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

A CONSULTATION PAPER ON PROPOSED MEASURES TO ADDRESS RISKS ARISING FROM SECURITIES MARGIN FINANCING

Hong Kong
September 2004

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FOREWORD

The Securities and Futures Commission ("SFC") invites the public to submit written comments on the proposals discussed in – and draft provisions attached to - this Consultation Paper, or to comment on related matters that might have a significant impact upon the proposals, **no later than 31 October 2004**.

Any person wishing to submit comments on behalf of any organization should provide details of the organization whose views they represent. Please note that the names of commentators and the contents of their submissions may be published by the SFC on its website and in other documents to be published by the SFC. In this connection, please read the Personal Information Collection Statement attached to this Consultation Paper.

You may not wish your name to be published by the SFC. If this is the case, please state that you wish your name to be withheld from publication when you make your submission.

Written comments may be sent -

By mail to:	Intermediaries Supervision Department The Securities and Futures Commission 8/F Chater House 8 Connaught Road Central Hong Kong
By fax to:	(852) 2523 4598
By on-line submission:	http://www.hksfc.org.hk
By e-mail to:	2004frrconsultation@hksfc.org.hk

All submissions received before expiry of the consultation period will be taken into account before the proposals are finalized. A Consultation Conclusions Paper will be published as soon as practicable thereafter.

Additional copies of the Consultation Paper may be obtained from the SFC's address shown above. A copy of this Consultation Paper, together with a summary of the Public Consultation Procedures adopted by the SFC, can also be found on the SFC's website at *http://www.hksfc.org.hk*.

Intermediaries Supervision Department
Securities and Futures Commission
Hong Kong

28 September 2004

Personal Information Collection Statement

1. This Personal Information Collection Statement ("PICS") is made in accordance with the guidelines issued by the Privacy Commissioner for Personal Data. The PICS sets out the purposes for which your Personal Data[1] will be used following collection, what you are agreeing to with respect to the SFC's use of your Personal Data and your rights under the Personal Data (Privacy) Ordinance (Cap. 486) ("PDPO").

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2. The Personal Data provided in your submission to the SFC in response to this Consultation Paper may be used by the SFC for one or more of the following purposes:
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   - for research and statistical purposes;
   - for other purposes permitted by law.

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5. Personal Data provided to the SFC in response to this Consultation Paper will be retained for such period as may be necessary for the proper performance of the SFC's functions.

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[1] Personal Data means "personal data" as defined in the Personal Data (Privacy) Ordinance.

[2] Defined in Schedule 1 to the Securities and Futures Ordinance (Cap. 571) ("SFO") to mean provisions of the SFO and subsidiary legislation made under it; and provisions of Parts II and XII of the Companies Ordinance (Cap. 32) insofar as those Parts relate, directly or indirectly, to the performance of functions relating to prospectuses; the purchase by a corporation of its own shares or a corporation giving financial assistance for the acquisition of its own shares, etc.

Enquiries

6. Any enquiries regarding the Personal Data provided in your submission on this Consultation Paper, or requests for access to Personal Data or correction of Personal Data, should be addressed in writing to:

The Data Privacy Officer
The Securities and Futures Commission
8/F, Chater House
8 Connaught Road Central
Hong Kong

CONSULTATION PAPER ON PROPOSED MEASURES TO ADDRESS RISKS ARISING FROM SECURITIES MARGIN FINANCING

I. OBJECTIVE

1.1 This Consultation Paper aims to solicit public comment on the SFC's proposed measures to address the risks of pooling and re-pledging the securities collateral of margin clients ("client collateral"), and lending in securities margin financing ("SMF"). The proposals, divided under the headings "Principal Measures" and "Supplementary Measures", set higher standards for the regulation of SMF providers. The SFC believes these measures are necessary to provide more effective investor protection, and to strengthen our position as premier international financial centre and the gateway to China.

II. EXECUTIVE SUMMARY

2.1 The financial services industry is one of the key growth sectors of Hong Kong's economy. It contributes 12% of Hong Kong's GDP (in value-added terms) and employs more than 5% of its workforce[1]. SEHK participants[2] have been doing well since mid-2003, recording a total net profit of almost $5 billion in the first half of 2004[3].

2.2 Securities brokers are a very important component of the financial services industry. It is for this reason that the industry simply cannot afford to have another collapse like C.A. Pacific. The damage to Hong Kong's reputation as a premier international financial centre would severely affect all parties and businesses. Some brokers have pointed out that should a broker fail, clients of other brokers may move their business to bigger firms or banks.

2.3 After the C.A. Pacific incident, the law was tightened to bring unregulated finance companies providing SMF within the regulatory framework administered by the SFC. Under this new law and subsequent refinements, SMF activities are subject to much stricter regulation than before. Since year 2000, the brokerage industry has grown with a 60% increase in shareholders' funds.

2.4 While the vast majority of SMF providers operate prudently, responsibly and with integrity, there are some that engage in imprudent lending practices. The SFC's main concern is that a small number of SMF providers are, in fact, putting the entire industry and its hard earned good reputation at risk. This is neither fair nor acceptable.

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[1] Figures obtained from Hong Kong Annual Report 2003

[2] "SEHK" means the Stock Exchange of Hong Kong

[3] Figures obtained from financial returns submitted to the SFC by brokers from January 2004 to June 2004.

2.5 As pointed out by the SFC's Working Group on Review of the Financial Regulatory Framework for Licensed Corporations (the "Working Group"), the current law still allows SMF providers to pool and re-pledge client collateral. A very small number of SMF providers take advantage of the loophole and excessively re-pledge client collateral (including, in particular, collateral of those margin clients who have not borrowed). Elsewhere in major financial markets, this is not allowed.

2.6 Hence, if the SMF provider becomes insolvent, its margin clients (even those that have not borrowed) may lose their collateral which have been re-pledged by the SMF provider with its bank(s). The C.A. Pacific incident is a good example of the danger of excessive pooling and re-pledging of client collateral.

2.7 This Consultation Paper sets out the measures recommended by the SFC's Working Group to address the loophole and to reduce risky lending. These measures are not complete solutions but are essential measures to reduce risks to the Hong Kong market. The main objective of the recommended measures is to raise industry standards and best practices and thus provide better investor protection and increase investor confidence in SMF providers. These recommended measures will help to:

(i) safeguard Hong Kong's reputation as a premier international financial center;

(ii) enhance the level of protection for Hong Kong's 1,000,000 investors; and

(iii) reduce pooling and credit risk, having regard to the special characteristics of the Hong Kong market.

2.8 The recommended measures include:

Principal measures

(*i*) Limit on the Re-pledging of Client Collateral - In order to address pooling risk, the SFC recommends that a limit be imposed on the amount of client collateral that an SMF provider can re-pledge to secure bank loans ("re-pledging limit") on an aggregate basis. This limit will be set at a percentage of the SMF provider's aggregate outstanding margin loans.

(*ii*) Adjustment of Securities and Futures (Financial Resources) Rules ("FRR") Haircut Percentages - The SFC recommends that the haircut percentage rates used to calculate an SMF provider's regulatory capital be brought up-to-date in order to better reflect the liquidity, volatility and realisable value of client collateral. This will ensure that an SMF provider devotes to his business sufficient capital to buffer against the risks inherent in his business.

Supplementary measures

(*iii*) Better Disclosure – The SFC recommends that better disclosure of SMF activities both to the regulator and clients be made by SMF providers. At the same time, the SFC will step up investor education on the risks of pooling.

2.9 The recommended limit on re-pledging would result in improved investor protection, as SMF providers would be re-pledging a smaller proportion of their client collateral with banks. This would increase the amount of client collateral retained by the SMF provider and thus available for distribution in the event of the SMF provider becoming insolvent. It would also prevent SMF providers from over-borrowing against client collateral, thereby encouraging them to adopt more cautious lending and borrowing practices.

2.10 While the Working Group recommended a re-pledging limit of 130%-150% of aggregate margin loans, the SFC is open minded as to what would be the most appropriate percentage limit and the transitional period that should be allowed to help existing SMF providers to achieve compliance.

2.11 Regarding the second principal measure, the FRR haircut percentage rates are a risk management tool that enables the SMF provider's assets to be valued in a more realistic and prudent manner for the purpose of calculating regulatory capital. It is important to note that this proposal does <u>not</u> prohibit a SMF provider from lending to margin clients on terms that are more favourable than the FRR haircut percentage rates. The proposal only encourages SMF providers to adopt better lending discipline by requiring them to put in more of their own capital to cover the additional risk if they decide to lend on more favourable terms. Again, the SFC is mindful that there should be sufficient time and space given so that SMF providers can comply and continue their business.

2.12 We conducted a series of impact analyses in respect of the two principal measures which indicated that the vast majority of SMF providers will only experience an insignificant impact to their level of regulatory capital. Only a small handful of SMF providers will actually need to put in further capital or find an alternative source of funding in order to comply with these two measures. Basically, this small group includes firms who re-pledge excessively and/or lend imprudently. (There are 243 SMF providers, 154 do not re-pledge and the remaining 89 do. The vast majority of them do not engage in imprudent practices. Only a small percentage do.)

2.13 As for the supplementary measures, one proposal is for SMF providers to notify the SFC when their exposures to illiquid collateral or usage of available bank lines have crossed a certain threshold. The other supplementary measure requires SMF providers to make their clients more aware of their re-pledging practices.

2.14 The SFC believes that the recommended measures above are a reasonable solution to address the most pressing risks existing in the SMF industry at present. But they are not complete solutions. In the longer term, Hong Kong will need to consider how it could move towards the complete segregation of collateral of non-borrowing margin clients (which is an international standard) and tiering of regulatory capital requirements according to risks of a firm.

2.15 In addition to the Working Group's recommendations, the SFC also wishes to consult on an ancillary change to the existing FRR requirements. It is proposed to shorten the existing grace period allowed for adjusting the

regulatory capital of brokers in respect of overdue receivables from cash clients for their stock purchases from 5 to 2 business days after the due settlement date, so as to better address the risks arising from granting extended periods to cash clients to pay for their purchases. In addition, in the course of preparing this paper, it was pointed out that existing practice, which is enshrined in the FRR, mandates one set of FRR haircut percentage rates applies to both client collateral as well as house investments of all firms. The SFC would like to hear further from the public on whether the existing practice to apply one universal set of FRR haircut percentage rates should continue.

2.16 Depending on the final rules and feedback from the public consultation, the SFC will also consider the possibility of relaxing certain existing FRR requirements.

2.17 The SFC will keep an open mind on these proposals. We encourage the market and investing public to share their views regarding the proposed measures. If these proposals are to be adopted, changes to the Securities and Futures (Client Securities) Rules, Securities and Futures (Financial Resources) Rules and the Securities and Futures (Contract Notes, Statements of Account and Receipts) Rules will have to be made. Rule amendments are subject to negative vetting by the Legislative Council ("LegCo").

2.18 We anticipate publishing consultation conclusions and finalising the draft rules and code amendments by early 2005, with a view to implementing the new regime once the draft rules have been negatively vetted by the LegCo subject however to a transitional period.

III. BACKGROUND

3.1 The recommended measures in this Consultation Paper are mainly based on the measures recommended by the Working Group and the SFC's own assessment of the key issues.

3.2 The collapse of C.A. Pacific Securities Limited and C.A. Pacific Finance Limited in January 1998 highlighted how margin clients could suffer losses as a result of the crystallization of pooling risk (i.e. the risk that client collateral that has been re-pledged to a bank[4] to secure an SMF provider's borrowings, will be liquidated to repay the SMF provider's indebtedness after it defaults on the loan). At the time of its collapse, C.A. Pacific Finance Limited had a capital of only $16 million, but had borrowed $548 million by re-pledging client collateral of over $2.5 billion. The two companies had over 5,000 clients. Allowed compensation claims amounted to $983 million and the Unified Exchange Compensation Fund made payments totalling $300 million. Even after 6 years, the liquidation is not completed.

[4] Under the law, a securities margin financier may also re-pledge margin client collateral with a securities dealer though this arrangement is not common. The word "bank" should be construed to include "securities dealer" whenever one refers to the person with whom client collateral can be re-pledged.

