

## **LEGISLATIVE COUNCIL BRIEF**

### **Securities and Futures Ordinance (Cap. 571)**

#### **SECURITIES AND FUTURES (FINANCIAL RESOURCES) RULES**

### **INTRODUCTION**

Pursuant to section 145 of the Securities and Futures Ordinance (Cap. 571 (the SFO)), the Securities and Futures Commission (the SFC), after consultation with the Financial Secretary, has made the Securities and Futures (Financial Resources) Rules (the Rules) at the **Annex**.

### **BACKGROUND**

#### **The SFO**

2. The SFO was enacted in March 2002. It consolidates and modernizes ten existing ordinances governing the securities and futures markets into a composite piece of legislation to keep the regulatory regime on a par with international standards and practices. For effective regulation, the SFO has already provided flexibility in addressing changing market practices and global conditions by empowering the Chief Executive in Council, the Financial Secretary, the Chief Justice and the SFC to prescribe detailed and technical requirements as necessary by way of subsidiary legislation, to supplement the regulatory framework laid down under the primary legislation.

3. On 22 February 2002, the House Committee of the Legislative Council established the Subcommittee on Draft Subsidiary Legislation to be made under the Securities and Futures Ordinance (the Subcommittee) to consider the subsidiary legislation necessary for commencing the SFO. From March 2002 to October 2002, the Subcommittee held 12 meetings and considered a total of 37 sets of draft subsidiary legislation, including the vires to make them.

## **THE PROPOSALS**

### **Major policy considerations**

4. To support the new single licensing regime under the SFO, the Rules consolidate and replace the current Financial Resources Rules made under the Securities and Futures Commission Ordinance (Cap. 24) (including the amendments effected by the Financial Resources (Amendment) Rules 2002) and the Leveraged Foreign Exchange Trading (Financial Resources) Rules made under the Leveraged Foreign Exchange Trading Ordinance (Cap. 451). Moreover, the Rules seek to streamline and rationalize requirements as appropriate (paragraph 8 below). While the SFC perceives a need to address various structural and financial issues (such as pooling of clients' securities collateral and the required capital level for firms conducting different regulated activities<sup>1</sup>) in the context of the overall regulatory framework, the relevant review<sup>2</sup> is ongoing and pending the result, new policy initiatives are kept to a minimum.

### **Overview of the Rules**

5. The Rules apply to all corporations licensed to conduct one or more type of regulated activities. They are designed to address risks arising from various aspects of the regulated activities carried out by licensed corporations and aim to ensure that licensed corporations have sufficient liquid assets to meet ongoing liabilities as they fall due. In the event of the failure of a firm, compliance with the Rules would facilitate orderly liquidation and repayment of liabilities to customers.

6. Licensed corporations are required to comply with the capital requirements of the Rules in order to become and remain licensed by the SFC. The capital requirements comprise a liquid capital requirement and, for licensed corporations that are allowed to hold client assets, a paid-up share capital requirement. The minimum amounts which a licensed corporation must maintain its paid-up share capital and liquid capital vary according to the

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<sup>1</sup> There are nine types of regulated activities the conduct of which requires a licence granted by the SFC under Part V of the SFC. They are dealing in securities, advising on securities, providing securities margin financing, dealing in futures contracts, advising on futures contracts, advising on corporate finance, providing asset management and providing automated trading services.

<sup>2</sup> The SFC has formed a Working Group on the Review of the Financial Regulatory Framework for Intermediaries to consider the various structural and financial issues and to propose the means to address the relevant risks and the basis upon which a firm's financial resources should be computed. The intention is to set out the results and proposals in a White Paper to be released for consultation in 2003.

particular type of regulated activity for which it is licensed. The amounts are designed to reflect the level of risk posed to investors and the market by each type of regulated activity. The liquid capital requirement is a risk-based approach in that risky assets and risk exposures of licensed corporations are subjected to adjustments to arrive at the firm's liquid capital. The applicable minimum amount of liquid capital that an individual licensed corporation needs to maintain, known as its "required liquid capital", is comprised of a base amount and a variable parameter, so the minimum amount also varies with the size of the business undertaking of the licensed corporation.

7. As a safeguard against non-compliance, licensed corporations are required to periodically report their financial positions and are subject to early warning reporting to help the SFC identify potentially risky firms.

