



SECURITIES AND
FUTURES COMMISSION
證券及期貨事務監察委員會

Consultation Conclusions on Proposed Measures to Address Risks Arising from Securities Margin Financing

Hong Kong
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EXECUTIVE SUMMARY

1. After the collapse of the C.A. Pacific group in 1998, the practices of pooling and repledging of margin clients' securities collateral ("clients' collateral") by firms offering securities margin financing ("SMF providers") continue to expose such margin clients to risk, despite specific interim measures that were implemented in 2002 to contain these risks. On 28 September 2004, the SFC published the Consultation Paper on the Proposed Measures to Address Risks Arising from Securities Margin Financing ("Consultation Paper") to consult the public on certain proposed measures. A total of 24 submissions were received from industry participants, professional bodies and other interested parties and numerous discussions had since been held with industry participants and other interested parties.
2. Overall, the respondents accepted that the proposed measures are for better protection of investors and greater market confidence. Respondents provided a variety of views on individual proposed measures. Non-industry respondents were generally more concerned about whether the measures went far enough to protect margin clients, whereas industry respondents were more concerned about the costs and inconvenience to their businesses. The SFC also received the support of most members of the Legislative Council Panel on Financial Affairs ("FAP") for the much-debated repledging limit proposal.
3. The proposals set out in this consultation conclusions paper constitute a balanced package of measures that would, in our view, offer better protection to investors in Hong Kong, while keeping the impact on the industry to a minimum. These proposals seek to:
 - (a) implement measures to introduce limits on repledging and make some moderate changes to selected FRR¹ haircut percentages. These measures are targeted primarily at firms that repledge clients' collateral. **Firms that do not repledge clients' collateral will not be affected (except with respect to a proposed increase in the haircut percentage for warrants);**
 - (b) improve transparency by requiring SMF providers that repledge clients' collateral to provide their margin clients with more information and better disclosure about the risks of pooling and repledging, thus helping them to make an informed decision whether to open or maintain a margin account. **Again, firms that do not repledge clients' collateral will not be affected;** and
 - (c) provide some relaxation on certain requirements currently imposed on firms, as pooling risk will be contained to a certain extent by the proposed

¹ Securities and Futures (Financial Resources) Rules

measures. **Such relaxation will apply to all SMF providers (whether or not they repledge clients' collateral).**

4. The market has been doing well for the past three years since 2003, as evidenced by the significant increases in market capitalisation and the daily trading volume. Brokers have generally benefited from these increases. With such solid fundamentals, this is the right time to proceed with the proposed measures to give investors better protection. Factors such as increased market volatility and recent cases of misappropriation may give rise to additional risks to investors and the industry. SMF providers that rely heavily on bank borrowings secured by repledging clients' collateral to finance their operations are particularly vulnerable to such risks. In short, the implementation of the proposed measures should not be delayed any further.

Final Proposals

5. After carefully considering the feedback on the consulted proposals, we have decided to develop different sets of requirements for firms that repledge clients' collateral and for those that do not, bearing in mind the disparity in the level of their business risks, and the risks that their business operations pose to their margin clients.

A. **Requirements applicable to securities firms that conduct securities margin financing business but do not repledge clients' collateral (there were 150 such firms operating in Hong Kong as at end of December 2005)**

We have decided that firms that do not repledge clients' collateral should be subject to less stringent requirements:

- They will not be subject to any of the new requirements applicable to firms that repledge clients' collateral, except one, which is a revised haircut percentage for warrants (whether held as clients' collateral or house investments)². This haircut will be increased to 100%.
- These firms will benefit from the following FRR relaxations:
 - abolition of the concentration discounting factor (i.e. the "CDF", which makes additional haircut deduction where firms have particularly large exposures to individual stocks held as clients' collateral); and

²As warrants are leveraged products that tend to be very volatile, the haircut percentage applicable to warrants should be raised to 100%, meaning that warrants will be assigned a zero value for the purposes of calculating regulatory capital. The application of haircut percentages is a key risk management tool under the FRR, set to value securities prudently to take into account their broad characteristics.

- abolition of the ad hoc notification requirement on the amount of concentrated margin client adjustment made under the FRR.
- The 65% gearing adjustment set out in the FRR does not apply to these firms.

B. Requirements applicable to securities firms that repledge clients' collateral to banks (there were only 81 such firms operating in Hong Kong as at end of December 2005)

Firms that repledge clients' collateral will be subject to more stringent requirements due to the pooling risks their activities pose, as below:

- These firms will be subject to the repledging limit requirement, which restricts the amount of clients' collateral that can be repledged by a firm for the purpose of securing bank facilities based on the amount of total margin loans outstanding at the time. This requirement will apply, irrespective of whether or not the firm utilizes its banking facilities which are secured by repledging clients' collateral.