3.3 In the wake of the incident, the Securities (Margin Financing) (Amendment) Ordinance was introduced whereby all SMF providers, including unregulated finance companies, were brought within the regulatory framework administered by the SFC. Under this new law, SMF activities were subject to much stricter regulation than before.

3.4 The SFC introduced two interim measures in the FRR in 2002 (i.e. the 65% gearing ratio adjustment and the illiquid collateral haircut) to manage down risks arising from SMF. The measures have partially succeeded in their objective. Aggressive lending practices have since been tempered in most cases. However, these measures are deficient to the extent that they permit SMF providers to re-pledge client collateral (including that belonging to non-borrowing margin clients[5]) without limitation. As a result, the LegCo Financial Affairs Panel ("FAP") suggested in May 2002 that the SFC should review the practices of pooling and re-pledging client collateral and study the risks inherent in SMF activities. In response, the SFC established the Working Group in the same month to assist in reviewing the financial regulatory framework.

3.5 The Working Group consisted of senior financial and industry people, members from academia and the Consumer Council. In March 2004, after almost 2 years of in-depth study and deliberation, a report setting out a package of recommended measures was presented to the FAP. The FAP supported the recommended measures and the SFC's intention to consult the public on them.

3.6 Details concerning the background, objectives and discussions behind the Working Group's recommendations are contained in the SFC report which can be read online and downloaded from the SFC's website at *http://www.hksfc.org.hk/eng/press_releases/html/press_release/04/04pr39_report.pdf*.

IV. REGULATORY ISSUES ARISING FROM SECURITIES MARGIN FINANCING

4.1 In the event that any SMF provider were to fail as a result of its adoption of imprudent business practices, it could affect a large number of investors and adversely impact confidence in Hong Kong's securities market. The current regulatory framework for SMF providers which permits unlimited re-pledging must therefore be tightened to contain such risks.

4.2 No other major financial market permits the pooling and re-pledging of non-borrowing margin client collateral (collateral belonging to margin clients who have no current borrowing from the firm). The U.S, in fact, goes a step further by imposing restrictions so that even for collateral belonging to clients who have borrowed, there is a limit that the firm can re-pledge. For each client

[5] i.e. margin clients who have no current borrowings from their SMF provider

who has borrowed, the firm may only re-pledge the client collateral equal to (in market value) 140% of the client's borrowings.

4.3 There are currently in Hong Kong, 243 SMF providers. 154 finance their lending business out of their own funds. They do not re-pledge client collateral. Only 89 SMF providers re-pledge their client collateral to finance their operations. Of this group, a small number maintain very low excess liquid capital to buffer against risks. Their weak capital position, coupled with reliance on bank lines secured by client collateral, makes these firms particularly susceptible to market volatility and hence pose serious risks to their clients.

4.4 Apart from utilizing bank borrowings obtained through re-pledging their client collateral, many of these identified firms also finance the activities of their connected parties, such as buying the listed securities of group companies or diverting funds to treasury hubs within the group. As these connected parties and group companies are not subject to any prudential regulation, such financing may undermine the financial strength of the securities firms. Furthermore, borrowings obtained from re-pledging client collateral can be used for these purposes. This is unacceptable and very unfair to those clients whose collateral is re-pledged. This practice in itself however may not trigger a breach of FRR capital requirements, yet there clearly are conflicts of interest issues, especially when these SMF providers are not as independent or rigorous as they should be in assessing the credit of their group companies or connected parties.

4.5 While the SFC's existing powers and sanctions have proved adequate in the vast majority of cases in respect of most firms (these value their licensed status, carefully guard their market reputation and honour their clients' trust), the SFC does not have clear and effective legal powers in situations where a firm's lending and/or re-pledging activities pose serious risks to investors, to require firms to take immediate action, such as injecting additional capital or segregating non-borrowing margin client collateral. The SFC has been resorting to a program of close supervision and intensive moral suasion, combined with the imposition of licensing conditions (which is a lengthy process) or the issue of restriction notices (which could have adverse consequences for firms rather than the intended remedial effect). For so long as this loophole that allows excessive and unfair re-pledging to continue, investors, the brokerage industry and the Hong Kong market all stand to lose. Consequently, this loophole must be plugged.

What Happens When A Brokerage Fails

4.6 When an SMF provider fails, especially one with a large client base, losses to investors could be very substantial. Where a large number of investors are involved, the failure could have a severe systemic impact on the market through a contagion effect; as clients of other SMF providers demand the return of collateral and scrip on a scale beyond the SMF providers' capacity to deliver. In the resulting collapse of additional SMF providers, even more investors would sustain losses and the price of some stocks that are subject to selling pressure could drop dramatically, compounding the loss to investors.

In addition, when one SMF provider fails, the reputation of the securities industry as a whole suffers. Generally speaking, the higher the risks (perceived or otherwise) to investors, the lower the confidence in the market and the incentive to invest.

4.7 Further, SMF providers that have a large client base are effectively comparable to banks because they utilize the assets of their clients and borrow against such assets; the ramifications of their failure are also comparable to those of the failure of banks. Brokers themselves have commented that when one firm fails, clients of other firms move their business to bigger firms or banks.

PRINCIPAL MEASURES

V. LIMITING THE RE-PLEDGING OF CLIENT COLLATERAL

5.1 The Working Group believes that the pooling and re-pledging of client collateral are not inherently unsafe practices, if conducted prudently and authorized by margin clients who are fully aware of the risks to which they are exposed as a result. Indeed, these practices usefully contribute to the liquidity of the stock market and provide a valuable service to investors and intermediaries alike. Hence, the SFC at present does not intend to ban either the pooling or the re-pledging of client collateral.

5.2 The Working Group considered that measures should be implemented with a view to putting a stop to excessive re-pledging of client collateral. Whilst currently only a small number of SMF providers do this, recognizing that the existence of this loophole could facilitate risky practices and that the Hong Kong regime governing SMF was significantly behind those of the major financial markets, the Working Group recommended that the loophole should be closed. This would provide the entire industry with a workable set of "base-line" requirements in relation to SMF.

5.3 The Working Group agreed that the public should be consulted on the proposal to impose a re-pledging limit in order to reduce the danger of pooling risk crystallizing. The Working Group initially considered the U.S. model of imposing a stringent 140% re-pledging limit on its brokers on a per-client basis (see paragraph 4.2). This method was favoured because it has a similar effect to the segregation of non-borrowing margin clients' collateral, plus the additional safeguard that a cap is imposed on the value of client collateral that can be re-pledged in respect of each client. This measure would effectively limit the amount of collateral that each client could stand to lose in the event that the firm became insolvent. It would also prevent the occurrence of a situation whereby one client stands to lose more relative to his borrowings than another. However, the practical and operational difficulties associated with complying with a per-client re-pledging limit would be essentially the same as those in the case of a ban on the re-pledging of non-borrowing margin clients' collateral. Accordingly, the Working Group did not see the introduction of a per-client re-pledging limit as being a realistic option given the present market infrastructure.

RE-PLEDGING LIMIT

5.4 The first principal measure for addressing pooling risk entails imposing a per-firm re-pledging limit, whereby the aggregate value of client collateral that can be re-pledged by an SMF provider is capped at a percentage of its aggregate margin loans to clients.

5.5 This measure requires physical segregation by an SMF provider of client collateral other than that which it is allowed to re-pledge with banks. This measure has the desirable effect of ensuring that a portion of client collateral would be held by the SMF provider (rather than by its bank) and would thus be available for distribution to margin clients in the event of the SMF provider becoming insolvent and going into liquidation. The following example illustrates how the per-firm re-pledging limit would work: an SMF provider lends an aggregate of $100 million to its margin clients and receives from them $500 million of client collateral. If the per-firm re-pledging limit were 130%, the firm would be allowed to re-pledge client collateral worth (in market value) not more than $130 million. In this way, the remaining $370 million of client collateral would be kept intact.

5.6 Although this measure would not prevent an SMF provider from re-pledging collateral belonging to non-borrowing margin clients, the Working Group nevertheless fully supported it because it would overall reduce the excessive re-pledging of client collateral. Currently, there are no legal restrictions on the amount of client collateral an SMF provider may re-pledge, provided the client has authorized the SMF provider to do so, irrespective of whether the client has any current borrowings from the firm.

Establishing the re-pledging limit

5.7 The SFC believes that while we should seek to provide greater protection for margin clients against pooling risk, this should be achieved to the fullest extent possible, without the imposition of unreasonable limitations or a disproportionately high cost burden on the industry. The Working Group agreed that the value of a per-firm re-pledging limit, in terms of both investor protection and safeguarding the industry from any contagion effect caused by the financial collapse of an SMF provider, to a very large extent depends upon the percentage at which the limit is set.

5.8 The lower the re-pledging limit, the greater the level of investor and systemic protection it would provide because –

(a) a greater proportion of all client collateral would be retained by SMF providers and be available for distribution to margin clients in the event of the firm becoming insolvent; and

(b) the risk profile of the SMF providers affected by the measure would be considerably improved as a result of their implementation of a more prudent lending policy and the consequent reduction of their gearing ratio, thereby reducing the risk of them becoming insolvent as a result of becoming unable to make necessary payments on their borrowings.

Question 1

A per-firm re-pledging limit will inevitably involve a compliance cost to market players. The SFC invites suggestions on how best to keep the compliance cost within reasonable limits without compromising the level of protection afforded by the re-pledging limit.

5.9 The Working Group believed that the per-firm re-pledging limit should be fixed between 130% and 150%, on the view that between such levels, SMF providers would still be able to obtain sufficient funding by re-pledging client collateral whilst preserving a reasonable proportion of client collateral. The Working Group was clearly of the view that setting the per-firm re-pledging limit at a level higher than 150% would not provide substantive investor protection and would fail to prevent the over re-pledging of client collateral. The SFC agrees.

5.10 Under a per-firm re-pledging limit of 130% to 150%, the majority of SMF providers would not be materially affected as they currently do not re-pledge client collateral (out of 243 SMF providers, 154 do not re-pledge). A big majority of the remaining 89 firms that do re-pledge, do not do so excessively. In the absence of a re-pledging limit, SMF providers that rely heavily on the funding obtained by re-pledging client collateral would continue to exhibit a high risk profile. In the SFC's view, this situation must not be permitted to continue as investors and the securities sector should no longer be exposed to such risks.

Question 2

What is the most appropriate level of re-pledging limit?

How the re-pledging limit is proposed to work

5.11 Whilst a per-firm re-pledging limit is conceptually straightforward, the actual implementation process may pose some practical difficulties, such as:

(a) Ideally, a firm should at all times monitor compliance by adjusting the market value of its pool of re-pledged securities collateral with reference to its aggregate margin loans and the re-pledging limit. However, real-time monitoring is not feasible because it is impossible to adjust the portfolio of re-pledged stocks on a real time basis, even for firms that have the necessary computer systems to keep track of constant movements in their margin loans and the market value of their portfolio of re-pledged client collateral;

(b) Typically, margin loans are accounted for on a trade date basis but clients often only pay on the settlement date. This affects the firm's flow of funds and impacts the firm's ability to repay the bank in order to redeem re-pledged client collateral. In this way, a firm may potentially be disadvantaged because of the timing difference; and

(c) Given the impracticability of real-time monitoring of these constantly changing values, it is necessary to establish clear reference points to help the firm comply with the re-pledging limit and, where necessary, to withdraw re-pledged client collateral from the lending bank(s) in order to stay within the re-pledging limit.

5.12 To overcome the operational difficulties identified in paragraph 5.11, the SFC proposes that at the end of each trading day[6] ("Day One"), an SMF provider shall calculate the aggregate market value of collateral that it has re-pledged with banks using the market price as at close of trade on Day One, and shall determine if that value has exceeded the "Re-pledging Limit in Value", namely, the permitted per firm re-pledging limit multiplied by the amount of margin loans outstanding. For this purpose, the amount of margin loans outstanding is calculated on a settlement date basis[7].

5.13 In the event the aggregate market value of re-pledged collateral as at end of Day One exceeds the Re-pledging Limit in Value, the SMF provider shall by the end of the trading day immediately following Day One ("Day Two") withdraw from the banks re-pledged collateral to ensure that the aggregate historical value of re-pledged collateral as at the end of Day Two, after withdrawal of the shares, shall not exceed the Re-pledging Limit in Value of Day One. In this scenario, the aggregate historical value of re-pledged collateral as at the end of Day Two shall be calculated using the market price as at end of Day One so as to ensure that the firm's rectification action would not be affected by price movements of the re-pledged collateral during Day Two.

