relating to the gearing adjustment required under the new section 21(2).

## Summary of comments received on Proposed Amendments to the Financial Resources Rules

	Section reference	Details of the Rules/ Areas of concern	Respondent's comments	SFC's response
1.	-	General comments	<ul style="list-style-type: none"> <li>Comments generally support the proposal to manage down the financial risks of margin financing intermediaries, and increase protection to investors.</li> <li>Some commentators have proposed that we should look at more fundamental issues such as capital requirements and pooling.</li> </ul>	<ul style="list-style-type: none"> <li>We thank the market for their support and valuable comments.</li> <li>We will examine these structural issues as part of an overall review later in the year.</li> </ul>
<i>Specific Comments</i>				
2.	S13(4)(b) & (10)	"Illiquid collateral" – general comments	<ul style="list-style-type: none"> <li>The haircut % should be reduced from 90% to 80% as applied by the authorized institutions.</li> </ul>	<ul style="list-style-type: none"> <li>We agree and have amended the proposal to reduce the haircut to 80%.</li> </ul>
3.	S13(4)(b) & (10)	"Illiquid collateral" - concern over reducing liquidity	<ul style="list-style-type: none"> <li>Some commentators were concerned that the proposal would affect market liquidity and brokers' ability to meet on-going liquidity requirements.</li> </ul>	<ul style="list-style-type: none"> <li>The objective is to ensure that firms have adequate capital buffer in case they cannot liquidate their clients' securities collateral within a reasonable timeframe.</li> </ul>
4.	S13(10)	"Illiquid collateral" - definition	<ul style="list-style-type: none"> <li>The definition of 'illiquid collateral' cannot address the problem because there are stocks of sound fundamentals but not frequently traded.</li> <li>There are also stocks of dubious quality but being traded actively, this haircut may encourage "manufactured" liquidity (liquidity does not define the quality of a stock).</li> </ul> <p>There are technical difficulties in applying the definition to IPO with less than 6 months track records.</p>	<ul style="list-style-type: none"> <li>We have already excluded from "illiquid collateral" all HSI index or HSI HK LargeCap and MidCap stocks.</li> <li>Entering into wash sales (which involve the sale and purchase of stocks without any change in their beneficial ownership) is a criminal offence, as is the creation of a false market. The SFC will be vigilant in its monitoring of share movements to detect incidents involving the ramping of share prices. In relation to all such malpractices the Commission will take decisive action, including the prosecution of offences and disciplining persons guilty of misconduct.</li> </ul> <p>We agree that the illiquid collateral haircut should only apply to any share or warrant which has been listed or traded for 7 consecutive months or more immediately preceding the month in which the calculation is made.</p>

	Section reference	Details of the Rules/ Areas of concern	Respondent's comments	SFC's response
5.	S21(2)	Ranking liabilities on repledging margin client securities – general comments	<ul style="list-style-type: none"> <li>50% loan to bank borrowing ratio appears high.</li> </ul>	<ul style="list-style-type: none"> <li>In response to market comments, we agree that the firm loan to bank borrowing adjustment should only be triggered when bank borrowings, secured by clients' securities collateral, exceed 65% of aggregate margin loans (<u>i.e.</u>, two-thirds).</li> </ul> <p>Our major concern is over pooling where one client's collateral can be used to secure the firm's borrowings. If a firm's own practice is not to allow pooling and the bank is willing to regard each sub-account under the umbrella margin financing account on a stand-alone basis (<u>e.g.</u>, it agrees not to combine these accounts or to effect any netting), we would be prepared to consider granting an FRR modification in these circumstances.</p> <p>We will work with the industry and where appropriate, be prepared to grant modifications of the FRR provided that the risks are adequately addressed by compensating controls and investor protection is not undermined.</p>
6.		Other Comments	<ul style="list-style-type: none"> <li>Given the increasing pressure on consumers to plan for their long term financial needs, and the role that the stock market plays in this regard, every endeavour should be undertaken to ensure that investors' funds are adequately protected. The proposals are therefore a step in the right direction for HK as an international financial center.</li> <li>It was suggested that the proposals be examined in light of other regulatory capital requirements in other international markets. The concern expressed was that the regulators should be addressing concerns that are unique to Hong Kong but also being mindful of established systemic approaches in other international regimes so that the competitiveness of Hong Kong brokerage firms is not otherwise negatively impacted as compared to their counterparts in other countries.</li> </ul>	<ul style="list-style-type: none"> <li>We thank the market for their support and valuable comments.</li> <li>We thank the market for the suggestions and will consider these concerns in the White Paper.</li> </ul>

## List of Respondents

<b>Date Received</b>	<b>Respondent</b>
7 March 2002	Fidelity Investments Ltd
11 March 2002	Albert Pun
14 March 2002	Anne Ng (Retail Investor)
14 March 2002	- (Retail Investor without name)
20 March 2002	POP Electronic Product Ltd
21 March 2002	Consumer Council
21 March 2002	Hong Kong Stockbrokers Association
21 March 2002	City University of Hong Kong
23 March 2002	Cho Man Sang
25 March 2002	Tai Fook Securities Group Ltd
25 March 2002	Institute of Securities Dealers Ltd
26 March 2002	- (no name)
26 March 2002	- (commentator reserved anonymity and contents of submission)
26 March 2002	Sun Hung Kai & Co Ltd
26 March 2002	OSK Asia Corporation Ltd
26 March 2002	South China Securities Ltd
26 March 2002	Albert T. da Rosa, Jr.
27 March 2002	- (commentator reserved anonymity and contents of submission)
27 March 2002	Hong Kong Society of Accountants
28 March 2002	Hong Kong Institute of Directors
28 March 2002	Survey conducted by Hong Kong Securities Institute on its members
9 April 2002	Shengyin Wanguo Group
12 April 2002	Hong Kong Securities Professionals Association