



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

Conclusions to Further Consultation on Proposed General Changes to Update the Securities and Futures (Financial Resources) Rules

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Abbreviations and acronyms

FRR	Securities and Futures (Financial Resources) Rules
GCP	General clearing participant
HKSCC	Hong Kong Securities Clearing Company Limited
HSCLI	Hang Seng Composite LargeCap Index
HSI	Hang Seng Index
LC	Licensed corporation
MSTD	Mainland Settlement Deposit
MSCD	Mainland Security Deposit
OTCD	Over-the-counter derivatives
SFC	Securities and Futures Commission

I. Foreword

1. On 24 July 2017, the Securities and Futures Commission (SFC) published consultation conclusions on the proposed capital regime for regulating over-the-counter derivatives (OTCD) activities and other proposed changes to the Securities and Futures (Financial Resources) Rules (FRR) which apply generally to all licensed corporations (LCs) and are not specific to OTCD (non-OTCD specific changes). At the same time, the SFC further consulted on proposed modified and additional FRR changes and draft FRR amendments for implementing the non-OTCD specific changes (Further Consultation). This paper summarises the comments received on the non-OTCD specific changes and draft FRR amendments during the Further Consultation and the SFC's responses thereon. The SFC will respond to the comments on the proposed modified and additional FRR changes which are specific to OTCD when the draft amendment rules for those changes are published for consultation.
2. The Further Consultation ended on 23 August 2017. A total of eight submissions in respect of the non-OTCD specific changes and draft FRR amendments were received from various market practitioners, professional firms and industry associations. Five respondents requested that both their names and submissions or just their names be withheld from publication. A list of the respondents (other than those who requested anonymity) is set out in Appendix 1.
3. The key comments on the non-OTCD specific changes and draft FRR amendments, together with the SFC's responses thereon, are discussed in detail in Part III. The full texts of the comments, other than those from the respondents who requested that their submissions not be published, can be viewed on the SFC's website at www.sfc.hk.

II. Executive Summary

4. Respondents generally welcomed the non-OTCD specific changes. We have accepted a respondent's suggestion to allow LCs to include in liquid assets Mainland Settlement Deposit (MSTD) and Mainland Security Deposit (MSCD) paid by LCs to general clearing participants (GCPs) in relation to the LCs' trading of A-shares under the Stock Connect programme. We have also accepted a respondent's suggestion to modify the definitions of "qualifying debt securities" and "special debt securities" to better reflect the nature and characteristics of such securities.
5. No substantive comments on the text of the draft FRR amendments were received. Accordingly, the SFC has finalised the amendment rules incorporating the aforementioned changes. The SFC is planning to submit the final version of the amendment rules to the Legislative Council for negative vetting as soon as possible.

III. SFC's responses to the comments received

Definition of "equity"

6. We proposed to modify the definition of "equity" by removing the condition that shares must be held for trading purposes so that "equity" will include shares held as collateral or for long-term investment.
7. One respondent commented that this may create confusion since mutual funds and unit trusts may fall within the definitions of "equity", "authorised fund" and "recognised

jurisdiction fund”. He also questioned what haircut percentage should apply to mutual funds and unit trusts.

8. The treatments for the different types of equities are clearly set out in the rules. For instance, equities which are authorised funds or recognised jurisdiction schemes would be subject to the haircut percentages specified in Table 7 or Table 9 (in the case of funds which are illiquid investments) in Schedule 2 to the FRR, whereas equities which are listed shares but not authorised funds, recognised jurisdiction schemes or illiquid investments would be subject to the haircut percentages specified in Table 1 or 1A in Schedule 2.

Definition of “non-freely floating foreign currency”

9. We proposed to rename “controlled currency” as “non-freely floating foreign currency” and modify the definition of this term to mean a foreign currency in respect of which an authority of the jurisdiction of which the currency is the lawful currency specifies, in respect of one or more foreign exchange markets also specified by the authority:
 - (a) the rate at which the currency is permitted by the authority to be converted into one or more other currencies; or
 - (b) a range of rates within which the currency is permitted by the authority to be converted into one or more other currencies.
10. We requested any comments on the modified definition of “non-freely floating foreign currency” and examples of such currencies.
11. Respondents welcomed the modified definition of “non-freely floating foreign currency” and provided examples of such currencies including renminbi and the Malaysian ringgit. On the other hand, guidance was sought on the difference between a non-freely floating foreign currency and a pegged currency.
12. In the case of a non-freely floating foreign currency, an authority determines the exchange rate or range of exchange rates. In the case of a currency peg, the central bank maintains a peg to an exchange rate or range of exchange rates through market activities.