5.14 The same calculation as detailed in paragraphs 5.12 to 5.13 above shall be made at the end of Day Two for purposes of determining the Re-pledging Limit in Value of Day Two, and in the event the aggregate market value of re-pledged collateral as at end of Day Two (calculated using the market prices as at the end of Day Two) exceeds the Re-pledging Limit in Value of Day Two, the SMF provider shall by the end of the trading day immediately following Day Two ("Day Three") take the same steps as detailed in paragraph 5.13 above such that as at end of Day Three, the aggregate historical value of re-pledged collateral as at the end of Day Three (calculated using Day Two closing prices) shall not exceed the Re-pledging Limit in Value of Day Two. (Please refer to **Annex 10** for illustrative examples of how the re-pledging limit mechanism works).

5.15 The same steps as detailed in paragraphs 5.12 to 5.14 shall be adopted by the SMF provider for each of the trading days following. It is worth noting that the SMF provider does not breach the law when it exceeds the re-pledging limit at the end of one day. It will only breach the law when it fails to effect the stock withdrawal by the end of the following trading day.

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[6] "Trading day" means a business day other than a Saturday.

[7] "Settlement date basis" which is defined in the FRR essentially means that on Day One, the SMF provider takes the amount of loans as at the end of the trading day which is two trading days immediately preceding Day One (that is, taking into account two days for settlement of securities transactions).

5.16 During its deliberations over the re-pledging limit, the Working Group was particularly concerned that firms that needed to constantly withdraw excess re-pledged client collateral from their banks would incur substantial stock transfer fees. The Working Group therefore suggested that some flexibility could be introduced so that they would not be required to withdraw re-pledged client collateral every time it exceeded the Re-pledging Limit in Value.

5.17 The SFC has given careful consideration to the question of how best to provide such flexibility. We first considered the option of giving firms a grace period within which re-pledged client collateral in excess of the Re-pledging Limit in Value need not be withdrawn. However, we were concerned that there would effectively not be any limit on re-pledging during the grace period and this could weaken the investor protection provided by the limit. Further, a grace period may provide an undesirable opportunity for firms to defer the rectification action until the last minute, which could make it even harder for the firm to rectify the breach if the re-pledging level at the expiry of the grace period turns out to be much higher than the level when the breach first occurred.

5.18 We then considered the option of providing a buffer in addition to the re-pledging limit, so that an SMF provider that re-pledges client collateral of a value that exceeds the Re-pledging Limit in Value but the excess amount does not exceed the buffer, would not need to take rectification action; the obligation to take rectification action would only arise where the buffer is exceeded. We believe that once the re-pledging limit comes into effect, the majority of SMF providers that re-pledge client collateral would re-pledge client collateral in an aggregate amount well below the Re-pledging Limit in Value so as to have a cushion against abrupt market movements which might bring the collateral to above the re-pledging limit. The SFC believes that in the event the re-pledging limit is set at the low end of the 130% to 150% range, there might be good grounds for giving SMF providers a small buffer (say a few percentage points) in order to provide some flexibility to the industry.

5.19 If there were a buffer on top of the Re-pledging Limit in Value, SMF providers would have greater flexibility as they need not withdraw stocks for minor breaches of the limit, for example, those caused by small increases in collateral values due to movements in market price. The buffer approach appears to be more appropriate than the grace period approach discussed in paragraph 5.17 above because the obligation to effect withdrawal would only arise when the sum of buffer plus the Re-pledging Limit in Value is exceeded.

Question 3

If the re-pledging limit is set at the lower end of the range recommended by the Working Group, is it practicable and useful to add a buffer? If a buffer is included, how many percentage points should it be?

5.20 Draft amendments of the Securities and Futures (Client Securities) Rules (Cap. 571 sub. leg.) to introduce the re-pledging limit and the buffer are attached at **Annex 2**, together with explanatory notes.

5.21 The proposed re-pledging limit requires changes to the relevant regulatory requirements. Once the re-pledging limit is enacted into subsidiary legislation (Securities and Futures (Client Securities) Rules), the re-pledging limit requirement, similar to other investor protection rules (e.g. Securities and Futures (Client Money) Rules), becomes a statutory requirement.

5.22 The SFC wishes to gauge whether the buffer provision discussed above would be sufficient to provide firms with the necessary flexibility. The SFC is also open to suggestions regarding alternative arrangements.

Question 4

Do you agree that the re-pledging limit, after being incorporated into the appropriate subsidiary legislation under the SFO, would ensure better compliance and enhance investor protection?

What other alternative mechanisms or arrangements could provide an appropriate level of flexibility and investor protection?

Permitted Bank Borrowing (PBB) Model

5.23 While the Working Group collectively did not believe the PBB model was an acceptable alternative to the re-pledging limit proposal, the Working Group agreed that the SFC could canvass the public's views on this model. The PBB model is a refinement of the existing 65% gearing ratio adjustment as it is a capital charge in nature but operates on a client-by-client basis and takes into account the quality of collateral received. Under this concept, margin loans granted by an SMF provider would be compared to the amount that a bank would lend against the same collateral. If the margin loans were funded by the firm re-pledging client collateral, the firm would sustain a capital charge in the amount by which each margin client's margin loan exceeded the amount the bank would lend against that client's collateral.

5.24 The shortcoming of the PBB model is that it does not limit the amount of client collateral that can be re-pledged. In addition, there are practical concerns noted by members of the Working Group in that:

(a) the PBB concept might be difficult to implement as it would impose a heavy compliance burden in terms of the constant monitoring of changes in account balance and collateral position (and its market value) of <u>each</u> of the SMF provider's margin clients; and

(b) there is a lack of uniformity and comparability amongst the lending ratios adopted by banks.

Question 5

Do you have any views on the PBB idea?

VI. ADJUSTING THE FRR HAIRCUT PERCENTAGE RATES

6.1 The imposition of a re-pledging limit alone would not be sufficient to combat the risky practices identified by the Working Group. The Working Group therefore considered that the existing risk management mechanism provided by the application of haircuts to liquid assets under the FRR should be brought up-to-date in order to better reflect their liquidity, volatility and realisable value.

6.2 The FRR haircut percentage rates are effectively a risk management tool designed to adjust for the quality of an SMF provider's assets that are accepted as regulatory capital under the FRR. Under the FRR, margin client receivables are capped at the amount of the aggregate value of collateral, as reduced by a haircut percentage, before they are recognized as part of an SMF provider's liquid assets. It is important to note that this proposal does not prohibit an SMF provider from lending to margin clients, nor from lending against stocks with high FRR haircut percentage rates. SMF providers can still decide on the level of margin ratio extended to individual clients. The proposal only encourages SMF providers to adopt better lending discipline by requiring them to put in more of their own capital to cover the additional risk if they decide to lend on more favourable terms than the FRR haircut percentage rates. If they wished to engage in imprudent lending practices, they should put at risk their own money rather than securities of their clients.

6.3 The Working Group recommended that the big gap, shown in Table 1 - between the haircut percentages presently adopted by banks and SMF providers and those set out in the current FRR - should be substantially reduced. In some instances the haircut rates prescribed in the FRR are as much as 66 percentage points lower than those typically assigned by both banks and SMF providers. The Working Group agreed that the current FRR haircut percentage rates are no longer adequate for the risk management purposes for which they were intended. Please refer to Table 1 for the current and proposed revised FRR haircut percentage rates, together with the average haircut rates used by banks and SMF providers that we have reviewed on a sample basis.

Question 6

Do you agree that the FRR haircut percentage rates should be adjusted in order to improve their utility as a risk management mechanism?

Warrants and "illiquid collateral"

6.4 The Working Group favoured increasing the FRR haircut percentage rates on both listed warrants and "illiquid collateral" to better reflect their higher risks. The Working Group recommended that listed warrants, which are volatile instruments, should be haircut at 100% (i.e. the same as applied by the sampled banks and SMF providers as indicated in Table 1 below).

Question 7

Is the proposed 100% haircut for listed warrants appropriate?

6.5 The Working Group recommended that the public should be consulted on whether the 80% illiquid collateral haircut, which has been in operation since October 2002, should be revised up to at least 90%, or possibly to 100%, to better reflect the realizable value of illiquid collateral and to counter the risks arising from lending against such stocks. The SFC takes the view that the illiquid collateral haircut, which is applied in calculating the firm's liquid assets, should be increased because in many cases the realizable value of such stock is less than the after haircut amount. In other cases, the SMF providers themselves are reluctant to liquidate illiquid collateral for fear of causing the share price to plummet. This occurs because many such stocks have such low turnover, in comparison with the amount held by the firm, that there is either little demand for those stocks in the market or selling even a small amount of them could substantially depress the prevailing market price.

Question 8

Should the haircut for illiquid collateral be increased? If so, what is the appropriate haircut percentage?

Proposed haircut table with additional indices and additional qualifying criteria to reduce compliance costs for securities firms

6.6 The Working Group took the view that it would benefit the industry and reduce compliance costs to firms if the categories of stocks, by reference to which the various haircut levels are prescribed, were broadened. It therefore recommended that two popular and widely used indices, the MSCI Hong Kong Index and the MSCI China Index (both compiled by Morgan Stanley Capital International Inc.) should be added to the HSHK MidCap tier, bringing into this band an additional 38 stocks that would otherwise be subject to higher haircuts. The proposed FRR haircut percentage rates, which are still more favourable than those adopted by the banks and SMF providers we have reviewed on a sample basis, are set out in Table 1 below.

Table 1
Current and Proposed FRR haircut percentage rates and banks'/SMF providers' average haircut rates

Stocks and warrants	Existing FRR haircut rates	Proposed new FRR haircut rates*	Banks' average haircut rates	SMF providers' average haircut rates
HSI / HSHK LargeCap Index constituents	15%	20%	43%	41%
Mkt cap.>$10 billion & Monthly turnover >$300 million	N/A	20%	56%	56%
HSHK MidCap Index constituents	20%	40%	57%	57%
MSCI HK / MSCI China Index constituents	N/A	40%	64%	64%
Mkt cap.>$5 billion & Monthly turnover>$300 million	N/A	40%	74%	70%
Other Hang Seng Composite Index (HSCI) constituents	30%	60%	77%	80%
All other Hong Kong listed stocks	30%	80%	96%	96%
Warrants	40%	100%	100%	100%

The above has been extracted from the Report on the Working Group's Recommendations.

*Do note that for stocks which are listed on both the Stock Exchange of Hong Kong and any overseas stock exchange, the Hong Kong haircut percentage will prevail.

6.7 The Working Group considered that certain stocks which are not on the HSI/MSCI index but which have sufficiently high market capitalization and turnover should qualify for a more favourable haircut because these factors are indicative of better liquidity and lower volatility. Under this proposal[8], stocks with market capitalization exceeding $10 billion and monthly turnover exceeding $300 million would qualify for the best haircut rate and those with corresponding figures of over $5 billion and $300 million would qualify for the next best haircut rate (as shown by the shaded rows in Table 1).

Providing flexibility

6.8 In order to address compliance burden issues and to provide additional flexibility, the SFC proposes to:

[8] The proposed figures of market capitalization and monthly turnover are based on -

(a) in the case of the top tier, $13 billion was the market capitalization of the smallest HSI stock as at 30.9.2003 and $300 million is almost the minimum turnover of HSI constituent stocks; and

(b) in the case of the second tier, $6 billion was the average market capitalization of constituent stocks of HSHK MidCap, MSCI HK and MSCI China as at 30.9.2003 and $471 million is the average turnover of such stocks.