In response to the requests from the industry for a gradual phased-in approach so that they are better able to comply, we will adopt a pragmatic two-stage approach. First, a higher level of repledging limit of 180% will become effective on 1st October 2006. After a period of 12 months i.e. on 1st October 2007, the repledging limit will be set at 140%.

- It is recognized that imprudent margin lending risk is more likely to affect clients of firms that repledge clients' collateral as any collapse may also cause clients to lose the collateral that they pledged with the firm due to pooling. While the original proposal was to apply more stringent haircuts across the board for all categories of stocks held as clients' collateral by SMF providers for the purpose of computing the amount of their margin client receivables that qualify as liquid assets under the FRR, we have decided that, with the repledging limit being in place, the proposed haircut percentages could be relaxed moderately. As a result, we consider it appropriate to apply a 60% haircut deduction (raised from the existing level of 30%) to these firms for non-index constituent stocks (i.e. stocks other than constituents of the Hang Seng Composite Index or the MSCI Hong Kong and China indices³).

³ These indices are compiled by Morgan Stanley Capital International Inc.

In addition, these firms will be subject to the new 100% haircut percentage for warrants (whether held as clients' collateral or house investments).

Apart from the above changes, the haircut percentages currently in force will remain unchanged.

- To ensure that their clients are better informed of the pooling risks and repledging practices, these firms will be required to:
 - include a risk disclosure statement about pooling risk upon each and every annual renewal of the client authority to repledge clients' collateral so that clients can consider whether they would like to maintain a margin account; and
 - disclose to their margin clients whether they have repledged clients' collateral upon opening of new margin accounts and in the monthly client statements.
- To help the SFC better monitor the liquidity of firms that have repledged clients' collateral, these firms will need to notify the SFC when they have used 80% or more of their total credit limit with banks for a continuous period of 2 weeks.
- The following FRR relaxations will be made:
 - abolition of the CDF;
 - abolition of the ad hoc notification requirement on the amount of concentrated margin client adjustment made under the FRR; and
 - the triggering level of the gearing adjustment will be relaxed to 80% from 65% once the repledging limit is fixed at 140%, at which time a firm may finance more margin loans with the same amount of capital compared to the existing rate.

C. Requirements applicable to securities firms that do not conduct securities margin financing business (there were 216 such Stock Exchange of Hong Kong participant firms operating in Hong Kong as at end of December 2005)

The only change that applies to these firms is the new 100% haircut percentage for warrants.

It should also be noted that the 65% gearing adjustment does not apply to these firms.

6. As mentioned in the Consultation Paper, segregation of non-borrowing margin clients' collateral remains the most effective way of addressing the remaining risks arising from pooling of clients' collateral. However, our findings and industry operators' responses indicate that this may significantly raise the industry's operating costs and, possibly, investors' transaction costs. Consequently, such segregation will only be set as a longer-term objective. We will work with the industry to further assess other possible effects of this proposal and how it could be implemented cost-effectively.
7. The SFC will continue its efforts to step up investor education and will further explore with the industry what more can be done to increase the transparency of SMF providers' repledging practices.
8. The proposed rules and Code of Conduct⁴ changes for the proposed measures mentioned above can be found in Annexes 1, 2, 3 and 4 of this consultation conclusions paper. These proposed rules and Code of Conduct changes are currently in draft form and are subject to further changes. The final rules and Code of Conduct amendments will be gazetted shortly.

Way forward

9. Subject to the negative vetting process by the Legislative Council, these new measures are scheduled to come into effect on 1st October 2006, and will be implemented in phases in accordance with a timetable (see Table 1). We will work closely with the industry to implement these new measures.

⁴ Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission

INTRODUCTION

1. On 28 September 2004, the SFC published the Consultation Paper which set out the measures recommended by the SFC's Working Group on Review of the Financial Regulatory Framework for Licensed Corporations (the "Working Group") to address the risks in securities margin financing, which include the risks arising from imprudent lending and the pooling and repledging of clients' collateral.
2. The main objective of the proposed package of measures is to:
 - (i) make the repledging practices of SMF providers fairer for investors and provide investors with better protection from pooling risks;
 - (ii) maintain market confidence and reduce systemic risks; and
 - (iii) bring Hong Kong closer to international standards.
3. The consultation period ended on 31 October 2004 but the SFC continued to receive responses after that date. In total, the SFC has received 24 written submissions, 17 of which were from industry respondents. These consist of organisations representing the brokerage industry/staff (collectively "Trade Associations"), individual brokerage firms, and the Chamber of Hong Kong Listed Companies. The remaining 7 submissions came from non-industry respondents. These include the Consumer Council, independent persons and professional bodies (such as the two legal professional bodies). All the submissions, save those where consent for publication had been withheld, and the Consultation Paper are published on the SFC's website at <http://www.sfc.hk>.
4. Furthermore, the SFC held numerous discussions during the intervening period with industry participants and other interested parties concerning the final measures contained in this report to ensure that the measures provide adequate investor protection without imposing too heavy a compliance burden on the industry.
5. The SFC has also reported twice, in December 2004 and more recently in February 2006, to the FAP regarding the consultation feedback and subsequent discussions. The SFC received the support of the majority of the FAP members for the repledging limit proposal that had been the focus of attention.
6. This document sets out the key issues raised during the consultation process and the rationale for the SFC's conclusions. *This document should therefore be read in conjunction with the Consultation Paper.*

