

3 August 2018

## Circular to Licensed Corporations

### Margin Financing Activities Disguised as Investments

The Securities and Futures Commission (SFC), in the course of its ongoing supervision of licensed corporations (LCs), has observed that some LCs carrying on asset management activities may have aided and abetted unlicensed affiliates or third parties to provide securities margin financing in the guise of investments. The SFC warns that the provision of margin financing in the guise of investments under such an arrangement is illegal. Parties involved in the illicit activities may have avoided certain capital, conduct or disclosure requirements aimed at protecting investors and market integrity.

These suspected margin financing arrangements are set up or operated in different forms. For example, they may operate through discretionary accounts or private funds with the following features:

- jointly with an LC's clients<sup>1</sup>, the unlicensed affiliates or third parties appear to fund the acquisition and holding of sizeable, concentrated positions in one or more securities;
- the clients are required to provide additional capital or collateral when the value of these investments falls below a pre-determined level, similar to a margin call;
- the unlicensed affiliates or third parties are entitled to receive a guaranteed or pre-determined yield from these investments, similar to margin interest; and
- the LC does not have actual investment discretion as the listed securities to be acquired were previously agreed between its clients and the unlicensed affiliates or third parties.

Arrangements which involve the provision of financial accommodations to facilitate the acquisition and holding of listed securities may constitute "securities margin financing" (ie, Type 8 regulated activity) as defined under Part 2 of Schedule 5 to the Securities and Futures Ordinance (SFO). The unlicensed affiliates and third parties in the examples above are not licensed by the SFC in any capacity. As such, they may be in breach of section 114 of the SFO, which provides that no person shall carry on a business in a regulated activity unless it is licensed for such regulated activity.

Persons conducting business activities which constitute securities margin financing are also subject to other regulatory requirements, including the capital requirements under the Securities and Futures (Financial Resources) Rules (FRR) and the risk management requirements governing margin lending under the Code of Conduct<sup>2</sup>.

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<sup>1</sup> In the context of a private fund, these refer to a particular class of investor of the fund whereas the unlicensed affiliate or third party belongs to another class of investor of the fund.

<sup>2</sup> The Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission.



The SFC warns LCs that they should not facilitate the setting up or operation of *de facto* margin financing arrangements to circumvent the FRR and the risk management requirements. The fitness and properness of LCs may be called into question when they aid and abet the conduct of illegal activities. Anyone involved in these arrangements may be liable to prosecution and should cease such arrangements immediately.

In addition, LCs and their senior management are reminded to heed the circulars issued by the SFC on 31 July 2017 and 15 September 2017, which highlighted irregularities, deficiencies and common instances of non-compliance in managing funds and discretionary accounts. They are responsible for maintaining appropriate standards of conduct and robust policies and procedures to ensure fair treatment of their clients and compliance with regulatory requirements.

Should you have any queries regarding this circular, please contact Ms Kammy Kwok at 22311455 or the case officers in charge.

Intermediaries Supervision Department  
Intermediaries Division  
Securities and Futures Commission

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