(a) determine the figures for market capitalization and turnover on a historical basis, as provided for in section 22 of the existing FRR;

(b) allow firms the option to choose whether to take advantage of the qualifying criteria (see shaded rows in Table 1), but not making it mandatory to do so; and

(c) allow a 3-month grace period for stocks which would otherwise be subject to a higher haircut, by reason of their being moved out of an index or no longer meeting the qualifying criteria, during which time the previous haircut would still apply. The intention is to enable firms to avoid the possibility of breaching their liquid capital requirement as a result of immediately applying such higher (less favourable) haircut. For illustration, let us assume that Stock X ceased to be a HSHK LargeCap constituent stock on 15 May and became a HSHK MidCap constituent stock on the same day. Under the proposal, a HSHK LargeCap constituent stock would be subject to a 20% haircut whereas a HSHK MidCap constituent stock would be subject to a 40% haircut. With the proposed grace period, Stock X would continue to enjoy the lower haircut of 20% until 31 August but would be subject to the 40% haircut commencing 1 September.

6.9 The proposed measure to revise the FRR haircut percentage rates would require amendments to be made to the FRR. Draft amendments of these rules are attached at **Annex 4** and **Annex 5**.

Question 9

Do you think the proposed haircut rates as set out in Table 1 are appropriate? Do you have any suggestions as to how the proposed flexibility mechanism could be improved?

VII. APPROPRIATE TRANSITIONAL ARRANGEMENTS

7.1 The SFC is open minded as to what would be an appropriate transitional period that should be allowed to enable existing SMF providers to comply with the recommended measures. While it is clear that the current law which allows unrestricted re-pledging and the FRR haircut percentage rates need to be revised, the SFC is mindful that there should be sufficient time and space given so that SMF providers would not be inordinately affected and comply.

7.2 The SFC also wishes to ensure that as far as possible, existing firms would be able to transit smoothly to the new regime. Therefore, the SFC is open to views as to how the transitional period should be implemented, for example, whether it should be in a single stage or in stages such as implementing a higher re-pledging limit at the initial stage and moving to the target percentage by the end of the entire transitional period.

Question 10

How long should the transitional period be for existing firms for each recommended measure (re-pledging limit and the revised FRR haircut percentage rates)? Should the transitional period involve a single stage transition or more than one stage?

7.3 In addition, given the need to address the risks arising from the currently over-generous haircut rates for warrants and illiquid collateral, the SFC wishes to consult the public on whether the proposed 100% haircut for warrants, and any increased haircut rate change for illiquid collateral, should be given the same or an accelerated timetable.

Question 11

Do you think that the revised haircut rates for listed warrants and illiquid collateral should become effective after a transitional period or as soon as the FRR amendments come into force?

7.4 To avoid any confusion, newly licensed firms will be required to immediately comply with the two principal measures once they are in effect. The draft alternative transitional provisions, with explanatory notes, are attached at **Annex 2**, **Annex 6** and **Annex 7**, respectively.

VIII. IMPACT ANALYSIS

8.1 There are currently 243 SMF providers, of which 154 finance their margin lending business out of their own funds and 89 re-pledge client collateral to fund their operations. Only a small number of these 89 SMF providers lend imprudently and/or excessively pool and re-pledge their client collateral.

8.2 We conducted a series of impact analyses in respect of the two proposed principal measures based on the financial resources returns submitted to the SFC by SMF providers for June 2004. Although all SMF providers are affected by the proposed measures to various degrees, the vast majority of SMF providers will only experience an insignificant impact to their level of regulatory capital. Only a small handful of SMF providers will actually need to put in additional capital or find an alternative source of funding in order to comply with these two measures. Basically, this small group consists of wayward firms which re-pledge excessively and/or lend imprudently.

IX. SUPPLEMENTARY MEASURES

New notification requirements to the SFC

9.1 To bolster the effectiveness of the principal measures described in Parts V and VI, the Working Group recommended introducing notification requirements

that would increase the transparency of SMF activities to both the SFC and the firms' clients.

9.2 It is proposed that the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission ("the Code of Conduct") be amended so that an SMF provider would be required to notify the SFC if, for a continuous period of 2 weeks –

(a) the aggregate outstanding margin loans receivable from its top 20 margin clients that are secured against "illiquid collateral" have exceeded 50% of the sum of its shareholders' funds and approved subordinated loans (if any); or

(b) it has utilized 80% or more of its available credit lines (calculated at the lower of total bank facilities and aggregate amount banks are willing to lend against the security it has provided as well as house investments and any client collateral that has not been re-pledged but may be so re-pledged as permitted by the proposed re-pledging limit).

9.3 The objective of establishing these benchmarks of best practice is to require SMF providers that exceed these thresholds to review their financial situation and take such steps as may be necessary to ensure that their financial viability is safeguarded. Any firm that persistently fails to comply with these benchmarks can expect the SFC to assess whether the firm's financial and credit practices give rise to risks which call into question its fitness and properness to remain licensed. Please refer to **Annex 8** for draft amendments to the Code of Conduct.

Question 12

Do you agree that the above measures should be implemented to encourage firms to adhere to these minimum standards of best practice? If not, what are other alternative measures that could achieve the same objectives?

New requirements on disclosure to clients

9.4 Client collateral can only be re-pledged if margin clients authorize their SMF provider to do so. Clients should therefore be made aware that they are exposing themselves to pooling risk when they authorize their SMF provider to use their collateral as security for the firm's borrowings.

9.5 The results of the SFC's Retail Investor Survey 2003** that was published in March 2004 show that investors may not always be aware of the risks arising from SMF. Only about 59% of respondents to the survey knew about pooling risk, whereas only about 40% were aware that some SMF providers usually required margin clients to authorize the firm to re-pledge their collateral as security for loans obtained by the firm. Moreover, 61% of respondents supported the idea of enhancing the transparency of pooling arrangements in relation to margin client collateral as a means of reducing pooling risk. (**A copy of the Survey can be downloaded from the SFC's Website at www.hksfc.org.hk.)

9.6 The Working Group considered that SMF providers should take steps to increase their clients' level of awareness regarding their re-pledging practices. The Working Group agreed that SMF providers should –

(a) include in the monthly statements of account a statement or message to the effect that –
  (i) the client had authorized the firm to re-pledge his or her collateral to obtain its credit facilities; and
  (ii) the firm had, during the period covered by the statement, re-pledged client collateral (i.e. collateral belonging to any margin clients; not necessarily or specifically that of the margin client to whom the statement is sent) to secure its credit facilities; and

(b) include a reminder, in the notice of annual renewal of client authorization to the firm to re-pledge client collateral, –
  (i) to remind the investor to read the risk disclosure statement in respect of giving such authorization; and
  (ii) that, if the client does not need SMF facilities, he or she may always switch to a cash account.

The SFC supports this approach and agrees that investors should be made better aware of the risks arising from authorizing SMF providers to re-pledge their collateral. The SFC believes that, to be effective, disclosure should be made in plain, simple language and should be as clear and concise as possible.

9.7 Please see the draft amendments to the Securities and Futures (Contract Notes, Statements of Account and Receipts) Rules at **Annex 3** and the Securities and Futures (Client Securities) Rules at **Annex 9**.

Question 13

Do you agree that the above disclosure and notification proposals may help investors to be more aware of the risks to which they are exposed in holding margin accounts?

Question 14

How long should the transitional period be for existing firms for each supplementary measure above? Should the transitional period involve a single stage transition or more than one stage?

X. ANCILLARY CHANGES

Ancillary FRR Changes

Tightening the FRR provision on cash client receivables

10.1 The SFC is confident that the proposed FRR haircut percentage rates would significantly reduce the credit risks faced by the SMF providers that will be impacted by the measures. However, there is a concern that some of the affected firms might try to sidestep the new rules by providing financial

accommodation to their margin clients in a different form. For example, by converting their margin clients into cash clients and allowing them an extended settlement period for paying for their stock purchases, these clients are effectively allowed to trade on margin.

10.2 The current FRR allow a firm to include in its liquid assets amounts receivable from cash clients in the firm's liquid assets in full, provided that such amount has not been outstanding for more than 5 business days after the due settlement date. Thereafter, the firm can include in its liquid assets the lower of the cash client receivable and the market value of securities purchased by that client (without any haircut deduction). The firm can continue to do this until the amount has been outstanding for more than one month after which it will be excluded in full from the firm's liquid assets.

10.3 In October 2003 there was prominent media coverage of the fact that more securities firms were allowing their cash clients to defer settlement of their purchases by up to eight days. This practice inevitably carries with it higher credit risk as effectively these firms are providing credit by not enforcing prompt settlement and may not possess clear security interest in the client's stock holdings under this arrangement (unlike the case of bona fide margin financing where client stock is required to be pledged as collateral). A great number of brokers raised concerns with the SFC. Some urged the SFC to take action by both reminding the industry of the risks and closely monitoring those firms that engaged in such a practice. In response, the SFC issued a circular, urging firms to stop extending such credit to their cash clients if the firms did not have the necessary risk management measures in place. The SFC believes that it is not acceptable for firms to offer extended settlement periods to clients, taking advantage of the current FRR's lenient approach, without having sufficient capital that is commensurate with the risk arising from such granting of credit, especially when the securities being purchased are volatile and where firms do not have clear security interest in the client's stock holdings. In addition, the longer the extended settlement period, the higher the market risk to the firm. In view of the above, we propose to reduce the current grace period from 5 business days to 2 business days after the settlement date.

10.4 This proposal would inevitably impact those securities brokers that allow long settlement periods - they would either have to shorten their settlement periods offered to clients or put in additional capital of their own to hedge the risk. However, we consider that this forms an essential part of prudent risk management and that our present proposal already strikes a fair balance by seeking to reduce the risks to a reasonable level whilst still allowing firms some time to follow up on late settlement. Some firms also tell us that if we used regulation to plug this loophole, it would actually help them when they are pushed by clients into offering a longer settlement accommodation.

Question 15

Do you agree that the proposal to reduce the current grace period governing cash client receivables can help moderate the risks arising from firms granting cash clients an extended period to pay for their stock purchases?

Do you think reducing the current grace period from 5 business days to 2 business days is appropriate?

If this ancillary measure is to be adopted, how long should the transitional period be for existing firms for this ancillary measure? Should the transitional period involve a single stage transition or more than one stage?

We invite suggestions or alternative proposals that may address these concerns.

Other applications of the proposed haircut table

10.5 Under the existing regulatory framework, the application of haircuts not only dictates the amount in which margin client receivables are included in a firm's liquid assets, but it also affects other positions such as the broker's house investments.

10.6 During discussions with some market participants in the last few months, the issue was raised as to whether the brokers should continue following existing practice and be subject to the same set of FRR haircut percentage rates for all positions, including house investments.

10.7 If the new FRR haircut percentage rates were to continue to apply to house investments, more firms might be affected. Of course, the degree of impact to the affected firms would depend on a firm's composition of house investments. For firms that mostly hold blue chip shares and shares in the Hong Kong Exchange and Clearing Corporation (Stock Code: 388), the impact on them is minimal because the proposed revised haircuts for such stocks are either just a few percentage points above or exactly the same as the currently applicable haircuts. The firms which would be most affected will be those holding less liquid stocks.

10.8 According to the financial resources returns submitted by brokers to the SFC for June 2004, the level of regulatory capital for most brokerage firms will be minimally impacted, other firms will experience a reduction in regulatory capital to varying degrees, but only a small handful of firms will actually need to add more capital to meet the minimum FRR requirements and the amount of additional capital involved is insignificant.

Question 16

What are your views on whether there should continue to be one universal set of FRR haircut percentage rates that would apply to all positions?

Other ancillary changes

10.9 The SFC proposes that the other new notification requirements outlined in paragraph 9.2(b) above should also apply to all licensed corporations, except for advisers and fund managers that are subject to the specific licensing condition that they do not hold client assets.

XI. OTHER FRR AMENDMENTS

Possible relaxations of the FRR

11.1 The SFC recognizes that the risks arising from SMF business may be moderated by the proposed per-firm re-pledging limit and adjusted FRR haircut percentage rates. Depending on the final level of the FRR haircut percentage rates and re-pledging limit, there may be room for relaxing certain existing measures in the FRR which are aimed at controlling the risks inherent in SMF. The SFC has identified the following areas for potential relaxation.

Gearing ratio adjustment

11.2 The gearing ratio adjustment was introduced in 2002 as an interim measure to discourage SMF providers from over reliance on re-pledging client collateral to fund their operations. It requires an SMF provider to take a capital charge in the amount by which its borrowings secured by client collateral exceed 65% of its aggregate margin loans. The result is that the excess amount must be funded out of the firm's own resources.