SUMMARY OF CONSULTATION COMMENTS/DISCUSSIONS AND THE SFC'S RESPONSES

General

7. All respondents generally accepted that the proposed measures are for better investor protection and greater market confidence. Non-industry respondents were generally more concerned about whether the measures went far enough to protect margin clients, whereas industry respondents were more concerned about the costs and inconvenience to their businesses.
8. FAP members agreed that investors deserve better protection and that the interests of margin clients should be better safeguarded, in particular those who have no current borrowing from their SMF providers. The FAP agreed with the SFC that the repledging limit should be put in place now, as part of an overall package, to help address pooling risks in order to protect investors and Hong Kong's financial market.

Principal Measures

Repledging limit

Summary of comments and discussions

9. All non-industry respondents fully supported the proposal as a means to achieve better investor protection and greater market confidence, which is in the larger interests of Hong Kong. FAP members, the Consumer Council and a legal professional body advocated for complete segregation of non-borrowing margin clients' collateral as soon as possible (see paragraphs 62 to 65 for SFC's responses).
10. Most respondents from the brokerage industry accepted the proposal of setting a repledging limit as an effective measure to contain pooling risk, but held different views as to what would be considered an acceptable repledging limit level. One staff association argued that instead of the repledging limit, the market should simply move to complete segregation of non-borrowing margin clients' collateral and set the timetable for its implementation. Several individual brokerage firms did not support the proposal.
11. Despite continuous discussions, the industry generally still argued for a more relaxed arrangement that would give them greater freedom to repledge clients' collateral. While the majority of the Trade Associations are now in general agreement with the SFC that the repledging limit proposal is currently the most practical measure and would help reduce pooling risks, they are still unable to reach a consensus on the appropriate level of the repledging limit, expressing their preferences for a repledging limit ranging between 150% and 180%. The Trade

Associations initially suggested a very generous 180% repledging limit, to be reduced after a period of time. However, they were reluctant to commit to a definite timetable for reducing the repledging limit to a more appropriate level.

12. During a meeting held in February 2006, the majority of FAP members supported the SFC's proposal to implement the repledging limit proposal without further delay.

SFC's responses

13. At present, SMF providers may repledge any amount of clients' collateral provided that there is valid standing client authorisation. In particular, there is no prohibition against repledging of non-borrowing margin clients' collateral. A repledging limit would help improve the fairness of the repledging practices for investors as well as reduce the pooling risk on the basis that the lower the repledging limit, the lower the pooling risk, similarly the higher the repledging limit, the higher the pooling risk. Therefore, we take the view that a high repledging limit provides little protection to margin clients.
14. Having considered the downside of setting a high repledging limit, we maintain the view that the ultimate repledging limit should preferably be set between 130%-150% as recommended by the Working Group. We initially considered it desirable to set the repledging limit at the lower end of the range. However, after taking into account the industry respondents' concerns about increased operational and administrative costs, we have decided to bring the final limit to a more generous level of 140% which we believe to be appropriate. This 140% level is on par with the US requirement although the US requirement is still more stringent given that it is set on an individual client basis rather than on a per-firm basis as proposed.
15. In addition, in order to allow market practitioners more time to adjust, we are prepared to adopt a two-stage approach by:
 - (a) implementing a repledging limit of 180% that will come into effect on 1st October 2006; and
 - (b) after a further period of 12 months, i.e. on 1st October 2007, the repledging limit will be fixed at 140%.
16. In our discussions with market participants, the question of whether the problem of pooling risks could be remedied by utilising the investor participant account (IP account) system via CCASS⁵ was raised.

⁵ Central Clearing and Settlement System which is a computerised securities clearing and settlement system developed and operated by Hong Kong Securities Clearing Company Limited.

