

**Responses to Questions Raised in Consultation Paper on the Proposed Guidelines for Securities
Margin Financing Activities**

A. Total margin loans controls

- 1. Do you agree that an SMF broker should control its total margin loans with reference to the amount of its capital?**

ANSWER:

We do not agree that controlling total margin loan exposure by reference to a SMF broker's capital is appropriate because capital only absorbs loss after a debt becomes irrecoverable. Accordingly, matters such as broker liquidity, the quality of securities collateral and margin client creditworthiness have principal relevance when assessing the true margin loan exposure of a SMF broker.

Appealing though it might be from a regulatory perspective to control total margin loan exposure by reference to a SMF broker's capital, this would be a simplistic approach and would fail to distinguish between those brokers adopting prudent margin lending practices and those adopting more reckless margin lending practices. A sounder and more equitable approach would be one resembling that adopted by the Hong Kong Monetary Authority, by which a SMF broker's margin loan exposure, after taking into account the value of the securities collateral, is measured against its shareholders' funds only.

- 2. Do you agree that the proposed guidelines should provide a benchmark for the total margin loans-to-capital multiple?**

ANSWER:

Yes, but subject to our response to Question 1. If a benchmark is set, we consider that it should be a total net margin loans-to-capital (i.e. shareholders' funds only) multiple of five times, where the total net margin loan amount is the total value of all margin loans less the total value of the securities collateral held in respect of such loans.

- 3. During the soft consultations, some respondents recommended setting the benchmark for total margin loans-to-capital multiple at two to five times. Within the suggested range of two to five times, what do you think is the appropriate quantitative benchmark for total margin loans-to-capital multiple? Please provide the rationale for your comment or suggestion.**

ANSWER:

We agree that the total net margin loans-to-capital multiple should be five times, as elaborated in our answer to Question 2.

- 4. Do you agree that a higher benchmark for total margin loans-to-capital multiple should apply to a broker that does not use approved subordinated loans as regulatory capital than to a broker that does?**

ANSWER:

We disagree. The purpose of approved subordinated loans is to provide funding support for the business operations of a broker, with repayment of such loans being subject to the prior repayment of the claims of other creditors of the broker and to other regulatory requirements. We consider that drawing the suggested distinction between SMF brokers that do not use approved subordinated loans as regulatory capital and those that do would be unfair because it would be inconsistent with the principal by which subordinated loans are effectively treated as capital under the Securities and Futures (Financial Resources) Rules. Furthermore, the proposed distinction between SMF brokers that do not use approved subordinated loans as regulatory capital and those that do, does not make any allowance for the differences in the numbers of approved subordinated loans that may be drawn down by different SMF brokers falling into the latter group.

B. Margin client credit limit controls

5. While “group of related margin clients” is defined in section 42(3) of the FRR, do you agree that the coverage of related margin clients should be extended, e.g., to include margin accounts which are held by the same beneficial owner for the purposes of monitoring aggregate credit risk exposures?

ANSWER:

We favour monitoring the financial capability of margin clients and having in place a system by which appropriate credit limits are conferred on margin clients, based on such monitoring. However, extending such monitoring to a “group of related margin clients” and establishing defined credit limits which apply such groups would, at best, be very difficult. Tracking constant changes to the financial capability of such groups would be time consuming and operationally burdensome. It would also be burdensome for groups of related margin clients to update their SMF brokers in a timely manner to ensure that appropriate credit limits are maintained. Furthermore, the process of adjusting such credit limits and justifying such adjustments would likely lead to continual disagreement and debate between such groups and their SMF brokers, especially in the case of independent spouses.

In light of the foregoing observations, we agree that it is appropriate to monitor credit risk in respect of margin accounts having the same beneficial owner, but not in respect of the accounts of the members of groups of related margin clients.

C. Securities collateral concentration controls

6. Do you agree that exposures to different securities held as collateral which are highly correlated should be aggregated for the purposes of monitoring concentration risk?

ANSWER:

In principle, it would be desirable to aggregate exposures to "highly correlated" securities collateral. In practical terms, however, this would be extremely difficult to achieve and, therefore, is not a proposal that we feel could effectively be implemented.