11.3 Although the gearing ratio adjustment is useful in discouraging firms from relying excessively on financing secured by re-pledging client collateral, it does not limit the amount of client collateral that they can re-pledge. The re-pledging limit is designed to address this gap. It may be that the gearing ratio could be relaxed or even removed, depending on the level at which the re-pledging limit is set.

Question 17

What are your views on lifting or adjusting the gearing ratio? At what level of re-pledging limit should we consider removing or adjusting the gearing ratio?

Concentration Discounting Factor ("CDF") and Concentrated margin client adjustment

11.4 The FRR revision in 2000 introduced the CDF and concentrated margin client adjustment, which aimed to discourage concentrations of collateral and margin loans that might jeopardise an SMF provider's liquidity and solvency.

11.5 In essence, the CDF seeks to provide a moderation against the concentration risk that arises when a holding in a particular stock exceeds a certain size compared to the aggregate amount of client collateral held by the firm. Similarly, as a means of discouraging concentrated exposure to a margin client (or a group of related margin clients), the concentrated margin client adjustment requires an SMF provider to take a capital charge whenever its lending to the client (or group of clients) exceeds 10% of its aggregate margin loans. This directly affects the amount that can be included in the SMF provider's liquid assets, irrespective of the quality of the collateral deposited by that client or group of clients.

11.6 Under the proposed revised haircut percentages, stocks will be subject to a higher and more risk-sensitive haircut. Additionally, an increase in the illiquid collateral haircut will further discourage firms from holding concentrated positions in illiquid stocks. Therefore, the SFC will consider the possibility of abolishing the CDF and the concentrated margin client adjustment after reviewing the consultation responses to the proposed haircuts.

Question 18

Should the CDF and the concentrated margin client adjustment be abolished? At what haircut percentages should we start to consider abolishing them?

XII. WAY FORWARD

Proposed measures to apply to all newcomers

12.1 The SFC strongly believes that the measures proposed above are the minimum needed to provide better investor protection while maintaining a healthy and vibrant securities market. Hence, the measures should be implemented as soon as possible with a reasonable transitional period for existing firms. New firms will be required to comply with all proposed measures from day one.

12.2 Market turnover for the first half of 2004 has been good and profitability has improved. Daily stock turnover achieved a healthy average of $16.5 billion for the first half of 2004 (compared to $7.1 billion for the first half of 2003) and the profitability of the SEHK participants has increased significantly to almost $5 billion for the first half of 2004 (compared to $1.6 billion for the first half of 2003). Against this background and with the provision of a transitional period, affected firms should be able to find the necessary financial means to comply with the new measures before they come into effect. The SFC will work closely with them during the transitional period. We are happy to consider an appropriate transitional period, or implementation in stages, to ensure that all firms have adequate time to prepare themselves and can comply.

Long-term solutions

12.3 The SFC shares the belief of a number of Working Group members that Hong Kong should not only look at short-term answers but also long-term solutions.

These would include segregating non-borrowing margin client collateral and tiering capital to risks.

Segregation of client collateral

12.4 Although the Working Group generally recommended a per-firm re-pledging limit of between 130% and 150%, there had been a suggestion that ultimately, the re-pledging limit should be 100%. Whilst this would give margin clients a greater degree of protection, we believe that this might be too drastic a measure.

12.5 The Working Group pointed out, and the SFC also recognizes, that the re-pledging limit will not stop an SMF provider from re-pledging non-borrowing margin client collateral; a practice which is prohibited in other major overseas markets, such as the US and the UK. Some members of the FAP have questioned why the SFC did not propose a complete segregation, and why Hong Kong continues to lag behind international practice in this regard.

12.6 The SFC takes the view that segregation of non-borrowing margin client collateral should eventually be required in Hong Kong, but not until an infrastructure to support such segregation in a cost effective way is in place. The reasons for requiring the segregation of the collateral of non-borrowing margin clients are manifold. First, it is the international standard of investor protection as it limits the exposure of margin clients to pooling risk to those who actually trade on margin. Secondly, there is no sound justification for an SMF provider to profit from leveraging on the collateral of clients who have no margin loan from the firm. From an investor protection point of view, the firm should be allowed to use the collateral put up by borrowing clients to secure loans from the firm, however, the firm should not be allowed to use the collateral of clients who are not indebted to the firm. Thirdly, banning such a practice would greatly improve the risk profiles of SMF providers that rely to a great extent on the funding obtained by re-pledging the collateral of non-borrowing margin clients. This, in turn, would protect the securities industry from the damaging domino effect that could occur if an SMF provider were to go into liquidation as a consequence of its having assumed risk levels beyond its capacity. However, currently there is no market wide infrastructure that would enable all firms to move to such a business model. The SFC recommends that the market devote resources in this area with a view to identifying and building this infrastructure.

Question 19

Do you think that Hong Kong should move towards prohibiting the pooling and re-pledging of non-borrowing margin client collateral? What other considerations should the SFC take into account?

Regulatory capital requirements

12.7 The Working Group recognized that the global trend is for securities firms to maintain sufficient capital to buffer against the risks that they assumed in carrying on their business. Compared to Hong Kong, brokers capital requirements are very substantial elsewhere in the region. Experience shows that well capitalized firms invest in technology and risk management methodologies, thus assuring their clients that they not only have the technology and the expertise to look after their investment needs, but that their client assets will be less likely to be jeopardised by the firm's financial collapse.

12.8 This trend seems to have gained public support as 57% of respondents to the SFC's Retail Investor Survey 2003 favoured imposing higher capital requirements on SMF providers as a means of reducing pooling risk.

12.9 In this context, the Working Group agreed that firms that do not hold client assets could have lower capital requirements than those that do. Towards this end, the Working Group looked at the viability of an investor participant ("IP") account model. Under this measure, cash clients would be holding their securities in IP accounts for safe custody under their own name. As this affords better protection for cash clients, the SFC supports the establishment of a cost effective and user-friendly IP model. However, securities of margin clients, as they are pledged with the broker, and in some cases have been re-pledged with banks, cannot be placed in the clients' IP accounts.

12.10 Hence, the SFC believes that the long-term objective should be to tier regulatory capital to risks – the higher the risks; the higher the capital requirements, and the lower the risk; the lower the capital requirements, a view that was also shared by the Working Group.

Question 20

What are your views on this long-term objective?

Annex 1

List of Questions

1. A per-firm re-pledging limit will inevitably involve a compliance cost to market players. The SFC invites suggestions on how best to keep the compliance cost within reasonable limits without compromising the level of protection afforded by the re-pledging limit.

2. What is the most appropriate level of re-pledging limit?

3. If the re-pledging limit is set at the lower end of the range recommended by the Working Group, is it practicable and useful to add a buffer? If a buffer is included, how many percentage points should it be?

4. Do you agree that the re-pledging limit, after being incorporated into the appropriate subsidiary legislation under the SFO, would ensure better compliance and enhance investor protection?
   What other alternative mechanisms or arrangements could provide an appropriate level of flexibility and investor protection?

5. Do you have any views on the PBB idea?

6. Do you agree that the FRR haircut percentage rates should be adjusted in order to improve their utility as a risk management mechanism?

7. Is the proposed 100% haircut for listed warrants appropriate?

8. Should the haircut for illiquid collateral be increased? If so, what is the appropriate haircut percentage?

9. Do you think the proposed haircut rates as set out in Table 1 are appropriate? Do you have any suggestions as to how the proposed flexibility mechanism could be improved?

10. How long should the transitional period be for existing firms for each recommended measure (re-pledging limit and the revised FRR haircut percentage rates)? Should the transitional period involve a single stage transition or more than one stage?

11. Do you think that the revised haircut rates for listed warrants and illiquid collateral should become effective after a transitional period or as soon as the FRR amendments come into force?

12. Do you agree that the above measures should be implemented to encourage firms to adhere to these minimum standards of best practice? If not, what are other alternative measures that could achieve the same objectives?

13. Do you agree that the above disclosure and notification proposals may help investors to be more aware of the risks to which they are exposed in holding margin accounts?

14. How long should the transitional period be for existing firms for each supplementary measure above? Should the transitional period involve a single stage transition or more than one stage?

15. Do you agree that the proposal to reduce the current grace period governing cash client receivables can help moderate the risks arising from firms granting cash clients an extended period to pay for their stock purchases?
Do you think reducing the current grace period from 5 business days to 2 business days is appropriate?
If this ancillary measure is to be adopted, how long should the transitional period be for existing firms for this ancillary measure? Should the transitional period involve a single stage transition or more than one stage?
We invite suggestions or alternative proposals that may address these concerns.

16. What are your views on whether there should continue to be one universal set of FRR haircut percentage rates that would apply to all positions?

17. What are your views on lifting or adjusting the gearing ratio? At what level of re-pledging limit should we consider removing or adjusting the gearing ratio?

18. Should the CDF and the concentrated margin client adjustment be abolished? At what haircut percentages should we start to consider abolishing them?

19. Do you think that Hong Kong should move towards prohibiting the pooling and re-pledging of non-borrowing margin client collateral? What other considerations should the SFC take into account?

20. What are your views on this long-term objective?

Annex 2

Draft amendments of the Securities and Futures (Client Securities) Rules: Repledging limit

[*Commencement provision will be in section 1 of the Amendment Rules.*]

Section 2 – Interpretation

"business day" (營業日), means a day other than –

(a) a Saturday;

(b) a public holiday; or

(c) a gale warning day or black rainstorm warning day as defined in section 71(2) of the Interpretation and General Clauses Ordinance (Cap 1);

Section 7 – Treatment of securities collateral by dealers and their associated entities

(1) This section applies to -

(a) an intermediary licensed or registered for dealing in securities; and

(b) an associated entity of such intermediary.

(2) With a standing authority, an intermediary or an associated entity to which this section applies may –

(a) apply any of the client securities or securities collateral in question pursuant to a securities borrowing and lending agreement;

(b) subject to section 8A, deposit any of the securities collateral in question with an authorized financial institution as collateral for financial accommodation provided to the intermediary; or

(c) deposit any of the securities collateral in question with –

(i) a recognized clearing house; or

(ii) another intermediary licensed or registered for dealing in securities,

as collateral for the discharge and satisfaction of the intermediary's settlement obligations and liabilities.

(3) Where an intermediary to which this section applies –

(a) provides financial accommodation to a client of the intermediary in the course of dealing in securities; and

(b) also provides financial accommodation to the client in the course of any other regulated activity for which the intermediary is licensed or registered,

the intermediary or an associated entity of the intermediary may apply or deposit any of the securities collateral in question in accordance with subsection (2) with a standing authority.

Section 8 – Treatment of securities collateral by SMF & their associated entities

(1) This section applies to –

(a) an intermediary licensed for securities margin financing; and

(b) an associated entity of such intermediary.

(2) With a standing authority, an intermediary or an associated entity to which this section applies may, subject to section 8A, deposit any of the securities collateral in question with –

(a) an authorized financial institution; or

(b) an intermediary licensed for dealing in securities,

as collateral for financial accommodation provided to the intermediary.

Section 8A – Repledging limit

(1) This section applies to –

(a) an intermediary licensed for dealing in securities; or

(b) an intermediary licensed for securities margin financing; and

(c) an associated entity of such intermediary,

that deposits, causes to be deposited or has on deposit securities collateral as collateral for financial accommodation provided to the intermediary.

(2) On any business day, an intermediary or an associated entity of an intermediary to which this section applies shall ascertain the aggregate market value of the repledged securities collateral, which is calculated by reference to the closing prices on that business day.

(3) If the aggregate market value of the repledged securities collateral calculated pursuant to subsection (2) exceeds [*repledging limit, including buffer (if any)*]% of the intermediary's aggregate margin loans on the same business day, the intermediary shall by the close of business on the following business day withdraw, or cause to be withdrawn, from deposit an amount of repledged securities collateral such that the aggregate market value of the repledged securities collateral at the close of business on the second-mentioned business day, which is calculated by reference to the respective closing prices on the first-mentioned business day, does not exceed [*repledging limit*]% of the intermediary's aggregate margin loans as at the close of business on the first-mentioned business day.