17. Although IP accounts provide the most effective protection for cash clients, these accounts cannot resolve the pooling risks inherent in securities margin finance business. In securities margin financing business, an SMF provider will take collateral from its clients into its possession or control, even if it does not repledge their collateral. As a result, such collateral will not be held in the clients' own names and thus cannot be kept in their IP accounts.

Proposed revision of FRR haircut percentages for Hong Kong listed securities

Summary of comments

18. Respondents were divided as to what would be the appropriate level of haircut percentages to be applied to the value of clients' collateral under the FRR. Non-industry respondents and several industry respondents supported raising the FRR haircut percentages. The Consumer Council noted that the proposed FRR haircut percentages were still more lenient than the average haircut percentages adopted by banks and SMF providers, and suggested that the new FRR haircut percentages should be brought in line with such average haircut percentages.
19. Most industry respondents wanted no change at all or only a modest increase to the FRR haircut percentages. Their main argument was that the current set of measures, including haircut, concentration adjustments and illiquid collateral haircut, was sufficient to reduce risks in margin lending. Some respondents also flagged that the proposed haircut percentage for non-index constituent stocks might be too harsh for some stocks with good fundamentals and might affect investors' perception of them. One respondent argued that SMF providers chose to set higher haircut rates in-house so as to reduce the risk of breaching the FRR. Some respondents suggested that there should be two separate haircut tables - one table for firms that repledge clients' collateral and one table for those that do not.
20. As for warrants, respondents generally shared the view that these are volatile instruments and supported the proposal to increase their haircut percentage. Some respondents agreed that warrants should be subject to a 100% haircut while others counter-proposed to either keep the current haircut percentage or only increase the rate slightly.
21. Some respondents were in favour of the proposal to increase the haircut percentage for illiquid collateral, with one industry respondent recommending an increase to 100%. Other respondents took the view that the present haircut percentage for illiquid collateral was adequate for risk management purposes.
22. Most respondents suggested that higher FRR haircut percentages should only apply to clients' collateral so that this would only affect the computation of the amount of margin client receivables accepted for liquid capital computation purposes. This should not affect house positions or other securities transactions. They indicated a strong preference for keeping the existing FRR haircut

percentages for securities held for house investment purposes.

SFC's responses

23. The SFC generally agrees that only clients' collateral, and not house positions, should be subject to any increased haircut percentages. Furthermore, we maintain the view that the considerable gap between the FRR haircut percentages and the haircut percentages generally adopted by SMF providers and banks for in-house risk management purposes suggests that the existing FRR haircut percentages may not provide adequate risk management for margin financing activities. The gap is particularly significant in the case of stocks which are not constituents of the Hang Seng Composite Index (HKSI) and the Morgan Stanley Capital International (MSCI) Hong Kong and China Indices ("non-index constituent stocks").
24. However, the SFC is prepared to accept at this time the argument that as part of a set of measures to manage down the risks of repledging, the FRR haircut percentages could be set at levels not as stringent as those adopted in the marketplace by banks and the majority of SMF providers. Bearing in mind that only firms that repledge clients' collateral pose pooling risks, we consider it fair to differentiate between firms that repledge client's collateral and those that do not.
25. We have decided to raise the haircut percentages assigned to non-index constituent stocks from the existing 30% to 60% for firms that repledge client's collateral, and keep all other existing haircut percentages on listed shares unchanged. This move should substantially improve the risk management of SMF providers, while allowing them the flexibility to provide finance for clients to trade in stocks of their choice.
26. The revised 60% haircut percentage for non-index constituent stocks will not apply to SMF providers that do not repledge client's collateral. All existing haircut percentages on listed shares will remain unchanged for these SMF providers.
27. We have decided to maintain the haircut percentage for illiquid collateral at 80% in view that the other proposed measures should be sufficient to manage down the pooling risks.
28. As warrants are leveraged products that tend to be very volatile, we have decided to adopt the Working Group's recommendation to raise the haircut percentage of warrants to 100%. This will be applied to clients' collateral (whether the firm repledges clients' collateral or otherwise), house positions and other securities transactions.

29. Apart from the above, the haircut percentages on listed shares for house investments and all other securities transactions will remain unchanged. The revised haircut percentages for SMF providers that pool and repledge clients' collateral are summarised in **Annex 5**.

Relaxation of existing FRR requirements

Gearing adjustment

Summary of comments

30. Respondents suggested that the gearing adjustment should be substantially relaxed or removed if the proposed principal measures were implemented.

