

### 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?*

We have concern over the “total margin loans-to-capital multiple” benchmark. We do not think that capital is the only parameter to determine the maximum amount of margin loan of a SMF broker. The most important element in SMF is quality of collateral, which has already been factored in the FRR calculation. This initiative would have a significant impact to small size brokers as they normally do not have large capital. As long as a SMF broker has collateral of good quality for its SMF business and keeps the LTV ratio granted to clients at a reasonable level, the risk of the SMF broker can still be managed well. Higher haircut ratio for collateral in FRR calculation with regular stress testing on ELC would be a more appropriate measure.

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

If the SFC at the end concluded that the “multiple” benchmark is a must, we suggest the SFC to provide a benchmark, otherwise, it is difficult for SMF brokers to assess whether they have complied with the Guideline, and it can ensure consistency across the industry as different firms may have different interpretation.

*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.*

As we do not agree to impose the “multiple” benchmark, if it is a must, five times would be preferable.

*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?*

As approved subordinated loan is a type of capital, we do not see the point why broker that does not use approved subordinated loan can have a higher benchmark.

#### *Other comments*

1. We strongly suggest the SFC to exempt IPO loan from the “multiple” benchmark calculation. In addition, we consider that capping the aggregated credit limits is not appropriate because:

(1) The credit limit is not committed basis, and is approved based on the client's financial capabilities e.g. income, NAV, etc. The client is required to put up sufficient collateral before he or she is able to draw down the margin loan.

(2) Our client base is vast and comprise of clients with various backgrounds. The correlation between their actions is not high and we do not expect all of them to put collateral in and draw down all available margin facilities at the same time.

(3) From our monitor of the usage of the margin loan limits, a sudden spike of margin loan usage is uncommon.

(4) FRR consideration already limited actual margin loan usage.

A more appropriate approach is to regulate the total margin loan usage and that the margin loan limits shall be granted based on the client's financial capabilities.

2. Please also clarify whether the proposed controls are on actual exposure or client credit limit.

3. Appendix 1 – Proposed draft of the Guidelines for Securities Margin Financing Activities P.24

1.1. An SMF broker should avoid granting margin loans beyond its financial capability. It should control the total amount of margin loans by implementing a prudent total margin loans limit which is commensurate with its liquidity profile and capital, the risk profile of its margin loan portfolio and prevailing market conditions.

1.3. An SMF broker should clearly document the methodology to be adopted and factors to be considered in the determination of the total margin loans limit in its margin lending policy.

Since the client credit limit for margin financing is not on a committed basis, i.e. we may cut limit on our own discretionary, we consider that controls on the actual exposure is a more appropriate measure.

#### **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, eg, to include margin accounts which are held by the same beneficial owner for the purposes of monitoring aggregate credit risk exposures?

It is rare case where 2 margin accounts are held by the same beneficial owner but not falling under s42(3) of the FRR, considering the cost and benefit, we suggest to keep the original definition in FRR.

Moreover, we consider that the original concept in the current FRR S42(3) that the ‘voting rights’ and ‘control’ should be the determining factor for ‘group of related margin clients’ is correct and should be upheld. Introducing ‘beneficial owner’ on top of voting rights will complicate the issue and may not be reflecting the actual credit risk.

#### ***Other comments***

1. As mentioned in “Total margin loans controls” section, we do not agree to impose a multiple of capital as a benchmark on margin loan size, so the same view is applied on credit limit, i.e. we do not agree that broker’s capital needs to be considered when setting credit limits for margin loans, especially when the credit limit is uncommitted.

2. Appendix 1 – Proposed draft of the Guidelines for Securities Margin Financing Activities P.24

2.4. An SMF broker should take into account, among others, the following specific factors about an individual margin client or a group of related margin clients in setting credit limit for the client(s) or group:

- (a) Financial situation of the client(s), supported by objective proof;
- (b) Any internal and external credit reference information (eg, credit history) about the client(s);
- (c) Quality of the underlying collateral and any other credit support (eg, third-party guarantee);
- (d) Investment objectives, risk appetite and trading patterns of the client(s); and
- (e) Any known events which may reflect adversely on the financial status or default risk of the client(s).