(4) In this section –

"repledged securities collateral" (已轉按證券抵押品) means any securities collateral which is on deposit as collateral for financial accommodation provided to an intermediary to which this section applies, whether deposited or caused to be deposited by the intermediary or an associated entity of such intermediary;

"aggregate margin loans" (保證金貸款總額) in relation to an intermediary to which this section applies, means the total value of margin loans owed to the intermediary by its margin clients as at the close of business on a business day, excluding any amounts added to or deducted from the margin loans in respect of dealings in securities which are not yet due for settlement according to the settlement date;

"settlement date" (交收日期) means the date on which payment for dealings in securities is first due between the parties to the transaction.

Section 14 – Transitional

Where –

(a) an intermediary is licensed immediately prior to [*commencement date*] for dealing in securities or a corporation is an associated entity of such intermediary immediately prior to that date; or

(b) an intermediary is licensed immediately prior to [*commencement date*] for securities margin financing or a corporation is an associated entity of such intermediary immediately prior to that date,

for the purpose of section 8A –

(i) for the period from [ ] 2005 to [ ] 2005] [i.e. *first stage of transitional period*] references in section 8A to –

(A) [*the repledging limit*]% shall be construed as references to [*XXX, ie a higher percentage*]%; and

(B) [*the repledging limit, plus buffer amount*]% shall be construed as references to [*ie, XXX plus the buffer amount*]%; and

(ii) for the period from [ ] 2005 to [ ] 2005 [*ie second stage of transitional period*] references in section 8A to –

(A) [*the repledging limit*]% shall be construed as references to [*YYY, ie a percentage between XXX and the repledging limit*]%; and

(B) [*ie, the repledging limit plus buffer amount*]% shall be construed as references to [*ie, YYY plus the buffer amount*]%.

Explanatory Notes

1. With a view to avoiding the imposition of excessive compliance burden upon firms affected by the repledging limit, snapshots of the aggregate value of the securities collateral repledged as collateral for financial accommodation to a licensed securities margin financing provider ("SMF provider") and of the aggregate margin loans are taken at the close of business on any business day. Therefore, intra-day fluctuations in these amounts are disregarded. Please see section 8A(2) - (4).

2. The obligation to observe the repledging limit rests upon all SMF providers and their associated entities. It is proposed that failure to take the necessary action under subsection (3) would be a contravention of section 10(1) of the Rules, it would attract criminal liability under section 13(3) and (4).

3. The obligation to withdraw a portion of the repledged client collateral (i.e. withdraw such securities collateral deposited by the SMF provider or any of its

associated entities as collateral for financial accommodation[1] provided to the intermediary) only arises when the aggregate market value of the repledged client collateral, as at the end of any business day exceeds the "Repledging Limit in Value", namely, the repledging limit percentage multiplied by the amount of margin loans outstanding (or exceeds the "Repledging Limit in Value" by more than the buffer, if any).

4. Once the obligation to withdraw repledged collateral arises, the SMF provider must within one business day withdraw, or cause its associated entity to withdraw, the excess repledged collateral. As long as section 8A(3) is complied with, no criminal liability will be incurred, even if at the end of the business day on which the requisite portion of collateral is withdrawn the aggregate market value of the repledged collateral is once again in excess of the "Repledging Limit in Value" when these figures are calculated using the closing prices and closing balances on that business day.

5. Where the SMF provider fails to withdraw, or cause to be withdrawn, the requisite amount of client collateral within the business day in question under section 8A(3), it must notify the SFC of that fact and the reasons for the failure within one business day of so failing, by virtue of the reporting obligation in section 12 of the Rules.

6. Some industry participants have already made known their views that a multi-staged transition would reduce the impact on the affected SMF providers. Section 14 illustrates one way in which the transitional period could be staged.

[1] "Financial accommodation" is defined in Schedule 1 to the SFO to mean, essentially, a loan or similar credit facilities.

Annex 3

Draft Amendments of the Securities and Futures (Contract Notes, Statements of Account and Receipts) Rules: Notification to clients

Section 11 – Preparation and provision of monthly statements of account

(1) In this section, "monthly accounting period" (按月會計期) means –

(a) in relation to the first statement of account required to be prepared and provided to a client of an intermediary in accordance with subsection (2) or (4) (as the case may be), a period not exceeding one month ending on a date selected by the intermediary; and

(b) in relation to any subsequent statement of account, a period the duration of which shall be not less than 4 weeks and not exceed one month, commencing on the day after the date on which the previous monthly accounting period ended, and ending on a date selected by the intermediary.

(2) Subject to subsection (4), where any of the circumstances specified in subsection (6) apply in respect of a client of an intermediary in respect of a monthly accounting period, the intermediary shall –

(a) prepare a statement of account in respect of the client in accordance with subsection (3); and

(b) provide the statement of account to the client no later than the end of the seventh business day after the end of the monthly accounting period.

(3) A statement of account referred to in subsection (2) shall include the information required to be included under section 7 and, to the extent applicable, the following information relating to the account of the client –

(a) the address of the principal place of business in Hong Kong of the intermediary;

(b) the outstanding balance of and the net equity in that account as at the beginning and as at the end of that monthly accounting period and details of all movements in the balance of that account during that period;

(c) details of all relevant contracts entered into by the intermediary with or on behalf of the client during that monthly accounting period, indicating those initiated by the intermediary;

(d) details of all events specified in section 8(3) which have taken place during that monthly accounting period, including what happened to the proceeds of any disposals initiated by the intermediary during that period of any client securities and collateral of the client held for that account;

(e) details of all movements during that monthly accounting period of any –

(i) client securities and collateral of the client; and

(ii) security provided by or on behalf of the client in relation to a margined transaction,

held for that account;

(f) the quantity, and, in so far as readily ascertainable, the market price and market value of each description of -

(i) client securities and collateral of the client; and

(ii) security provided by or on behalf of the client in relation to a margined transaction,

held for that account as at the end of that monthly accounting period;

(g) the margin ratio and margin value of each description of securities collateral held for that account as at the end of that monthly accounting period

(ga) in the case of an intermediary –

(i) which is licensed for securities margin financing; or

(ii) which is licensed or registered for dealing in securities,

which has, or whose associated entity (if any) has, received or held securities collateral during that monthly accounting period, a statement that –

(A) the client has provided the intermediary or the associated entity of such intermediary with a standing authority, which has not been revoked, to deposit his securities collateral as collateral for financial accommodation provided to the intermediary; and

(B) the intermediary or the associated entity of such intermediary has deposited any securities collateral as collateral for any financial accommodation provided to the intermediary during the period to which the statement of account relates;

(h) details of all income credited to and charges levied against that account during that monthly accounting period;

(i) all floating profits and floating losses in respect of open positions held for that account as calculated as at the end of that monthly accounting period and the prices used for such purposes;

(j) a list of all open positions held for that account as at the end of that monthly accounting period;

(k) the minimum margin requirement for all open positions held for that account as at the end of that monthly accounting period;

(l) the amount of margin excess or margin shortfall in that account as at the end of that monthly accounting period;

(m) the amount of option premium receivable or payable in respect of that account as at the end of that monthly accounting period; and

(n) where the account is for dealing in securities, an indication that it is a margin account.

(4) Where an intermediary is licensed or registered for asset management and, in relation to the conduct by the intermediary of asset management (other than the management of a collective investment scheme), any of the circumstances specified in subsection (6) apply in respect of a client of the intermediary in respect of a monthly accounting period, the intermediary shall –

(a) prepare a statement of account in respect of the client in accordance with subsection (5); and

(b) provide the statement of account to the client no later than the end of the tenth business day after the end of the monthly accounting period.

(5) A statement of account referred to in subsection (4) shall include the information required to be included under section 7 and, to the extent applicable, the following information relating to the account of the client –

(a) the address of the principal place of business in Hong Kong of the intermediary;

(b) a valuation of the client's portfolio as at the end of the monthly accounting period providing –

(i) details of the quantity, market price, purchase cost and market value of each description of securities held for that account as at the end of that period;

(ii) details of all open positions as at the end of that period;

(iii) the money balance held for that account as at the end of that period; and

(iv) the amount of accounts payable and receivable in respect of that account as at the end of that period;

(c) details of all income credited to and charges levied against that account during the monthly accounting period; and

(d) a list of all contracts entered into in Hong Kong by the intermediary with or on behalf of the client during the monthly accounting period for dealing in securities and futures contracts and that are leveraged foreign exchange contracts.

(6) The circumstances specified for the purposes of subsection (2) and (5) are –

(a) during a monthly accounting period, the intermediary is required to prepare and provide to the client –

(i) a contract note in accordance with section 5;

(ii) a statement of account in accordance with section 8 or 9; or

(iii) a receipt in accordance with section 13;

(b) during a monthly accounting period, an associated entity of the intermediary is required to prepare and provide to the client a receipt in accordance with section 13;

(c) at any time during a monthly accounting period, the client has an account balance that is not nil;

(d) the client has an open position as at the end of a monthly accounting period; or

(e) at any time during a monthly accounting period –

(i) any client securities and collateral; or

(ii) any security provided in relation to a margined transaction,
are held for the account of the client.

Annex 4

Draft amendments of the FRR: Schedule 2 - Haircut Tables

Schedule 2

TABLE 1

HAIRCUT PERCENTAGES FOR SHARES LISTED IN HONG KONG~~, THE UNITED KINGDOM, THE UNITED STATES OF AMERICA AND JAPAN (SHARES STRATIFIED ACCORDING TO STOCK INDICES)~~

Item	Description	Haircut Percentage %
1.	Shares which are listed on a recognized stock market-	~~15~~
	(a) being a constituent of the Hang Seng Index or the Hang Seng Hong Kong LargeCap Index	20
	(b) being a share – (i) which has been listed for a period of less than 7 months (including any period during which the share is suspended from trading) immediately preceding the month in which the calculation of liquid assets or ranking liabilities is made and having a reference date market capitalization of not less than $10,000,000,000; or (ii) which has been listed for a period of 7 months or more (including any period during which the share is suspended from trading) immediately preceding the month in which the calculation of liquid assets or ranking liabilities is made and having - (I) a reference date market capitalization of not less than $10,000,000,000; and (II) an average monthly market turnover not less than $300,000,000	20
	(b~~c~~) ~~to the extent not already covered in paragraph (a)~~ being a constituent of the Hang Seng Hong Kong MidCap Index, the Morgan Stanley Capital International Inc. Hong Kong Index or the Morgan Stanley Capital International Inc. China Index	~~20~~40
	(d) being a share – (i) which has been listed for a period of less than 7 months (including any period during which the share is suspended from trading) immediately preceding the month in which the calculation of liquid assets or ranking liabilities is made and having a reference date	40

	market capitalization of not less than $5,000,000,000; or	
	(ii) which has been listed for a period of 7 months or more (including any period during which the share is suspended from trading) immediately preceding the month in which the calculation of liquid assets or ranking liabilities is made and having -	
	(I) a reference date market capitalization of not less than $5,000,000,000; and	
	(II) an average monthly market turnover not less than $300,000,000	
	(e) being a constituent of the Hang Seng Composite Index	60
	(~~e~~f) being any share not referred to in paragraph (a), ~~or~~ (b), (c), (d) or (e)	~~30~~80
2.	Shares which are listed on a recognized stock market not being stratified according to stock indices or other criteria	80
~~2.~~	~~Shares which are listed on a specified exchange in the United Kingdom (other than the London Stock Exchange plc-SEAQ International), the United States of America (other than the Nasdaq Stock Market, Inc.-Nasdaq National Market) or Japan (other than the Japanese Association of Securities Dealers Automated Quotations)-~~	
	~~(a) being a constituent of the FTSE-100 Index, Nikkei 500 Index or Standard & Poor's 500 Index~~	~~15~~
	~~(b) being any share not referred to in paragraph (a)~~	~~20~~

TABLE 2

HAIRCUT PERCENTAGES FOR SHARES LISTED IN ~~HONG KONG,~~ THE UNITED KINGDOM, THE UNITED STATES OF AMERICA AND JAPAN ~~(SHARES NOT STRATIFIED ACCORDING TO STOCK INDICES)~~

