SECURITIES AND FUTURES COMMISSION

To: FRR/SFC@SFC Ext:
cc:

From: "Albert Pun"
Date: 11/03/2002 07:45 PM

Our Ref:

Subject: Consultation on the proposed amendments to the current financial resources rules

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Dear Sirs,

I refer to the recent consultation document on the proposed amendements to the current Financial Resources Rules and enclose my comments herewith.

(See attached file: FRR rules amendemnt comment.doc)

I want to emphasis that the comment is my personal comment.

Yours faithfully,

Albert Pun

- FRR rules amendemnt comment.doc

CONSULTATION DOCUMENT
THE PROPOSED AMENDMENTS TO THE CURRENT FINANCIAL RESOURCES RULES

I write to make my comments on the proposed amendments to the Current Financial Resources Rules (FRR) regarding the securities margin financing business.

Broadly speaking, I am supportive to the direction of the SFC to tighten up the FRR rules in response to the current market environment. I also agree that the SFC should take an appropriate measure to alleviate the systemic risk of the market.

I have no objection to your proposal 1 on the illiquid collateral. However, the fundamental problem on this matter is why there are so many illiquid stocks in the market. The proposal 1 will suffocate the liquidity of the third tier stocks. I would urge the SFC to come up with a mechanism to help improve the liquidity of the third tier stocks.

The proposal 2 is much more controversial. I agree in principle that we should not encourage or even allow firms to re-pledge securities of margin clients to obtain funding for the firms' own working capital. I appreciate the fact that tracking collateral movement is operationally impossible. I, however, feel that the current proposal is a bit too stringent and rough; and poses some technical difficulties for compliance.

First of all, I don't understand how 50% to be arrived at. If a firm with a very prudent margin policy and have a very good quality margin portfolio which can be refinanced, it seems to us the 50% capital requirement is too excessive. It makes the margin business heavily capital intensive. The SFC should explain why 50% is fair. Secondly, though I appreciate the difficulty on tracking the collateral movement, there is still a possibility that firms may be able to track the client collateral movement or to do back to back match financing to clients. The proposed rule does not offer an exemption to this scenario. Thirdly, the margin portfolio changes with the market sentiment and performance. When the market moves, the margin loan portfolio will change accordingly. The capital requirement will fluctuate accordingly. The firm may have difficulty to cap the amount of the margin loan or to increase the capital for meeting the short term margin loan book movement. The proposed rule poses a big technical problem for the firm to comply if the market moves rapidly.

The major drawbacks of the proposal are double counting of the capital requirements and no differentiation of good portfolio from bad portfolio. The market liquidity even on the blue chip stocks will be negatively affected. This will in turn increase the business risk of the brokerage industry as a whole.

If the SFC believes that 50% self-finance of the margin portfolio is adequate, I would like to remind you that the FRR liquid capital requirement is higher of HKD10MM or 5% of the total liabilities. It means that we have already been required to provide an incremental capital that equals 5% of our borrowings

Furthermore, firms are required as according to the proposal 1 and other concentration requirements in the FRR to provide additional capital for the margin loan with illiquid and concentrated collateral. It is not fair that those firms are suffered again for the same margin loan portfolio when the proposal 2 is applied.

Imagine that a firm which does not have any haircut on its margin portfolio. The proposed capital requirement to that firm is too excessive. The SFC should consider to allow for an exemption to the firms to take on good quality and well diversified portfolio.

Having said above, the ideal and easiest solution to this subject is to increase the liquid capital requirement for the margin business as opposed to inventing a completely new regulation.

In view of the above, if proposal 2 must be implemented, I would suggest the following modification.

1. To the extent that the amount of borrowings secured by re-pledging margin client' securities is to finance the same margin clients, the amount of the borrowings and the amount of corresponding margin loan amount should be excluded from the calculation.

2. The firm borrowing to margin loan ratio should be set higher to at least 60% or even higher to compensate the effect of double counting of the capital requirements. It assumes that the SFC are satisfied with the original idea of 50% self financing of the margin portfolio.

3. The SFC should consider granting exemption to those firms which have good quality and diversified margin portfolios. The criteria are that 1) the capital haircut as computed in the FRR on the margin portfolio is less than say 5 percentage of the total margin loan balance; and 2) the standard deviation of the top 20 margin clients' loan balance is smaller than 150% of the mean of the aggregate of the top 20 margin clients loan balances. In order to quality for this exemption, the SFC can also impose a higher minimum liquid capital requirement to say HKD50MM.

In conclusion, I appreciate the rationale of the new proposal. However, I concern the actual implication of the proposed changes. Pooling of client assets for refinancing is very common in other markets. But I haven't ever seen the requirements like the proposal 2 in the regulatory capital computation of other markets. The fundamental question is what causes the HK market unique from others. We should analyze the uniqueness and devise a rule to address the uniqueness instead of re-inventing a completely unproven method to curtail the ordinary business. The new method may solve one problem but may also have much bigger side effect that will cause another problems, such as competitiveness of HK brokerage firms as compared to other international firms or local banks; the market liquidity etc..