SFC's responses

31. The gearing adjustment was introduced in 2002 as an interim measure to manage pooling risk by ensuring that a firm at least finances one third of its total margin loans from its capital. With the introduction of the repledging limit and the FRR haircut measures to reduce the risk in securities margin financing activities, we believe that the role of gearing adjustment as a risk management tool will gradually diminish.
32. However, our view is that we should not abolish the gearing adjustment as we have yet to achieve complete segregation of non-borrowing margin clients' collateral. Until such time when pooling risk has been totally eliminated, we can only relax the gearing adjustment when the repledging limit is lowered to 140% so as to allow firms to have greater business flexibility, yet still having to retain a reasonable amount of capital to cover the pooling risk.
33. Accordingly, until the repledging limit is lowered to 140%, firms that repledge clients' collateral will continue to be required to make an adjustment to its liquid capital if the amount of bank borrowing obtained by repledging clients' collateral exceeds 65% ('the triggering level') of its total margin loans. After the 140% repledging limit becomes effective, the triggering level will be changed to 80%. At the 65% level, an SMF provider may borrow \$2 and use \$1 of its own capital to finance a total margin loan of \$3. To illustrate increased flexibility, at the new 80% level the SMF provider may now finance a total margin loan of \$5 using \$1 of own capital.
34. **The gearing adjustment will not apply at all to firms that do not repledge clients' collateral.**

CDF and concentrated margin client adjustment

Summary of comments

35. Most respondents suggested abolishing the CDF and concentrated margin client adjustment under the FRR if the new measures were implemented, while a few respondents preferred keeping these concentration adjustments and the existing haircut percentages.

SFC's responses

36. We have decided to abolish the CDF for all SMF providers (irrespective of whether they repledge clients' collateral or not).
37. We will also abolish the ad hoc notification requirement on the amount of concentrated margin client adjustment made under the FRR for all SMF providers (irrespective of whether they repledge clients' collateral or not) to alleviate their administrative burden.
38. The concentrated margin client adjustment encourages SMF providers to properly control the concentration risk in their margin loan portfolio. We have decided to retain the concentrated margin client adjustment to ensure that the FRR, as a whole, provides adequate risk management against margin lending risks.

Supplementary Measures

Proposed requirement to notify the SFC regarding SMF provider's total lending on illiquid collateral

Summary of comments

39. A few respondents supported the proposal, whereas some industry respondents found it difficult to apportion a margin loan into the amounts lent on illiquid collateral and on other collateral.

SFC's responses

40. We recognize that the benefits gained from adding this notification requirement on top of the FRR monthly financial returns may be outweighed by the compliance burden placed on SMF providers. Hence, we have decided to drop this requirement.

Proposed requirement to notify SFC on bank line utilisation

Summary of comments

41. Respondents generally supported increasing transparency but some industry respondents considered that the proposal might overlap with existing reporting requirements under the FRR and suggested reporting be made only at month end.

SFC's responses

42. The objective of the proposed notification requirement is to ensure that the SFC is made aware of a potential liquidity squeeze so as to take timely action to work with the relevant firm to alleviate the situation. In an attempt to strike an appropriate balance, we have decided to retain the proposed requirement to notify the SFC within one business day (the usual timeframe that is stipulated for similar notification requirements) once a firm has used 80% or more of its total bank credit limit for a continuous period of 2 weeks. This requirement will only apply to SMF providers that repledge clients' collateral. All other firms will not be affected.
43. In the calculation of the firm's total bank credit limit, firms **may** include the amount banks are willing to lend against house investments that have not been pledged to banks, plus the amount banks are willing to lend against any clients' collateral that has not been repledged but may be so repledged as permitted by the proposed repledging limit.

Proposed disclosure of repledging practice in monthly client statement

Summary of comments

44. Respondents generally agreed that steps should be taken to enhance investors' awareness of pooling risk but some of them questioned the necessity and effectiveness of providing disclosure of a firm's repledging status in a monthly client statement. Two respondents suggested that disclosure could be made upon account opening.
45. Most FAP members also urged the SFC to increase transparency of SMF providers' repledging status in order to help investors make informed decisions. Some members suggested that the Commission publish a name list of SMF providers that repledge clients' collateral in order to improve the transparency of the industry and enable investors to make more informed decisions when choosing their brokers.

SFC's responses

46. We have decided that firms who had repledged clients' collateral at any time during a month should provide disclosure in the monthly client statement to its margin clients informing them that it has a repledging practice and that the client has provided the firm with a standing authority. Such disclosure may usefully increase margin clients' awareness of the risks involved once the SMF provider has pooled and repledged their collateral. Given that firms are already required to issue monthly statements to their clients, this requirement should not create much additional administrative work.

