

18 October 2018

Securities and Futures Commission

35/F Cheung Kong Center

2 Queen's Road Central

Hong Kong

Dear Sirs

Re: Consultation Paper on the Proposed Guidelines for Securities Margin Financing Activities

We refer to your consultation paper dated on 17 August 2018 regarding Proposed Guidelines for Securities Margin Financing Activities, our responds and comments are set out as follows:

1. Comments on Point 1 and 2: Total margin loans controls and Margin client credit limit controls

The proposed guideline suggests to control total margin loan size based on a broker's shareholders' funds and SFC approved subordinated loan. This methodology ignores the quality of collaterals posted for the margin loans, it also ignores the capacity of brokers to raise its funding needs from external sources. If the total margin loans have to be contained in term of broker's shareholders' funds plus SFC approved subordinated loan, we would suggest to set the multiplier as 5 times. We further suggest the base should be counted on the licensed corporation's net asset instead of just shareholders' fund plus SFC approved subordinated loan, which will take into account the size of the licensed corporation will grow with profit generated over time. The suggested 5 times of shareholders' fund plus SFC approved subordinated loan is to cater the undrawn credit facility and serve the buffer for potential draw down. We

expect the actual total margin loan should be less than 5 times of shareholders' fund and thus the risk is manageable.

2. Comments on Point 3: Securities collateral concentration controls

Regarding the definition of "Highly correlated securities", it is hard for a broker to define the highly correlated securities itself as it involves heavy data analysis in finding out the historical price correlation, cross-shareholdings relationship, changes of the above happening every second in the market, etc. Besides, the Guideline does not provide quantitative thresholds in defining "Highly correlated securities". How high the historical price correlation is deemed to be high? How large the ownership percentage of cross-holdings is deemed to be material? Different brokers may have different interpretations in "Highly correlated securities", which dilutes the effectiveness of the control framework.

We would suggest the SFC to provide all brokers a list of groups of securities considered highly correlated periodically. A standardized definition of highly correlated securities avoids any uncertainty and help brokers to better control their exposure on single related securities. Regarding Clause 3.9 (a), in addition to Hang Seng Index or Hang Seng China Enterprises Index, we would suggest to include MSCI Hong Kong Index and MSCI China Index, which are globally recognized indexes. For the threshold, we would suggest to keep at 50%. Regarding Clause 3.9 (b), we suggest the threshold to be set at 25%.

3. Comments on Point 4: Margin client concentration controls

Regarding Clause 4.3 of the Guideline, we would suggest the threshold to be set at 40%. We also suggest the base of the formula should be based on the prevailing net asset of the licensed corporation instead of the shareholder's fund as stated in the present consultation paper. The purpose of setting the maximum loans advanced to an individual or a group of related margin client is to limit the potential impact on a

broker's liquidity in case of client default. Since the Guideline has imposed a stress testing on securities level, it should reflect the impact on a broker's liquidity situation in case the margin client default (client will default if the collateral value is less than the loan outstanding). Assuming the total margin loans is capped at 5 times of broker's shareholders' funds and the margin client concentration threshold set at 40%, the margin client concentration threshold is about 8% of total margin loans, which shows the loan portfolio of the broker is quite diversified and thus the single client default may not have significant impact on a broker's loan portfolio as well as liquidity structure.

4. Comments on Point 5: Haircuts for securities collateral

We are strongly against the controls proposed in the Guideline. This point in consultation, if effected, would hurt the overall profitability of all industry players and terminate the commercial existence of the whole brokerage industry. As per the Point 1 in the Guideline, the total margin loans already capped at certain times of broker's shareholder's funds plus SFC approved subordinate loans, which has already limited the overall leverage of the broker. Any broker should retain its freedom to decide the margin ratio of securities collateral given its commercial needs, risk appetite and funding structure. Besides, the stress testing on ELC stated in Clause 3.8, 3.9, 7.3 and 7.5 already estimated the impact on ELC under certain stress conditions in securities level, we believe the potential risk exposure have been quantified in these stress tests. Therefore, we suggest the SFC to set lift all restrictions in constraining securities collaterals' margin ratio.