Item	Description	Haircut Percentage %
~~1.~~	~~Shares which are listed on a recognized stock market~~	~~30~~
1.	Shares which are listed on a specified exchange in the United Kingdom (other than the London Stock Exchange plc-SEAQ International), the United States of America (other than the Nasdaq Stock Market, Inc.-Nasdaq National Market) or Japan (other than the Japanese Association of Securities Dealers Automated Quotations) -	
	(a) being a constituent of the FTSE-100 Index, Nikkei 500 Index or Standard & Poor's 500 Index; or	15

	(b) being any share not referred to in paragraph (a)	20
2.	Shares which are listed on a specified exchange in the United Kingdom (other than the London Stock Exchange plc-SEAQ International), the United States of America (other than the Nasdaq Stock Market, Inc.-Nasdaq National Market) or Japan (other than the Japanese Association of Securities Dealers Automated Quotations) not being stratified according to stock indices	20

TABLE 7

HAIRCUT PERCENTAGES FOR SPECIFIED SECURITIES

Item	Description	Haircut Percentage
1.	Specified securities being warrants listed on a specified exchange	~~40~~100%
2.	Specified securities being equity linked instruments	same as that applicable to the underlying securities
3.	Specified securities being units in any unit trust or shares in any mutual fund-	
	(a) which is authorized under section 104 of the Ordinance; or	
	(b) under a Recognized Jurisdiction Scheme specified in an Appendix to the Code on Unit Trusts and Mutual Funds published by the Commission,	
	where their nature is-	
	(c) the same as that of a warrant fund, futures and options fund, leveraged fund or hedge fund referred to in that Code; or	40%
	(d) not the same as any of the funds mentioned in paragraph (c)	20%

Explanatory Notes

1. In drafting the amended haircut Tables, we took the view that they would be more user-friendly if all the haircut percentages for Hong Kong listed shares were provided in one Table (the amended Table 1), both stratified according to stock indices and other qualifying criteria and not so stratified. Therefore, item 2 in Table 1 has been relocated from item 1 of Table 2. Table 2 has been amended in a similar way, so that it includes all haircut percentages for the

specified overseas listed securities, both with and without stratification according to indices.

2. It is proposed that the haircut percentages in Table 1 in Schedule 2, will apply after expiration of the transitional period (please see Annex 6). No transitional period is proposed for giving effect to the new 100% haircut for listed warrants, as prescribed in the amended Table 7.

3. During the transitional period, the haircut percentages in Table 1 would be those prescribed in Table 1 in Schedule 6 (please see Annex 7). The haircuts in the amended Schedule 2 would then take effect after expiration of the transitional period.

Annex 5

Draft amendments of the FRR: Definitions

Section 2(1) …

"average monthly turnover"* (平均每月成交額), in relation to a listed share or listed warrant, means one sixth of the aggregate value of transactions in that share or warrant on any exchange on which it is listed 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 of liquid assets or ranking liabilities is made;

"haircut amount" (扣減數額)-

(a) in relation to any shares-

(i) that are listed in Hong Kong~~, the United Kingdom, the United States of America or Japan (stratified according to stock indices)~~, specified in column 2 of Table 1 in Schedule 2;

(ii) that are listed in ~~Hong Kong,~~ the United Kingdom, the United States of America or Japan~~ (not stratified according to stock indices)~~, specified in column 2 of Table 2 in Schedule 2; or

(iii) that are listed (other than those referred to in subparagraph (i) or (ii)), specified in column 2 of Table 3 in Schedule 2,

means an amount derived by multiplying the market value of the shares by the haircut percentage in relation to such shares;

(b) in relation to specified investments, means an amount derived by multiplying the market value of the specified investments by the haircut percentage in relation to such specified investments;

(c) in relation to specified securities, means an amount derived by multiplying the market value of the specified securities by the haircut percentage in relation to such specified securities;

(d) in relation to qualifying debt securities, means an amount derived by multiplying the market value of the qualifying debt securities by the haircut percentage in relation to such qualifying debt securities;

(e) in relation to special debt securities, means an amount derived by multiplying the market value of the special debt securities by the haircut percentage in relation to such special debt securities;

"haircut percentage" (扣減百分率)-

(a) in relation to any shares-

(i) that are listed in Hong Kong~~, the United Kingdom, the United States of America or Japan (stratified according to stock indices)~~, specified in column 2 of Table 1 in Schedule 2;

(ii) that are listed in ~~Hong Kong,~~ the United Kingdom, the United States of America or Japan~~ (not stratified according to stock indices)~~, specified in column 2 of Table 2 in Schedule 2; or

(iii) that are listed (other than those referred to in subparagraph (i) or (ii)), specified in column 2 of Table 3 in Schedule 2,

means-

(iv) in the case where a share which is described in column 2 of item 1 of Table 1 in Schedule 2 -

(I) ceases to be a constituent stock of the applicable index; or

(II) ceases to meet the applicable market capitalization or average market turnover criteria; and

(III) the occurrence of the event specified in subsubparagraph (I) or (II) would result in the assignment of a higher haircut percentage to the share,

during the month in which the event specified in subsubparagraph (I) or (II) occurs and for the next 3 consecutive months, the percentage assigned to the share prior to such occurrence;

(v) in the case where the share is described in two or more paragraphs in column 2 of item 1 of Table 1 in Schedule 2, such percentage specified in column 3 of the Table opposite the applicable description set out in column 2 of the Table as may be elected by a licensed corporation;

(vi) in the case where the share is described in column 2 of Table 1 in Schedule 2 and in any or both of

(I) column 2 of Table 2; and

(II) column 2 of Table 3

in that Schedule, such percentage specified in column 3 of Table 1 opposite the applicable description set out in column 2 of Table 1 in that Schedule;

(~~iv~~vii) in the case where the share~~s are~~ is described in column 2 of ~~Table 1 or~~ Table 2 in Schedule 2 and in column 2 of Table 3 in that Schedule, such percentage specified in column 3 of the Table concerned opposite the applicable description set out in column 2 of the Table as may be elected by a licensed corporation; or

(~~v~~i-viii) in any other case, the percentage specified in column 3 of the Table concerned opposite the applicable description set out in column 2 of the Table;

(b) in relation to specified investments, means the percentage specified in column 3 of Table 8 in Schedule 2 opposite the applicable description set out in column 2 of the Table;

(c) in relation to specified securities, means the percentage specified in column 3 of Table 7 in Schedule 2 opposite the applicable description set out in column 2 of the Table;

(d) in relation to qualifying debt securities, means the aggregate of-

(i) the percentage specified in column 3 of Table 4 in Schedule 2 opposite the applicable description set out in column 2 of the Table; and

(ii) the percentage specified in column 2 or 3 (as the case may be) of Table 5 in Schedule 2 opposite the applicable description set out in column 1 of the Table;

(e) in relation to special debt securities specified in column 2 of Table 6 in Schedule 2, means the percentage specified in column 3 of Table 6 in Schedule 2 opposite the applicable description set out in column 2 of the Table;

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

"reference date market capitalization"** (參考日期市場資本值), for the purposes of column 2 of Table 1 in Schedule 2, in relation to a listed share which has been traded on a recognized stock market on which it is listed –

(a) for a period of one month or less (including any period during which the share is suspended from trading) immediately preceding the month in which the calculation of liquid assets or ranking liabilities is made, means its market capitalization as at the end of the day on which it commenced such trading;

(b) for a period of more than one month (including any period during which the share is suspended from trading) immediately preceding the month in which the calculation of liquid assets or ranking liabilities is made, means its market capitalization as at the end of the last trading day of the month preceding the month immediately prior to the month in which the calculation of liquid assets or ranking liabilities is made;

Legend

* Definition relocated from section 22(5) of the FRR, so as to be of wider application.

** New definition.

Explanatory Notes

1. The definitions of "average monthly turnover", "market capitalization" and "reference date market capitalization" are required to support the alternative qualifying criteria included in items 1(b) and (d) of Table 1 of Schedule 2.

2. The proposed paragraph (a)(iv) of the definition of "haircut percentage" is to provide flexibility where a share ceases to meet the qualifying criteria specified in item 1, column 2 of Table 1 in Schedule 2 (please see Annex 4), and would thereby qualify for a higher haircut, by delaying the application of the higher haircut for 3 months after the month in which the relevant event occurs.

3. As under the current definition of "haircut percentage", licensed corporations may choose to apply the haircut percentages assigned either by reference to the specified stock indices or those assigned to such stocks without differentiation. In the same way, licensed corporations may choose to apply the haircut percentages in Table 1 in Schedule 2 based either on the stock indices specified in item 1(a), (c) or (e) of Table 1 or those based on the alternative qualifying criteria specified in item 1(b) or (d) of Table 1.

4. Under the current definition of "haircut percentage", for shares which are listed in Hong Kong, Japan, the United Kingdom or the United States and one or more other markets, licensed corporations may choose to apply the haircut percentages assigned to those markets. Following the more detailed categorisation of haircut percentages for Hong Kong listed shares, for Hong Kong listed shares that are also listed on other market(s), the haircut percentages in Table 1 of Schedule 2 will prevail.

Annex 6

Draft amendments of the FRR: Transitional (if 2-stage transitional period)

Section 60 – Transitional

(1) (*Omitted as spent*)

(2) (*Omitted as spent*)

(3) Notwithstanding section 1 and subject to subsection (5), section 5 does not apply in respect of -

(a) a partnership deemed under section 27 of Part 1 of Schedule 10 to the Ordinance to be a licensed corporation; or

(b) an individual deemed under section 30 of Part 1 of Schedule 10 to the Ordinance to be a licensed corporation,

provided that-

(c) in the case of a partnership, the aggregate of amounts maintained in all partners' capital accounts; or

(d) in the case of an individual, the amount maintained in his capital account,

is not less than the amount of paid-up share capital required of a licensed corporation under section 5, until such time as the specified decision referred to, in the case of a partnership, in section 53(1)(b) of Part 1 of Schedule 10 to the Ordinance or, in the case of an individual, in section 53(1)(c) of Part 1 of Schedule 10 to the Ordinance, takes effect.

(4) For the purposes of these Rules, a transaction executed by -

(a) a partnership deemed under section 27 of Part 1 of Schedule 10 to the Ordinance to be a licensed corporation, for the account of a partner of the partnership; and

(b) an individual deemed under section 30 of Part 1 of Schedule 10 to the Ordinance to be a licensed corporation, for his own account,

shall be treated as a transaction executed by it or him (as the case may be) for a client.

(5) (*Omitted as spent*)

(6) (*Omitted as spent*)

(7) Where a licensed corporation is licensed immediately prior to [*the commencement date of amendments*] 2005, for the purpose of calculating its liquid assets or ranking liabilities for the period from [ ] 2005 to [ ] 2005, references in these Rules to Table 1 in Schedule 2, shall be construed as referring to Table 1 in Schedule 6.

(~~7~~8) In this section -

"capital account" (資本帳) means an account in which the amount of capital injected into the business of a partnership or sole-proprietorship is kept;

"net tangible assets" (有形資產淨值). (*Omitted as spent*)

Explanatory Notes

1. During the transitional period the haircut percentages in Table 1 in Schedule 2 would be those prescribed in Table 1 in Schedule 6, with those in the amended

Schedule 2 taking effect after expiration of the transitional period. Please also see the draft amendments of section 2 of the FRR at Annex 5 and the draft of Schedule 6 at Annex 7.

2. Upon expiration of the transitional period, Schedule 6 will cease to have effect, and the haircuts prescribed in Table 1 of the amended Schedule 2 will apply. No transitional period is provided for the increase in the haircut percentage for listed warrants (please see item 1 of Table 7 in Schedule 2 at Annex 4).

3. The transitional provision will not apply to firms that are licensed after the commencement date of the amendments of the FRR.