Due to the secured, non-committed nature of the margin loan business, relative liquidity of the collateral and that no repayment in arrears is required, in normal situation, we examine the client's income and net asset value through the Client Due Diligence ("CDD") process by the responsible business managers / AEs when conducting KYC process during the account opening and on regular basis, which we consider to be sufficient in objectiveness of assessing a client's financial capabilities. The CDD process enquired the client's net asset and liquid net worth with investigation of the client's source of wealth, reason for change in assets, etc. It is practically difficult for broker to require client's financial statements as asset proof in this purpose.

**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?*

We agree with this idea but it would be practically difficult for every SMF broker to maintain its own list of highly correlated securities. It may also involve different interpretation and judgement of different brokers.

Due to the significant hurdle of gathering vast amount of shareholding data of all listed securities, traded in Hong Kong or overseas, and that different brokers may have different interpretations and standard in implementing this control, we can only agree with this control provided that SFC to provide a rolling updated database for 'highly correlated securities', so that brokers will have a (consistent) source of information, with reference to 'high shareholding concentration' list, which shall be periodically updated.

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

We agree with the definition of "highly correlated securities" but it would be practically difficult for every SMF broker to maintain its own list of highly correlated securities. It may also involve different interpretation and judgement of different brokers.

We consider that the definition as suggested by SFC in the consultation paper is rather broad and not sufficiently specific for internal control purpose, and different brokers may have different interpretation for such definition. Therefore, as mentioned above, we are in the opinion that the SFC should provide a rolling updated database for 'highly correlated securities', so that brokers will have a consistent source of information, with reference to 'high shareholding concentration' list, which shall be periodically updated.

*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.*

We think constituent stocks of major overseas indices should also be included for the purpose of paragraph 43 but not limited to HSI, HSCEI, as the event risk of these stocks is also considered to be low. In addition, some major technology stocks may not be included in major equity indices but nevertheless has very good liquidity and very large market capitalization, shall also be included.

*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.*

For the stress testing, we are not very sure how it works. How many stocks should be tested under the stress scenario? It is not practical to perform the stress on all stocks one by one. Is it adequate if a broker only performs stress test by assuming its 10/20 largest stock collateral (or the 10/20 largest pool of highly correlated securities) is no longer acceptable by the FRR for liquid capital calculation one by one?

#### **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.*

Yes.

*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.*

As margin loan should be more secured with collateral than the loans granted by AI, we think that the benchmark should be much higher than 25% as required by the Banking Ordinance, probably 40% would be a better choice.

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

We agree with the definition of significant margin loan if broker's shareholders' funds include subordinated loan.

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.

We agree with the definition of significant margin loan if broker's shareholders' funds include subordinated loan.

#### **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.

No comments.

#### **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.

We agree in general.

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?

No comments.

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.

No comments.

#### **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 (ie, X%, Y% and Z%) suggested in paragraph 85 above? Please provide the reason for your suggestion.*

**No comments.**

*19. As regards the weighting of index stocks in the collateral pool in each of the hypothetical scenarios suggested in paragraph 85 above (ie, 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.*

**No comments.**

*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.*

**We think constituent stocks of major overseas indices should also be included for the purpose of paragraph 85, as the event risk of these stocks is also considered to be of high quality.**

*21. 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.*

**We agree with the definition of “significant”, but again we recommended the SFC to provide the list of correlated securities.**

*22. 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.*

**We agree with the definition of “significant”, but again we recommended the SFC to provide the list of correlated securities.**

*Other comments*

**Please clarify whether the requirement to perform stress testing on liquidity is for all SMF brokers or only those re-pledging brokers.**