The principal difficulty would be to define "highly correlated" in a sufficiently precise manner to avoid any ambiguity, with numerous factors potentially indicative of correlation and some being more so than others and therefore deserving of greater influence in determining the existence of correlation. We consider the definition of "highly correlated securities" contained in paragraph 38 of the Consultation Paper to be imprecise and potentially ambiguous and, therefore, to be entirely inadequate and unacceptable. Furthermore, were the determination of high correlation to be subjective (as would appear to be intended), this would inevitably lead to inconsistency between SMF brokers in the methodology adopted by them to identify highly correlated securities and, therefore, their determination of the existence or otherwise of correlation. Most SMF brokers do not have the resources to constantly monitor the existence or otherwise of correlation, particularly the constant updating of the financial circumstances and shareholder concentration of listed issuers.

The only manner in which we consider that this proposal could be made to work, would be if the SFC were to regularly publish lists of highly correlated securities.

7. Do you agree with the definition of "highly correlated securities" set out in paragraph 38 above?

ANSWER:

No. Please refer to our answer to Question 6.

8. Do you consider that constituent stocks of any other stock indices should also be treated as index stocks for the purposes of paragraph 43 above? Please provide the rationale for your suggestion.

ANSWER:

No comment.

9. During the soft consultations, some respondents suggested setting X% at between 30% and 50%, and Y% at between 20% and 25%. Within these suggested ranges, what percentages do you consider as appropriate benchmarks? Please provide the rationale for your suggestion.

ANSWER:

No comment.

D. Margin client concentration controls

10. Do you think that as a quantitative benchmark, margin client concentration should be measured with reference to the broker's shareholders' funds? If not, what is your alternative suggestion? Please provide the rationale for your suggestion.

ANSWER:

No. We agree that there is a need to manage margin client concentration risk, but consider that this should be based on more flexible and directly relevant matters, including the quality and quantity of particular securities collateral deposited to secure margin loans, the creditworthiness and risk profile of margin clients, and any short to medium term client concentration risk arising from IPO subscriptions, placement transactions, or general offers. We consider that regular stress testing serves to manage margin client concentration risk and that impact analysis on a SMF broker's excess liquid capital (ELC) should take collateral quality into consideration, rather than merely imposing rigid concentration limits on client margin loans.

11. During the soft consultations, some respondents recommended setting the quantitative benchmark for margin client concentration at between 20% and 40% of a broker's shareholders' funds. Within this suggested range, what percentage do you think is appropriate for benchmarking purpose? Please provide the rationale for your suggestion.

ANSWER:

Please refer our answer to Question 10. We make no comment concerning the issue of the percentage.

12. Do you have any comment on the basis for determining whether a margin loan is a significant margin loan?

ANSWER:

Please refer to our answer to Question 10.

13. What should be the appropriate percentage with reference to the broker's shareholders' funds for determining whether a margin loan is significant? Please provide the rationale for your suggestion.

ANSWER:

Please refer to our answer to Question 10. We make no comment concerning the issue of the percentage.

E. Haircuts for securities collateral

- 14. During the soft consultations, some respondents commented that X% in paragraph 64(b) above should be set at 15% to 20%. What percentage point within this range do you think is appropriate? Please provide the rationale for your suggestion.**

ANSWER:

In the case of the repledging of securities collateral, we generally agree that haircut rates should not be lower than the haircut rates assigned to those securities by the lending bank in question. However, we are of the view that imposing a prescribed and arbitrary percentage haircut to the rates assigned by banks is inappropriate, unnecessary and penalizes responsible SMF brokers which take into account the market capitalization, volatility and turnover of securities capital on a case-by-case basis when determining haircuts. This permits flexibility and ensures that appropriate haircuts are applied in each case.

Benchmarking securities collateral haircut rates by reference to the average of the haircut rates of the top three lending banks is likely to be problematic given the inconsistency of these rates and the frequency with which they are varied by the banks, the fact that the top three lending banks change from time to time, and the resulting difficulties and resource implications for SMF brokers having to keep track of these changes. Ongoing compliance would therefore be difficult and result in increased resource implications.

