SUBMISSION TO THE SECURITIES & FUTURES COMMISSION ON THE CONSULTATION PAPER CONCERNING THE PROPOSED AMENDMENTS TO THE FINANCIAL RESOURCES RULES

1. Sun Hung Kai & Co. Limited has three indirect, wholly-owned subsidiary companies that are involved in the provision of Margin Finance to clients.

   These are:

   - Sun Hung Kai Investment Services Limited ("SHKIS") – a broker-dealer;
   - Sun Hung Kai Online (Securities) limited ("SHK Online") – a dealer;
   - Sun Tai Cheung Credits Limited ("STCC") – a registered margin finance provider.

2. Based on the figures outlined in the Consultation Paper (Para. 5), roundly 1 in 10 of all margin finance loans outstanding in Hong Kong are thus held by us.

3. Since, according to the same paragraph there are a total of 263 entities involved in margin financing, three of which are ours, the remaining 90% is divided amongst the other 260 participants in this business, strongly suggesting that we seem to be substantially the largest provider of margin finance in Hong Kong.

4. It is clear from the numbers quoted in the SFC Paper that there are a huge number, relative to size of market, of Registered Persons involved in this business. The current requirements assist in this, in that barriers to entry into, or to remaining in, the business are low.

5. We understand and fully support the SFC's desire to ensure the safety of the investing public, and the integrity of and confidence in, the market. In the submissions we made in 1999 and 2000 concerning the introduction of legislation governing margin finance, we made a range of recommendations which would have substantially raised the barriers to entry and/or remaining in the market, including a suggestion that the minimum required paid-up capital for margin financiers should be set at HK$ 50 million.

6. At the same time, those of us who are in the industry are running businesses and making credit and business judgments all the time concerning not only the collateral deposited with us, but the overall credit-worthiness of clients, and their desirability from an overall point of view

7. We believe that the recommendations in the Consultation Paper approach what we acknowledge is a problem in the industry from the wrong direction.

8. Instead of trying, as would be appropriate, to ensure that those who participate in the industry are adequately resourced, both generally and as it

relates to their margin business portfolios, the suggested amendments seek to, in effect, have the regulator "micro-manage" the business decisions of the existing, multifarious participants in the industry.

9. This we believe is wrong, firstly as a matter of public policy, since government agencies should not try to manage private sector companies; and secondly as to effectiveness since a regulator, no matter how well-resourced, can not hope to properly supervise the actual, day-to-day activities of so many participants.

10. Furthermore, the suggested amendments render irrelevant any assessment by a lender of the overall credit-worthiness of clients, or other collateral or security arrangements that may have been made to protect the portfolio – such as the taking of non-securities collateral, or the protection afforded by Account Executive or third party indemnities with respect to a client.

11. We believe that it is the broad parameters that should be addressed rather than the detailed manner in which each of us runs our business, which will vary dependent upon client-base, and industry sector.

12. The **first step** should be to radically increase the level of minimum capital required to be in the margin financing business – whether as a dealer or as a margin finance provider. We understand that, at some stage, consideration was given to increasing the figure from $10 million to $30 million. We would have strongly supported this, and would go further and argue that the figure should be more like $50 to $100 million.

13. In all probability, this would reduce the numbers of participants in the industry – or at least ensure that more capital was directly deployed therein, thus automatically enhancing investor safety; but leaving the investors in the industry – i.e. the shareholders and directors of the margin finance providers - to make decisions as to how to best deploy their resources within the Rules already applying.

14. To come to what we believe should be the second step, we need to deal with what we perceive to be a bias – not only in the Consultation Paper, but also in previous SFC documents relating to this aspect of the industry - against "pooling". Pooling is frequently spoken of as though it was an inherently bad, imprudent or poor practice. In fact, of course, pooling is the basis of all banking practice. One could go further and state that, without pooling, every bank in Hong Kong would be automatically insolvent.

15. Furthermore, pooling in the banking industry makes no distinction between a client who is a borrower from a bank, and one who is a lender to that bank (a depositor) – not only on a nett basis – but even someone who has never borrowed a cent from the bank. Such a person can find, for example that the deposit he has with (e.g.) HSBC is used for the purposes of loans in (e.g.) Argentina, or to Enron.