47. We will require these SMF providers to make similar disclosure to margin clients when they open a new margin account. In addition, if an SMF provider changes its pledging status from non-pledging to pledging, it is required to disclose the new status to all existing margin clients as soon as practicable.
48. Firms that do not repledge clients' collateral may wish to state that their firm does not repledge clients' collateral in the interests of greater transparency for investors.
49. Some brokers expressed concerns over the idea of publishing a name list of SMF providers who repledge clients' collateral. Their main concern is that investors may regard the list as a kind of blacklist and discriminate against those firms named on the list. The danger being that some investors may select brokers solely on the basis of whether the broker is on the list or not, while disregarding other important factors, such as firms' financial background, reputation and experience etc.
50. We support any measure that can improve transparency and enables investors to make more informed decisions. We will further explore with the industry the need for further improving transparency. In the meantime, the proposed disclosure requirements as described in paragraphs 46 and 47 above will significantly enhance the transparency of SMF providers' pledging status to their clients and prospective clients.

Annual reminder of pooling risk

Summary of comments

51. Respondents generally supported the proposal.

SFC's responses

52. We have decided that SMF providers that repledge clients' collateral will be required to include a prominent risk disclosure statement in the reminders they issue to clients on an annual basis seeking to renew their client authority to repledge clients' collateral. The new requirement will be included in the Code of Conduct to supplement the existing requirement that SMF providers should provide a risk disclosure statement to their clients upon obtaining client authority to repledge the client's collateral. The need for an annual renewal is an existing requirement. As negative consent is currently required for the annual renewal, clients will not be required to acknowledge receipt of the risk disclosure statement.

Ancillary FRR Changes

Tightening the FRR grace period for marking-to-market overdue cash client receivables

Summary of comments

53. While some respondents supported the proposal of reducing the current 5-day grace period, other respondents were concerned about the effect of tightening the grace period on settlement with clients who are travelling or located overseas.

SFC's responses

54. Having considered the issues raised by the respondents, especially the practical difficulties in implementing the shorter grace period, we have decided to forgo this requirement. However, delay in settlement by clients may increase the settlement risk faced by brokerages. Brokerages must take note that they have a responsibility under the SFC's Code of Conduct and Internal Control Guidelines⁶ to manage their risks.

Transitional period

Summary of comments

55. Respondents generally agreed that sufficient time should be given to existing firms to adopt the new measures so as to minimise the impact on their operations and the market. The suggested length of transitional period ranged from three months to three years, depending on the measures proposed. Some respondents wanted implementation in stages, whereas others preferred full implementation after the transitional period.

SFC's responses

56. To balance investor protection and giving SMF providers sufficient time to prepare to comply with the new measures, we have decided that all the proposed measures to reduce repledging risks should be implemented on 1st October 2006 and in any event after the amendment rules have been passed by the Legislative Council. Existing firms that repledge clients' collateral will be subject to the 2-stage transition period for repledging limit. After the long period of discussion and negotiation with industry participants, we believe that the industry would have had ample time to make the necessary preparations to take onboard and comply with the new requirements.

⁶ Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the Securities and Futures Commission

57. Firms that are licensed after the new rules' commencement date will be required to immediately comply with all new requirements, including the 140% repledging limit.
58. For ease of reference, the timeframe for implementation of the proposed measures is set out in Table 1 below:

Table 1
Timetable for implementation of the proposed measures

Proposed measures	Existing licensed corporations	Firms licensed on or after 1st October 2006
180% repledging limit	Commencing 1 st October 2006 for a period of 12 months	N.A.
140% repledging limit	1 st October 2007	1 st October 2006
Revised haircut percentages Notification on bank line utilisation Disclosure of repledging practice in monthly client statement etc. Annual reminder of pooling risk Abolition of CDF Abolition of ad hoc notification on concentrated margin client adjustment	1 st October 2006	1 st October 2006
65% gearing adjustment	Existing requirement, continues to apply until and including 30 th September 2007	N.A.
80% gearing adjustment	1 st October 2007	1 st October 2006

59. The proposed rules and Code of Conduct changes for the proposed measures mentioned above can be found in Annexes 1, 2, 3 and 4 of this consultation conclusions paper. These proposed rules and Code of Conduct changes are currently in draft form and are subject to further changes. The final rules and Code of Conduct amendments will be gazetted shortly.

Long-term Objectives

Segregation of securities of non-borrowing margin clients of SMF providers

Summary of comments

60. Most respondents agreed that Hong Kong should move towards complete segregation of securities of borrowing margin clients and non-borrowing margin clients. The Consumer Council and some FAP members have strongly urged the SFC to fix a timetable for complete segregation. A legal professional body took the view that Hong Kong should legislate for complete segregation and give the industry a long transitional period to adapt to the new requirement. The FAP also asked for details regarding the costs and impact that might arise if SMF providers were required to carry out complete segregation.
61. On the other hand, industry respondents generally considered that this should not be implemented immediately. The industry's main concern is that complete segregation would involve prohibitively high administrative costs, particularly in cases where margin clients are trading actively.