### **Highlights of major new elements**

8. As mentioned in paragraph 4 above, the Rules streamline and rationalize requirements under the current two sets of financial resources rules as appropriate, mostly for facilitating market development and reducing compliance costs without compromising the protection afforded by compliance with the Rules for clients of licensed corporations. The major policy changes effected in the Rules are as follows:

- (a) introducing one standard set of capital rules for universal application to all types of licensed corporations (dispensing with the "net tangible assets requirement" currently applicable to advisers);
- (b) accommodating the conduct of multiple regulated activities by any licensed corporation by a unified set of requirements;
- (c) acknowledging that many brokers nowadays allow their cash clients to settle on a rolling balance basis, and making provision for that;
- (d) applying lower discount rates (i.e. haircut percentages) to constituent stocks of the Hang Seng Hong Kong LargeCap Index and the Hang Seng Hong Kong MidCap Index;
- (e) dispensing with the grouping of related securities in the calculation of the concentration discounting factor;

- (f) recognizing additional overseas futures/options exchanges and clearing houses, in Korea and Malaysia;
- (g) excluding liabilities corresponding to client money held overseas (subject to conditions) from the calculation of total liabilities;
- (h) allowing licensed corporations to use their own fiscal reporting dates rather than calendar month-ends; and
- (i) requiring quarterly submission instead of monthly submission for part of the financial returns.

## **THE RULES**

9. The Rules set out the financial resources requirements imposed on corporations licensed by the SFC.

10. Section 2 contains the interpretation provisions which apply throughout the Rules, whereas section 3 contains provisions regarding the accounting treatment of assets and liabilities of licensed corporations under the Rules.

11. Sections 4 to 6 of the Rules require licensed corporations to maintain paid-up share capital and liquid capital in accordance with the amounts specified in Schedule 1. Sections 17 to 35 of the Rules prescribe the accounting of the assets of licensed corporations and related matters, for the purposes of determining the liquid assets (and eventually the liquid capital) they have; with sections 7 to 16 and Schedules 2 and 3 supplemental to their operation.

12. Sections 36 to 53 of the Rules prescribe the accounting of the liabilities of licensed corporations and related matters, for the purposes of calculating the ranking liabilities (and eventually the liquid capital) they have; with sections 7 to 16 and schedules 3 to 5 supplemental to their operation.

13. Sections 54 and 55 of the Rules require notification to the SFC of failure to comply with the Rules or the occurrence of specified circumstances; and sections 56 and 57 require submission to the SFC of financial resources returns at specified intervals or in response to a request of the SFC.

14. Section 58 of the Rules provide for the grant of approvals for specified purposes and for the amendment or revocation of such approvals and for the publication thereof. A number of sections, including 21(2), 22(2), 27(4) and 43(6), permit licensed corporations to elect alternative treatment of assets, liabilities and other matters for the purposes of the Rules and section 59 provides for the withdrawal of such elections.

15. Section 60 deals with transitional arrangements.

## **PUBLIC CONSULTATION**

16. The SFC released a consultation document and an exposure draft of the Rules on 14 June 2002 for comment by the public. A total of thirteen submissions were received. In addition, the SFC consulted the Advisory Committee, established under section 10 of the Securities and Futures Commission Ordinance, on 22 July 2002. The SFC has considered all the comments received and revised the Rules as appropriate.

17. A draft of the Rules was considered by the Subcommittee at its meeting held on 7 October 2002. No major concerns were expressed by members of the Subcommittee at the meeting.

## **FINANCIAL AND STAFFING IMPLICATIONS**

18. There are no financial or staffing implications for the Government.

## **COMMENCEMENT DATE**

19. The Rules will come into operation on the day appointed for the commencement of the SFO, together with other subsidiary legislation necessary for the commencement. We expect this to take place shortly, after completion of the negative vetting procedure through the Legislative Council and allowing the industry a reasonable period of time for making necessary adjustments with reference to the subsidiary legislation. We aim to announce the commencement date by the end of 2002.

## **PUBLICITY**

20. The Rules will be published in the Gazette on 13 December 2002. The SFC will issue a press release on the same day.

## **ENQUIRIES**

21. For any enquiries on this brief, please contact Mrs. Yvonne Mok or Mr. Leo Lam of the Intermediaries Supervision Department of the Commission at 2842 7638 and 2842 7642, respectively.

The Securities and Futures Commission  
13 December 2002