Replacing the proposed cap on aggregate uncollateralised receivables from affiliated banks and brokers with a proposed control requirement

13. In the Further Consultation, we mentioned our plan to replace a previously proposed cap on exposure to affiliates¹ with a control requirement which requires LCs to properly manage their financial exposures to affiliates in the same manner as exposures to independent third parties undertaken by the LCs on an arm’s length basis. The detailed proposal has been included in a separate consultation paper issued in December 2017 (Conduct Requirements Consultation)².

¹ The aggregate uncollateralised receivables from affiliated banks and brokers was proposed to be capped at 25% of an LC’s shareholders’ funds.

² Consultation Paper on (1) the OTC derivatives regime for Hong Kong – Proposed refinements to the scope of regulated activities, requirements in relation to OTC derivative risk mitigation, client clearing, record-keeping and licensing matters; and (2) Proposed conduct requirements to address risks posed by group affiliates issued on 20 December 2017.

14. One respondent to the Further Consultation made some suggestions on this control requirement and these will be consolidated with the submissions we received on the Conduct Requirements Consultation.

Treatment of currencies subject to exchange control or assets the proceeds of which upon realisation are subject to remittance control

15. We clarified that in disapplying section 18(2) of the FRR, an asset which is qualified to be included as liquid assets should be subject to the applicable haircut or other deduction required under other provisions of the FRR. Moreover, if the aggregate amount of these assets exceeds the aggregate amount of the liabilities that the assets may be freely applied to meet, such excess amount shall be included in ranking liabilities.
16. A respondent sought clarification of whether renminbi in cash and bank deposits held in Hong Kong and renminbi-denominated assets listed in Hong Kong would fall within the definition of “controlled asset”. As such assets are not subject to remittance or exchange control, our view is that they would not fall within the definition of “controlled asset”.

Updating the list of specified exchanges

17. We proposed adding four Mainland commodity exchanges to the list of specified exchanges in Schedule 3 to the FRR.
18. One respondent sought clarification of whether there is a list of recognised overseas exchange companies or stock markets in addition to the list of specified exchanges provided in the FRR.
19. The FRR have only one list of specified exchanges which includes both overseas stock and futures exchanges. In order to ensure that all the markets operated by the exchanges on the list are covered, the amended FRR will continue to provide that a reference in the rules to an exchange includes a reference to any market operated by that exchange³.

Treatment of amounts receivable in respect of dealings in securities

20. We stressed that amounts receivable from a GCP of Hong Kong Securities Clearing Company Limited (HKSCC) may be set off against amounts payable to the GCP under a netting arrangement in exceptional situations where the settlement risk is considered to be low, subject to the SFC’s approval.
21. One respondent proposed to allow an LC to include in its liquid assets the amounts of MSTD and MSCD paid by it to a GCP for the purpose of fulfilling the obligation to the HKSCC in respect of transactions in the China Connect Market⁴.
22. In order to facilitate LCs’ participation in the China Connect Market and use of third party clearing, and in view of the non-mutualised nature of MSTD and MSCD, we agree that it would be appropriate to allow an LC to include in its liquid assets amounts receivable

³ New section 2G (References to exchange and clearing house) of the FRR.

⁴ The stock market determined by The Stock Exchange of Hong Kong Limited as “China Connect Market” in accordance with its rules.

from a GCP in respect of MSTD and MSCD paid to the GCP and have incorporated this into revised section 23 of the FRR.

23. Separately, to better reflect the policy intent and ensure proper capitalisation of settlement risks involved in securities settlement, we have clarified in the amendment rules that the following amounts receivable and amounts payable shall be excluded from the application of section 11(3)(a) of the FRR⁵:
- (a) amounts receivable by the LC from, and amounts payable by it to, a GCP of HKSCC which arise from transactions in securities that are cleared for it or its clients by the GCP with the HKSCC;
 - (b) if the LC is a GCP of the HKSCC, amounts receivable by it from, and amounts payable by it to, another person which arise from transactions in securities that are cleared for the person by the LC with the HKSCC; and
 - (c) amounts receivable from a GCP as referred to in paragraph 22.