SFC's responses

62. The SFC has discussed with the brokerage industry regarding when full segregation could be implemented in Hong Kong. While the SFC wholly agrees that full segregation is the best way to protect the interests of non-borrowing margin clients, the brokerage industry has expressed serious concern over the lack of a cost effective infrastructure for implementing full segregation in Hong Kong.
63. Our research indicates that to implement segregation on a day-to-day basis under the current infrastructure, an SMF provider who repledges clients' collateral will incur substantial bank charges on an ongoing basis, in addition to employing additional resources to develop, operate and maintain the necessary computer system.
64. Some brokerage firms estimated that firms may either absorb these costs themselves or charge their clients for the service, in either case this would create costs which will have to be borne by either brokerage firms or their clients or both.
65. The SFC supports segregation as our long-term goal. However, in light of its potential impact on the industry as well as potential additional cost on investors,

we need to further assess the possible consequences of the segregation proposition and how it could be implemented cost-effectively.

Tiering regulatory capital to risks

Summary of comments

66. The Consumer Council, a legal practitioner and a brokerage firm were keen for the SFC to further explore the idea of risk-based tiering of regulatory capital requirements for licensed firms. On the other hand, a few industry respondents did not support the capital tiering concept. Their main argument was that small firms might not be able to afford higher capital and that these smaller firms might present lower risk and impact even if they were to fail.

SFC's responses

67. The tiering of regulatory capital to risks remains a long-term objective. We strongly believe that licensed firms of all sizes must implement and maintain the appropriate infrastructure and commit commensurate resources to monitor and control the risks in their business so as to ensure adequate protection of their clients' interests. In the past, brokerage firm failures have demonstrated a damaging impact on the reputation of Hong Kong's financial services industry, the results of which are particularly harmful to the business of smaller local brokerage firms.
68. Risk-based regulation is an international trend with risk-based capital requirements forming an indispensable part of such regulation. The SFC already has in place a risk-based model of regulation and supervision. As such, we believe appropriately stratified capital requirements is the next step forward in terms of bringing long-term benefits in the form of enhancing public confidence and the competitiveness of brokerage firms of all sizes and in doing so, maintaining Hong Kong's status as an international financial centre.

FINAL NOTE

69. The SFC would like to thank the respondents and other interested parties who have made valuable suggestions and comments in response to the Consultation Paper.

**Proposed Amendments to the
Securities and Futures (Financial Resources) Rules¹**

1. Interpretation

(1) Section 2(1) of the Securities and Futures (Financial Resources) Rules (Cap. 571 sub. leg. N) is amended by repealing the definition of “concentration discounting factor”.

(2) Section 2(1) is amended by repealing paragraph (a) of the definition of “haircut amount” and substituting—

“(a) in relation to any shares –

(i) that are listed in Hong Kong, specified in column 2 of Table 1 in Schedule 2 for the purposes of these Rules except section 22(1);

(ii) that are listed in Hong Kong, specified in column 2 of Table 1A in Schedule 2 for the purposes of section 22(1);

(iii) that are listed in the United Kingdom, the United States of America or Japan, specified in column 2 of Table 2 in Schedule 2; or

(iv) that are listed (other than those referred to in subparagraph (i), (ii) or (iii)), specified in column 2 of Table 3 in Schedule 2,

means an amount derived by multiplying the market value of the shares by the haircut percentage in relation to such shares;”.

(3) Section 2(1) is amended by repealing paragraph (a) of the definition of “haircut percentage” and substituting—

“(a) in relation to any shares –

(i) that are listed in Hong Kong, specified in column 2 of Table 1 in Schedule 2 for the purposes of these Rules except section 22(1);

(ii) that are listed in Hong Kong, specified in column 2 of Table 1A in Schedule 2 for the purposes of section 22(1);

¹ Subject to comment by Department of Justice and further change before enactment.

- (iii) that are listed in the United Kingdom, the United States of America or Japan, specified in column 2 of Table 2 in Schedule 2; or
- (iv) that are listed (other than those referred to in subparagraph (i), (ii) or (iii)), specified in column 2 of Table 3 in Schedule 2,

means –

- (v) in the case where the shares which are described in column 2 of item 1 of Table 1A in Schedule 2 –
 - (A) cease to be a constituent stock of the applicable index; and
 - (B) the occurrence of the event specified in sub-subparagraph (A) would result in the assignment of a higher haircut percentage to the shares,

during the month in which the event specified in sub-subparagraph (A) occurs and for the next 3 consecutive months, the percentage assigned to the shares prior to such occurrence;

