

Comments on the draft Securities and Futures (Financial Resources) Rules

1 Introduction

The group of financial institution listed below (the "Group") welcomes the opportunity to comment on the draft Securities and Futures (Financial Resources) Rules (the "draft FRR").

Whilst the draft FRR do substantially follow the requirements of the existing Financial Resources Rules and the Leveraged Foreign Exchange Trading (Financial Resources) Rules, the Group does express an interest in seeing changes towards a more risk-based capital framework, which corresponds closely to the risk associated with the activities undertaken by intermediaries. The Group has the following comments on the draft FRR.

2 Introducing agent

Under the draft FRR it will be necessary to pay a fee to the SFC to be approved as an introducing agent. There is no indication in the draft FRR or Consultation Paper how much this fee will be, and whether it will be a once only or annual fee. The Group would also like some guidance on how long the SFC will take to grant such approval, and what procedures will need to be followed to obtain such approval.

Section 53(2) of the draft FRR specifies three scenarios where the capital charge on introductory transactions will not apply:

- (a) the other person is a member of the same group of companies as the licensed corporation;
- (b) the clients have a direct broker client contractual relationship with the other person; and
- (c) the licensed corporation is not legally liable to the client for clearing or settlement of such transactions or default by the other person.

It is our understanding that, in the majority of instances, Section 53 will not apply due to market practice, i.e. that the licensed corporation will not be subject to the recourse of clients. However, since in some cases direct client-broker relationships do not exist (under Section 53(2)(ii)), we feel a more reasonable approach would be if this sub-section is reworded to read "*the clients have a direct broker client or other relationship with the other person*".

3 Client monies

3.1 In determining the relevant treatment for balances held with overseas bodies (e.g., an authorized financial institution, an approved bank incorporated outside Hong Kong or a recognized clearing house), reference should be made to the local market regulation and requirements. For example, deposits held at Korea Securities Finance Corporation ("KSFC") should be considered a liquid asset since the Korean Securities and Exchange Law requires securities companies to deposit with the KSFC all cash deposits received from customers in excess of 15% margin.

3.2 Under Section 23(2) of the draft FRR, we wish to clarify whether a formal legal agreement is required in order to set off amounts receivable from and amounts payable to a client, or whether an implied agreement is sufficient, and whether any

agreement must be in writing. If netting off is allowed, we would like the SFC to confirm this can be done on a security- by- security basis and to confirm if the securities need to be the same value date.

4 Treatment of foreign exchange transactions

The Group notes that the draft FRR are explicit in the treatment of leveraged foreign exchange transactions. However, we have identified a potential inconsistency in how ranking liabilities are to be calculated under Section 43 (leveraged foreign exchange trading) and Section 52 (foreign exchange agreement). Specifically, Section 43(1) provides a detailed formula for determining the amount to be included under ranking liabilities, whereas in Section 52, a percentage applies according to the maturity term of the foreign exchange agreement and the counterparty.

We wish to clarify the correct treatment of foreign exchange transactions under this circumstance, i.e. would Section 43 only apply to corporations licensed to undertake leveraged foreign exchange trading, whilst Section 52 would apply to corporations exempt from being licensed. If not, would one section prevail over the other, or would the highest-ranking liability amount calculated under the respective section apply.

5 List of overseas markets

The Group notes that certain exchanges have been added to the list in Schedule 2 of the draft FRR. We believe that the SFC should consider the inclusion of other exchanges, such as the Taiwan Stock Exchange, Bombay Stock Exchange and Jakarta Stock exchange.

6 Submission of Financial Resources Rules (“FRR”) return

The Group would like clarification as to whether Section 58(2) will require any change to the report on proprietary derivative positions as is currently provided under Form 7 of the existing Financial Resources Rules.

The Group welcomes the change in the reporting cycle on proprietary derivative positions from a monthly to a quarterly basis.

Section 58(6)(c) indicates that a declaration document and the FRR return should:

“bear the digital signature of the licensed corporation, attached by a responsible officer or another officer of the licensed corporation approved by the Commission under section (60)(5)(g) for the purposes of this section, supported by a recognized certificate”.

The Group would like further guidance on who the SFC would consider as being suitable to be regarded as “another officer... approved by the Commission”. The Group would also like further information on the approval procedures and the fees to be paid for such approval.

In addition, Section 58(6)(d) requires both the declaration document and the FRR return to “*be submitted electronically by means of FinNet*”. We would like to confirm that as an alternative it would be possible to file the required information electronically via FinNet, and subsequently provide the SFC with a hardcopy signed by the relevant person of the licensed corporation. There also should be a fallback position if there is a system failure, which means it is not possible to submit the return electronically.

7 Change in accounting practice

Under s.60(5)(e), upon an application in writing and payment of a prescribed fee by a licensed corporation, the SFC may approve a *“change in the licensed corporation’s accounting practice that materially affects the amount of liquid capital or paid-up capital it maintains or is required to maintain under Part 2”*.

The Group would like the SFC to issue guidance on what it regards as material.

8 Valuations of debt securities

In the draft FRR, Section 11(a) indicates an average quote should be obtained from parties such as market makers, third party banks, licensed corporations or dealers outside Hong Kong. Otherwise, the securities will be valued at nil and face value for long and short positions respectively.

In respect of debt securities with no market value, we wish to point out that valuations per a discounted cash flow model can be used for the purpose of calculating the amount to be included as liquid assets and ranking liabilities, and therefore suggest that this method is included in the draft FRR.

9 Miscellaneous

9.1 The Consultation Paper states that a number of addition disclosures are to be required under the draft FRR, including management fees receivable from or payable to group companies or related parties of the licensed corporation. However, it is not clear from the draft FRR where those disclosures are required.

9.2 Rule 50 of the draft FRR refers to “non specified exchange traded derivative contracts”, whereas Rule 29(1) of the current Financial Resources Rules refers to “off-exchange derivative products”. It is not clear that these two terms refer to the same types of products.

9.3 Rule 60(5) sets out a number of items that will require the approval of the SFC, and states that a fee must be paid. The Group would like details of what fees are to be paid, whether these are once only or annual fees, and details of the procedures to be followed in order to obtain such approval.

List of Submitting Group Members

Goldman Sachs (Asia) L.L.C.

J.P. Morgan

Merrill Lynch (Asia Pacific) Limited

Morgan Stanley Dean Witter Asia Limited

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