Given the haircuts of securities collateral should not be less than the required haircut under FRR rules in any event (refer to the Guideline Clause 5.7), we would expect brokers no longer be able to provide major shareholder pledging business or provide majority / significant stake acquisition financing even if it has sufficient Liquid Capital (LC) to absorb 80% haircut as required in FRR rules (22.4) (the aggregate share market value greater than 5% of the market capitalization of that share is defined as illiquid

collateral and subject to 80% haircut). Currently, a broker tends to provide higher margin ratio (usually more than 20%) to listed firm's major shareholders, who will pledge 51% or more of listed firm's issued shares, as client demonstrate strong financial strength. The difference between the haircut granted to client and the haircut required by FRR rules will be absorbed by a broker's liquid capital. However, after implementing the Guideline, a broker no longer be able to grant higher than 20% margin ratio to the pledged collateral as the ratio is capped by haircut of 80% for illiquid collateral under FRR rules. We believe as long as a broker has sufficient LC, a broker should not drive out the financial needs from the major shareholder of listed company. We would also like to clarify the meaning of repledging broker vis-à-vis a particular stock. As the discussion in the consultation referred to "overflow" risk, we are of view that the relevant proposed Guideline is only applicable for a particular stock held by the broker if that broker has repledged that particular stock. Accordingly, if the broker has not repledged a stock, then the Guideline will not be applicable to the broker extends margin loans for that stock.

5. Comments on Point 6: Margin calls, stopping further advances, forced liquidation

Regarding the thresholds stated in Clause 6.4 in the Guideline, we propose the SFC to define long-outstanding margin call as margin calls that have remained unsettled for more than 90 days, which is in line with the general definition of high risk loan if the loan was pass due by more than 90 days. We suggest to set the total long-outstanding margin calls not exceeding 25% of broker's shareholders' funds.

We agree the principle set in Clause 6.5 and 6.6, but when enforcing these guideline, we would like to suggest not to stop further advances to client who have make partially settlement in margin call by either making deposit or selling stocks. From our point of view, if client has made partial settlement in margin call, the client should not be classified as a client with poor margin call settlement history.

With regarding Clause 6.5(a) in the Guideline, we would like to clarify if a long-outstanding margin call client who make deposit today, a broker could let this client to further purchase securities up to the deposit amount under the Guideline's control framework? Beside, we would also like to clarify the mean of "stop waiving margin call". Is it mean SMF broker's management cannot approve to defer client to settle margin call?

6. Comments on Point 7: Stress testing

In general, we agree with the stress testing mechanism as suggested in Clause 7.3 and 7.5 in the Guideline. However, we would suggest to incorporate diversification effect into the stress scenario. For example, if client's portfolio has more than certain number of securities, the assumed price drop can be relaxed, say 5% - 10% less.

For index stocks definition in Clause 7.3 and 7.5, we would suggest to include Hang Seng Hong Kong LargeCap Index. We also suggest the price drop set at 15% for portfolio with more than 75% market value contributed by index stocks, which is consistent with FRR rules' haircut for Hang Seng Index and Hang Seng Hong Kong LargeCap Index. For portfolio with less than 25% market value contributed by index stocks, we suggest to set the price drop at 40%. For 7.3(b) and 7.5(b), we would suggest the price drop at 25%.

With regarding Clause 7.4 and 7.6, as more and more index constituent companies try to spin off some of their businesses to be listed in Hong Kong, for example Tencent Holdings Limited (700.HK) which holds 6 listed companies in Hong Kong, we are concerning the ELC impact will become more and more significant as the haircut of these index constituent companies is only about 15%, while the haircut is 100% under the stress scenario stated in Clause 7.4 and 7.6. We would like to propose to exclude those securities which involved index constituent companies from the highly correlated securities list to reduce the impact on the ELC under the stressful scenario. Besides, as

discussed in our comments on Point 3, we strongly recommend SFC to provide a list of *highly correlated securities for brokers to perform the stress testing and monitoring.* With regarding to Clause 7.9 in the Guideline, there is no suggested threshold defining the situation of “significantly deteriorate under the stress conditions”, different brokers may have different interpretations, we suggest to set the reporting threshold at 50%, for ELC dropped more than 50% under stress conditions, a broker has to report to SFC, which is similar to the reporting threshold under FRR rules.

7. Comments on the implementation timeline

Given the Guideline requires brokers to do many stress testing on ELC and controls on further purchasing etc., which involved heavy change in a broker’s back and front office systems. The proposed six month’s transition period is insufficient to company system enhancement and UAT, we would propose to extend the transition period to 1 year

Yours Faithfully
For and on behalf of