Annex 7

Draft amendments of the FRR: Schedule 6 (if 2-stage transitional period)

Schedule 6

TABLE 1

HAIRCUT PERCENTAGES FOR SHARES LISTED IN HONG KONG

Item	Description	Haircut Percentage %
1.	Shares which are listed on a recognized stock market-	
	(a) being a constituent of the Hang Seng Index or the Hang Seng Hong Kong LargeCap Index	20
	(b) being a share –	20
	(i) which has been listed for a period of less ~~—~~than 7 months (including any period during which the share is suspended from trading) immediately preceding the month in which the calculation of liquid assets or ranking liabilities is made and having a reference date market capitalization of not less than $10,000,000,000; or	
	(ii) which has been listed for a period of 7 months or more (including any period during which the share is suspended from trading) immediately preceding the month in which the calculation of liquid assets or ranking liabilities is made and having -	
	(I) a reference date market capitalization of not less than $10,000,000,000; and	
	(II) an average monthly market turnover not less than $300,000,000	
	(~~b~~c) ~~to the extent not already covered in paragraph (a),~~ being a constituent of the Hang Seng Hong Kong MidCap Index, the Morgan Stanley Capital International Inc. Hong Kong Index or the Morgan Stanley Capital International Inc. China Index	30
	(d) being a share –	30
	(i) which has been listed for a period of less than 7 months (including any period during which the share is suspended from trading) immediately preceding the month in which the calculation of liquid assets or ranking liabilities is made and having a reference date market capitalization of not less than $5,000,000,000; or	
	(ii) which has been listed for a period of 7 months or	

	more (including any period during which the share is suspended from trading) immediately preceding the month in which the calculation of liquid assets or ranking liabilities is made and having - (I) a reference date market capitalization of not less than $5,000,000,000; and (II) an average monthly market turnover not less than $300,000,000	
	(e) being a constituent of the Hang Seng Composite Index	40
	(ef) being any share not referred to in paragraph (a), (b), (c), (d) or (e)	60
2.	Shares which are listed on a recognized stock market not being stratified according to stock indices or other criteria	60

Explanatory Notes

1. Please see the draft of Schedule 2 of the FRR at Annex 4.

2. During the transitional period, the haircut percentages in Table 1 in Schedule 2 would be those prescribed in Table 1 in Schedule 6. The haircuts in the amended Schedule 2 would then take effect after expiration of the transitional period.

3. Please also see the draft amended definitions, to be made in section 2 of the FRR at Annex 5, and the draft transitional provision (section 60 of the FRR) at Annex 6.

Annex 8

Draft amendments of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission

SCHEDULE 5: Additional requirements for licensed persons providing margin lending

Item 5 – Prudent bank borrowing

5. (a) To avoid potential over-borrowing, a licensed person should ensure that the aggregate of all outstanding bank borrowings, overdrafts, advances etc. secured by the pledging or deposit of securities collateral belonging to margin clients remains prudent when compared to the aggregate of all outstanding margin loans made to margin clients. As a general guide, the amount of such borrowings, overdrafts and advances should not exceed 120% of the value of outstanding margin loans.

(b) A licensed person should notify the Commission in writing whenever, for a continuous period of 2 weeks –

(i) the aggregate of margin loans granted to its top 20 margin clients against "illiquid collateral", within the meaning of the Securities and Futures (Financial Resources) Rules, exceeds 50% of the sum of its shareholders' funds and approved subordinated loans (if any); or

(ii) its undrawn credit facilities (including financial accommodation) fell below 20% of its total credit lines (calculated at the sum of unsecured credit facilities and the lower of secured credit facilities and the aggregate amount of credit that the credit providers would be willing to extend to the licensed person based on the security so far deposited by the licensed person as well as any securities collateral that it may further deposit as permitted under the re-pledging limit under the Securities and Futures (Client Securities) Rules and any house positions that are available for depositing as security for such credit facilities),

and provide to the Commission a full explanation of the reasons for the matter and a description of the steps that the licensed person proposes to take to prevent a recurrence.

For the purpose of computing the aggregate of margin loans granted to a licensed person's top 20 margin clients against illiquid collateral, the licensed person should take the amount of outstanding margin loan due from each of these top 20 margin clients and deduct from it the market value of all securities collateral (to the extent that such collateral is not illiquid collateral) that has been provided by these clients respectively.

Explanatory Notes

1. It should be noted that the Commission is currently proposing, in paragraph 5.4 of the Consultation Paper, to apply the requirement in paragraph 5(b) to all licensed persons (with the exception of advisers and asset managers that are subject to the specified licensing condition that they do not hold client assets). If that is adopted, this requirement may be moved from Schedule 5 to the main Code.

Annex 9

Draft Amendments of the Securities and Futures (Client Securities) Rules: Reminder at annual renewal

Section 4 – Requirements in respect of a client's standing authority

(1) For the purposes of section 6(1)(c), 7(2) or (3), 8(2) or 9(2), a standing authority is a written notice that –

(a) is given to an intermediary or an associated entity of an intermediary by a client of the intermediary;

(b) authorizes the intermediary or associated entity to deal with client securities or securities collateral from time to time received or held on behalf of the client, in one or more specified ways;

(c) subject to subsection (2), specifies a period not exceeding 12 months during which it is valid; and

(d) specifies the manner in which it may be revoked.

(2) Subsection (1)(c) shall not apply to a standing authority which is given to an intermediary or an associated entity of an intermediary by a client of the intermediary who is a professional investor.

(3) A standing authority which is not revoked prior to its expiry –

(a) may be renewed for one or more further periods –

(i) not exceeding 12 months, if the client of the intermediary who gave it is not a professional investor; or

(ii) of any duration, if the client of the intermediary who gave it is a professional investor,

at any one time, with the written consent of the client of the intermediary who gave it; or

(b) shall be deemed to have been renewed if –

(i) at least 14 days prior to the expiry of the standing authority, the intermediary or associated entity to which it was given, gives a written notice to the client of the intermediary who gave the standing authority, reminding the client of its impending expiry and informing the client that unless the client objects, it will be renewed upon expiry upon the same terms and conditions as specified in the standing authority and for –

(A) an equivalent period to that stated in the standing authority;

(B) any period not exceeding 12 months specified by the intermediary or associated entity, if the client of the intermediary is not a professional investor; or

(C) a period of any duration specified by the intermediary or associated entity, if the

client of the intermediary is a professional investor; and

(ii) the client does not object to the renewal of the standing authority before its expiry.

(3A) A written notice given by an intermediary or an associated entity under subsection (3)(b)(i) shall include a statement –

(a) inviting the client to read the risk disclosure statement regarding the provision of an authority to repledge securities collateral, as set out in the code of conduct for intermediaries published under section 169 of the Ordinance, a copy of which is to be provided or made available by the intermediary or associated entity (as the case may be) upon the client's written request; and

(b) informing the client that he may at any time close his margin trading account and change to a cash account if he finds that he does not need margin trading facilities.

(4) Where a standing authority is deemed to have been renewed in accordance with subsection (3)(b), the intermediary or associated entity (as the case may be) shall give a written confirmation of the renewal of the standing authority to the client of the intermediary within one week after the date of expiry.

Illustrative examples of how the re-pledging limit operates

The following examples demonstrate how the proposed re-pledging limit and buffer zone operate in practice under different scenarios.

In all of these examples, the following assumptions have been made –

(a) the percentage of re-pledging limit is set at 130%; and
(b) the buffer zone percentage is set at 5%.

These percentages are for illustration purposes only.

For a detailed description of the mechanism of the proposed re-pledging limit and buffer zone, please refer to Part V of the Consultation Paper.

Below are examples of how the re-pledging limit and buffer zone operate.

Examples 1 to 3 illustrate what happens when the re-pledging limit and buffer zone come into effect on the first day (Day One). We assume that the firm's portfolio of re-pledged client collateral has a different aggregate market value at the end of Day One.

Example 1: Aggregate market value of re-pledged client collateral does not exceed re-pledging limit

Assumptions: *At the end of Day One,*
(i) Firm A's portfolio of re-pledged client collateral has an aggregate market value of $129 million;
(ii) its aggregate margin loans outstanding on a settlement date basis amounts to $100 million.

- The "Re-pledging Limit in Value"[1] of Day One will be $130 million (i.e. 130% of $100 million).
- As the aggregate market value of re-pledged client collateral as at the end of Day One (i.e. $129 million) does not exceed the Re-pledging Limit in Value of Day One (i.e. $130 million), Firm A is within the re-pledging limit.
- Thus, no action will be required of Firm A on Day Two.

Example 2: Aggregate market value of re-pledged client collateral exceeds the re-pledging limit but the excess does not exceed the buffer zone

Assumptions: *Same assumptions as in Example 1 except that the portfolio of re-pledged client collateral has an aggregate market value of $134 million at the end of Day One.*

- Applying the 5% buffer zone percentage, there will be a Buffer Zone of $5 million (i.e. 5% of $100 million).

[1] Re-pledging Limit in Value equals to the re-pledging limit percentage multiplied by the aggregate amount of margin loans outstanding calculated on a settlement date basis

- The aggregate market value of re-pledged client collateral as at the end of Day One (i.e. $134 million) exceeds the Re-pledging Limit in Value of Day One (i.e. $130 million) by $4 million.
- This excess is within the Buffer Zone.
- Thus, no action will be required of Firm A on Day Two.

Example 3: Aggregate market value of re-pledged client collateral exceeds sum of re-pledging limit and buffer zone

Assumptions: Same assumptions as in Example 1 except that the portfolio of re-pledged client collateral has an aggregate market value of $139 million at the end of Day One.

- The aggregate market value of re-pledged client collateral as at the end of Day One (i.e. $139 million) exceeds the Re-pledging Limit in Value of Day One (i.e. $130 million) by $9 million.
- This excess is outside the $5 million Buffer Zone.
- Firm A is required to withdraw re-pledged 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[2] of the client collateral re-pledged as at the end of Day Two does not exceed the Re-pledging Limit in Value of Day One (i.e. $130 million).
- This means that Firm A is required to withdraw at least $9 million worth[3] of client collateral from banks on Day Two so that the aggregate historical value of the re-pledged client collateral will be reduced from $139 million to $130 million or below.

Demonstration of the effect of various changes during Day Two

Examples 4 to 5 illustrate how the re-pledging limit operates on the second day (Day Two), by assuming –

(a) Increase in the market value of the re-pledged client collateral on Day Two; or

(b) Decrease in the aggregate margin loans outstanding on Day Two.

Example 4: Increase in the market value of the re-pledged client collateral on Day Two

Assumptions: As at the end of Day Two, after effecting the withdrawal as described in Example 3,

(i) the aggregate market value of the remaining re-pledged client collateral increases to $150 million; and

(ii) the aggregate margin loans outstanding remains at $100 million.

[2] The aggregate historical value of client collateralre-pledged as at the end of Day Two shall be calculated at the market prices of those shares as at end of **Day One**.

[3] Calculated at the market prices as at end of **Day One** of the shares withdrawn.

- The Re-pledging Limit in Value of Day Two will be $130 million (130% of $100 million).
- The Buffer Zone of Day Two will be $5 million (5% of $100 million).
- The aggregate market value of re-pledged client collateral as at the end of Day Two (i.e. $150 million) exceeds the Re-pledging Limit in Value of Day Two (i.e. $130 million) by $20 million.
- This excess is outside the Buffer Zone of Day Two.
- Although Firm A exceeds the sum of the Re-pledging Limit in Value and Buffer Zone of Day Two, as far as the excess that arises on Day One is concerned, it remains in compliance with the regulatory requirements because it has already effected the withdrawal as described in Example 3.
- Firm A will have up to the end of Day Three to effect the necessary withdrawal based on Day Two positions.

Example 5: Decrease in the aggregate margin loans outstanding

Assumptions: *As at the end of Day Two, after effecting the withdrawal as described in Example 3,*

(i) the aggregate market value of the remaining re-pledged client collateral remains at $130 million; and

(ii) the aggregate margin loans outstanding decreases to $90 million.

- The Re-pledging Limit in Value of Day Two will be $117 million (i.e. 130% of $90 million).
- The Buffer Zone of Day Two will be $4.5 million (5% of $90 million).
- The aggregate market value of re-pledged collateral as at the end of Day Two (i.e. HK$130 million) exceeds the sum of the Re-pledging Limit in Value and Buffer Zone of Day Two (i.e. $121.5 million).
- As in Example 4, although Firm A exceeds the sum of the Re-pledging Limit in Value and Buffer Zone of Day Two, as far as the excess that arises on Day One is concerned, it remains in compliance with the regulatory requirements because it has already effected the withdrawal as described in Example 3.
- Firm A will have up to the end of Day Three to effect the necessary withdrawal based on Day Two positions.