16. Depositors (i.e. lenders to banks) interests are protected by the Capital Adequacy rules applying to banks, by the regulatory regime within which they

work, and in many cases by explicit or implicit Government guarantees or "Lender of Last Resort" facilities provided by central banks. These capital adequacy rules are stronger than those applying to the broking sector, but many other regulatory requirements are far less onerous. Banks are not required to distinguish between those who are net lenders to them, or borrowers from them. There is no restriction related to the nature of the client as to how the bank deploys his funds or other assets

17. In other words, within the broad parameters laid down, banks are free to make their own credit decisions, take what collateral they think is reasonable and so on. They do have to make risk adjustments, but these are of a far more general nature (e.g. no more than 10% of lending to be to one client) rather than going to the precise detail of underlying collateral. In the case of a client who a bank judges to be sufficiently credit-worthy, there is nothing to stop the bank deciding to lend to him without collateral at all – and indeed this is done all the time – including to clients who are, in effect, margin finance clients. That is, they are using their "clean" loans to purchase, or retain ownership of, shares.

18. The bank capital adequacy ratio is set a minimum of 8% as distinct from that of margin finance providers and dealers, which is set at 5%.

19. If the SFC considers that the broker ratio is inadequate, then the logical response is to increase that, giving the same capital protection to clients that they have in banks (in fact the protection would be greater, since a "cash" or non-borrowing client can effectively isolate himself from the credit risk taken on by a broker, whereas a bank client can not do that with respect to the credit risk taken on by the bank).

20. Thus, as a **second step**, Sun Hung Kai would support an increase in this ratio from 5% to 8% for participants in our industry. Although we could implement it immediately – indeed we are far higher than it now – in the interests of fairness, we believe it should be increased over time – say an immediate increase to 6%, followed by further increases each 6 or 12 months until the 8% figure was reached.

21. With respect to the lending ratio proposed by the SFC, as shown by the figures in Para.s 2., 5. and 6. above, at the moment, we would have no problem in meeting this requirement. However, as stated above, the recommendation appears to be based on a misplaced bias against the pooling of client resources, where we believe that the clients' interests are better protected by the measures suggested above.

22. We are, however, concerned as to how the situation might develop in a "hot" market, or in a rapidly falling market, where the ratios might get out of kilter for a brief period of time, causing more problems than they are supposed to solve.

23. For example during the bursting of the "dot.com bubble" in 2000 as a result of the substantial drop in value of many stocks, and the calling of margin or the forced liquidation of clients portfolios, we suddenly found ourselves in a

position where one of our best clients emerged as a client with more than 10% of the (reduced) margin portfolio outstanding. This particular client was not especially affected by the market decline, and held a substantial surplus of assets over liabilities with us, but because we were required to "write-off" for FRR purposes the whole of the value of his receivables in excess of 10% we were faced with a decision as to whether to "call" him on his perfectly well-performing loans (which had not increased, but merely - through no fault of his – changed as a proportion of our portfolio) or to increase the level of paid-up capital in the lending entity concerned. We took the second step, but it took a couple of days, in the process of which we were theoretically exposed to non-compliance.

24. We believe that the proposed lending ratio Rule could work in the same way in either a rapidly rising or a rapidly falling market and, in itself, create or magnify market disruption/distortions.

25. Another approach with the SFC/Government could take would be based on that taken in the PRC, where brokers who are "full-service" (including the granting of loan/margin facilities) are required to have a minimum capital of RMB 500 million. If they have less than that, they can only involve themselves in pure agency broking. This is a solution far better founded in public policy and effectiveness than the proposals being considered in the current Consultation Paper.

26. In this approach there could be a two-tiered system of brokers with those who are only agency brokers required to use custodians/trustees for the holding of client assets (as in Taiwan), whereas those who met a higher level of capital adequacy – both as to amount, and proportion – could be allowed to hold and deal in client assets, and provide full functions.

27. We can also see some merit in a modified version of the suggestion in the Consultation Paper that, if the pledged stock of a particular non-Index issue is above a determined threshold, then any stock <u>above that threshold</u> should be required to be subject to a greater haircut, provided that the threshold is set higher (possibly 10% of the issue, or 20% of the free float), and that the proposed exemption for stocks which are in certain indices, is continued.

28. In summary our views are as follows:

    (i) the SFC is right to take further steps in the margin finance business to further enhance investor protection, and market confidence and integrity;

    (ii) its proposed approach is wrong in both principle and practice and seems to be based more on how easily or quickly it can get change implemented, rather than what is the correct change that should be made;

    (iii) the changes that should be made are to increase substantially the level of capital required to be involved in the margin finance business (we suggest to at least HK$50

million) and to increase the capital adequacy ratio applicable to brokers to that applicable to banks.

29. Sun Hung Kai is willing and ready to respond to any changes made by the SFC, and can certainly meet the new requirements.

30. We are willing for our submission, and our names to be published, on condition that the commercially confidential information provided in Paragraphs 2., 5. and 6 of this document are excluded from such publication.