Treatment of client money received for settlement of client transactions

24. We proposed to allow LCs to include client prepayments for securities transactions in their liquid assets.
25. One respondent suggested amending the definition of “prescribed country”⁶ so that money placed in overseas branches of Mainland banks may be included in liquid assets under section 20 of the FRR.
26. We do not consider such a change necessary as major Mainland banks have already been licensed as banks and hence fall within the definition of “authorised financial institution” in section 2 of the FRR. This definition already covers both local and overseas branches.

Treatment of underwriting fees receivable

27. We proposed to allow LCs to include in their liquid assets any underwriting fee accrual or receivable which remains outstanding beyond the normal time limit prescribed in the FRR, up to the amount of the corresponding sub-underwriting fee liability to sub-underwriters, the settlement of which is contingent upon the collection of underwriting fees by the LCs.
28. One respondent suggested considering the default risk of Mainland-based clients in our proposal to allow LCs to include in liquid assets any underwriting fee accrual or receivable not meeting the conditions stated in section 35(a) of the FRR.
29. The proposal has already taken into account the possibility of client default. The amount of underwriting fees receivable that can qualify as liquid assets would be capped at the related amount of sub-underwriting fees payable and the settlement of the latter would

⁵ Section 11(3)(a) of the FRR permits LCs to set off receivables from and payables to the same person if the amounts do not arise from regulated activities.

⁶ According to section 2 of the FRR, “prescribed country” means Singapore and member countries of the Organisation for Economic Co-operation and Development.

be required to be contingent upon the collection of the former. Therefore, the LC's liquid capital would not be affected in the event of a client default.

Treatment of tenancy agreements for business premises

30. We proposed to allow an LC to exclude from its ranking liabilities the amount of recognised liabilities arising from a tenancy agreement entered into by it in respect of any premises used in carrying on regulated activity, up to the amount of recognised assets arising from the same tenancy agreement which is not included in its liquid assets. We also proposed to exclude the same amount from the LC's variable required liquid capital calculation.
31. One respondent suggested extending the proposed treatment to other lease agreements.
32. It would not be prudent to extend the proposed treatment to other leases as an LC may be held liable if it terminates a lease before its expiry. As for office leases, early termination is rare in the case of LCs because they need to maintain their office to provide client services, and the rental liabilities involved are usually significant.

Clarification of the treatments of different types of qualifying debt securities and special debt securities

33. We proposed that "fixed rate coupon" be defined in the FRR as interest which is payable periodically and calculated by reference to a predetermined fixed interest rate, and "floating rate coupon" be defined as interest which is payable periodically and calculated by reference to a variable interest rate reset periodically to equate to a widely quoted money market or interbank reference interest rate, plus or minus a specified rate. A respondent suggested limiting the scope of fixed rate bonds to debt securities which pay interest periodically for the entire term.
34. In light of this suggestion, we have modified the definitions of "fixed rate coupon" and "floating rate coupon" to clarify that the fixed interest rate or referenced variable interest rate (and specified rate, if any) does not change throughout the term of the securities.
35. Moreover, we proposed to categorise debt securities that would qualify for the haircut percentages specified in Column (I) of Table 5 in Schedule 2 to the FRR as "category 1 qualifying debt securities", which shall cover qualifying debt securities with a fixed rate coupon or a floating rate coupon, except bonds with: (a) no maturity date (ie, perpetual bonds); or (b) remaining term to maturity over 30 years (collectively referred to as "excluded bonds"). These excluded bonds and any other qualifying debt securities (such as inflation-linked bonds and inverse floater) will be categorised as "category 2 qualifying debt securities" and subject to the haircut percentages specified in Column (II) of Table 5 in Schedule 2 to the FRR.
36. A respondent sought clarification of how zero coupon bonds should be classified. We confirm that zero coupon bonds (ie, non-interest bearing debt securities) are classified as special debt securities.
37. In light of market developments and in order to provide greater clarity on our policy intent, the following incidental changes have been incorporated into the amendment rules:

- (a) allow LCs to calculate on a weighted average basis (subject to the SFC's approval) the haircut percentage of (i) a tradable securities index underlying a structured note, and (ii) a basket of shares underlying a convertible debt security or bond with non-detachable warrants;
- (b) in section 2 of the FRR, add new definitions for "specified convertible debt securities" and "specified bonds" (ie, bonds with non-detachable warrants) for the purposes of item 2 of Table 6 in Schedule 2 to the FRR to provide that their holder has the right, but not the obligation, to buy a specified number of shares in the issuer or a related corporation of the issuer (and make corresponding changes to the definition of "special debt securities" in section 2 of the FRR); and
- (c) carve out high risk and complex securities, such as contingent convertibles (which carry higher risks due to their loss absorbing nature and lack of transparency of the triggering events), from the definitions of "qualifying debt securities" and "special debt securities" in section 2 of the FRR.

Haircut percentage for constituents of Hang Seng Composite LargeCap Index

- 38. We proposed to subject constituents of Hang Seng Composite LargeCap Index (HSCLI) which are not Hang Seng Index (HSI) constituents to a haircut percentage of 20% and exempt them from being classified as illiquid collateral.
- 39. One respondent asked why the proposed haircut percentage for HSCLI (20%) is different from the 15% that applied to HSI constituents.
- 40. Our analysis noted that the constituent stocks of the HSCLI (other than those which are also HSI constituents) were generally more volatile and less liquid than HSI constituents. In view of this, it is appropriate to subject HSCLI constituents to a higher haircut percentage.

Definition of "in-the-money amount"

- 41. We proposed to expand the definition of "in-the-money amount" in section 2 of the FRR to cover index options. A respondent asked whether this definition should also cover put warrants on listed shares. This would not be necessary as the FRR do not include any references to in-the-money amounts for put warrants.

Use of fair value for valuation purposes

- 42. We proposed to require, for valuation purposes, the use of fair value determined in accordance with generally accepted accounting principles if no published market price is available.
- 43. One respondent suggested allowing the use of independent pricing information sources in valuations when published market prices are not available.
- 44. We consider that the generally accepted accounting principles for the valuation of financial instruments already provide detailed guidelines for determining fair value in the absence of published market prices.

Clarification of the applicability of various FRR provisions to listed options and other options

45. We proposed to clarify the applicability of various FRR provisions to listed options (such as listed warrants) and other options. Respondents sought clarification of the proposed amendments to various FRR provisions regarding standardised options contracts designed by an exchange for trading on its platform⁷ and OTC options contracts (collectively referred to as “unlisted options contracts”).
46. Those amendments aim to distinguish unlisted options contracts from options contracts issued by third party issuers and listed on an exchange⁸ so as to ensure a clear delineation between the respective FRR provisions that govern these two types of options contracts. No change has been proposed to the treatments of these options contracts.

IV. Concluding remarks and next steps

47. The SFC has today gazetted the Securities and Futures (Financial Resources) (Amendment) Rules 2018 and will submit them to the Legislative Council for negative vetting. Subject to the legislative progress and in order to give the market sufficient time to reconfigure their reporting systems, the SFC expects the amendment rules to come into operation on 1 April 2019, except for the provision referred to in paragraph 30 which shall come into effect on 1 January 2019 in order to avoid imposing additional capital charges on LCs as a result of the change in accounting treatment.
48. The drafting of the amendment rules for implementing the OTCD capital regime is ongoing. Once the drafting is completed, we shall publish the draft amendment rules for consultation together with the comments on that regime received in the Further Consultation and our responses thereto.
49. We take this opportunity to thank everyone who took the time and effort to comment on the proposals in the Further Consultation. Your comments and suggestions have been most useful, and have helped us refine and finalise many key aspects of the changes to the FRR.

⁷ Such as Hang Seng Index Options launched by The Hong Kong Futures Exchange Limited and stock options launched by The Stock Exchange of Hong Kong Limited.

⁸ Such as derivative warrants and covered warrants.

Appendix 1: List of respondents

(in alphabetical order)

1. CompliancePlus Consulting Limited
2. Credit Suisse (Hong Kong) Limited
3. International Swaps and Derivatives Association, Inc.