It follows that we do not favour the introduction of this proposal. However, if it were to be introduced, we suggest that it be varied by requiring each SMF broker to benchmark its securities collateral haircut rates by reference to the haircut rates of a single bank, that being its principal lending bank. Although this would not address the concerns expressed in the first paragraph of this answer, it would somewhat reduce the difficulties and resource implications associated with compliance.

F. Margin calls, stopping further advances, forced liquidation

15. Do you agree that total unsettled margin calls should not exceed the shareholders' funds of an SMF broker? Please provide the reason for your comment.

ANSWER:

We agree that total unsettled margin calls should not exceed the shareholders' funds of a SMF broker.

16. During the soft consultations, some respondents indicated that a margin call which has remained outstanding for more than 30 days to 90 days should be treated as a long-outstanding margin call. Within this suggested range, at which point do you think a margin call should be treated as a long-outstanding margin call?

ANSWER:

We agree that a margin call which has remained outstanding for more than 90 days should be treated as a long-outstanding margin call. In respect of a related matter, paragraph 6.5(a) of the draft Guidelines provides that a SMF broker should stop waiving a margin call if a margin client has a "poor history" of settling margin calls. This requirement is vague and, we believe, should be made rather more precise. It is correct that paragraph 6.5(a) provides an example of a margin client failing to meet margin calls "in" (sic) more than 15 occasions in the preceding 30 days. However, even this requirement is less than entirely clear because the value of securities collateral may change, making it unnecessary for a client to meet a margin call because his position has changed from being under-margined to over-margined. In terms of paragraph 6.5(a), however, this would appear to constitute a situation of the client having taken no action and, therefore, having failed to "meet" the margin call.

17. During the soft consultations, some respondents recommended limiting total long-outstanding margin calls to between 20% and 25% of an SMF broker's shareholders' funds. Within this suggested range, what percentage do you think is appropriate? Please provide the rationale for your suggestion.

ANSWER:

No comment.

G. Stress testing

18. During the soft consultations, some respondents suggested applying a 15% to 30% hypothetical price drop where the collateral pool mainly comprised index stocks, whereas for a collateral pool comprised few index stocks, the hypothetical price drop should be between 30% and 50%. Do you have any suggestions on the hypothetical price drop percentage to be applied in each of the scenarios (i.e., X%, Y% and Z%) suggested in paragraph 85 above? Please provide the reasons for your suggestion.

ANSWER:

We generally agree with the proposed approach to stress testing and the hypothetical stress scenarios referred to in the draft Guidelines. We have no comment concerning the proposed percentages.

19. As regards the weighting of index stocks in the collateral pool in each of the hypothetical scenarios suggested in paragraph 85 above (i.e., 75% and 25%), do you agree with the suggested thresholds as the dividing line for distinguishing a high-quality collateral pool from a low-quality collateral pool? Please provide the reason for your suggestion.

ANSWER:

No comment.

20. Do you consider that constituent stocks of any other stock indices should be treated as index stocks for the purposes of paragraph 85 above? Please provide the reason for your suggestion.

ANSWER:

No comment.

21. Do you agree that 10% is an appropriate threshold for the definition of “significant re-pledged securities collateral” and “significant group of highly correlated re-pledged securities collateral”? Please provide the reason for your suggestion.

ANSWER:

No comment.

22. Do you agree that 10% is an appropriate threshold for the definition of “significant group of highly correlated securities”? Please provide the reason for your suggestion.

ANSWER:

No comment.

23. Do you think that a six-month transition period is appropriate? Please provide the reason for your suggestion.

ANSWER:

No. The proposed six-month transition period is far too short given the new and stringent requirements proposed in the draft Guidelines. The introduction of these changes will result in SMF brokers having to expend considerable time and effort to raise additional capital from their shareholders, to hire additional personnel, and to develop and test monitoring tools within existing systems (or within entirely new systems) and other directive controls in order to ensure compliance with the draft Guidelines.