- (vi) in the case where the shares are described in two or more descriptions in column 2 of Table 1A in Schedule 2, such percentage specified in column 3 of the Table opposite the applicable description set out in column 2 of the Table as may be elected by a licensed corporation;
- (vii) in the case where the shares are described in column 2 of Table 1A in Schedule 2 and in one or more descriptions in:-
 - (A) column 2 of Table 1;
 - (B) column 2 of Table 2;
 - (C) column 2 of Table 3,

in that Schedule, for the purposes of section 22(1), such percentage specified in column 3 of Table 1A opposite the applicable description set out in column 2 of Table 1A in that Schedule;

- (viii) in the case where the shares are described in two or more descriptions in -
 - (A) column 2 of Table 1 in Schedule 2;

(B) column 2 of Table 2 in Schedule 2;

(C) column 2 of Table 3 in Schedule 2,

subject to subparagraph (vii), such percentage specified in column 3 of the Table concerned opposite the applicable description set out in column 2 of the Table as may be elected by a licensed corporation; or

(ix) in any other case, the percentage specified in column 3 of the Table concerned opposite the applicable description set out in column 2 of the Table;”.

(4) Section 2(1) is amended by adding –

““repledge”, in relation to a licensed corporation, means where –

(a) the licensed corporation or

(b) the associated entity of such licensed corporation, deposits, causes to be deposited or has on deposit securities collateral of the licensed corporation as collateral for financial accommodation provided to the licensed corporation;”.

2. Amounts receivable in respect of providing securities margin financing

(1) Section 22(1)(b)(i) is amended by repealing “and multiplied by the concentration discounting factor in relation to such collateral”.

(2) Section 22(1)(b)(ii) is repealed and the following substituted -

“(ii) the market value of all illiquid collateral provided by the client, multiplied by -

(A) 20% in the case of listed shares; and

(B) 0% in the case of listed warrants;”.

3. Provision of securities margin financing

Section 42(2) is amended by repealing “65%” and substituting “80%”.

4. Licensed corporations to notify Commission of circumstances relating to financial resources and trading activities and to submit returns in certain cases

(1) Section 55(1)(h) is repealed.

(2) Section 55(2)(a) is amended by adding “and” at the end.

- (3) Section 55(2)(b) is amended by repealing the semi-colon and substituting a full stop.
- (4) Section 55(2)(c) and (d) are repealed.

5. Licensed corporations to submit returns to Commission

- (1) Section 56(5) is amended by repealing “or section 55(2)(c) or (d)”.
- (2) Section 56(6) is amended by repealing “or section 55(2)(c) or (d)”.

6. Transitional

- (1) Section 60 is amended by adding –
 - “(6A) Where a licensed corporation is licensed immediately prior to 1 October 2006, for the purpose of calculating its liquid assets or ranking liabilities for the period from 1 October 2006 to 30 September 2007, references in section 42(2) to 80% shall be construed as referring to 65%.” .
- (2) Section 60(7) is amended –
 - (a) in the definition of “capital account”, by repealing the semi-colon and substituting a full stop; and
 - (b) by repealing the definition of “net tangible assets”.

7. Schedule 2 Haircut Percentages

- (1) In Schedule 2, Table 1 is amended –
 - (a) in the heading, by repealing “, THE UNITED KINGDOM, THE UNITED STATES OF AMERICA AND JAPAN (SHARES STRATIFIED ACCORDING TO STOCK INDICES)” and substituting “FOR THE PURPOSES OF THESE RULES (EXCEPT SECTION 22(1))”;
 - (b) by repealing the entry relating to item 2 and substituting in the second and third columns –
 - “Shares which are listed on a recognized stock market not being stratified according to stock indices 30”.

- (2) Schedule 2 is amended by adding the following new Table 1A –

“TABLE 1A

HAIRCUT PERCENTAGES FOR SHARES LISTED IN HONG KONG FOR
THE PURPOSES OF SECTION 22(1)

Item	Description	Haircut Percentage %
1.	Shares which are listed on a recognized stock market-	
	(a) being a constituent of the Hang Seng Index or the Hang Seng Hong Kong LargeCap Index	15
	(b) being a constituent of the Hang Seng Hong Kong MidCap Index	20
	(c) being a constituent of the Morgan Stanley Capital International Inc. Hong Kong Index or the Morgan Stanley Capital International Inc. China Index	30
	(d) being a constituent of the Hang Seng Composite Index	30
	(e) being any share not referred to in paragraph (a), (b), (c) or (d)	
	(i) for the purposes of calculation of liquid assets for a licensed corporation which does not repledge securities collateral	30
	(ii) for the purposes of calculation of liquid assets for a licensed corporation which repledges securities collateral	60
2.	Shares which are listed on a recognized stock market not being stratified according to stock indices or other criteria	
	(i) for the purposes of calculation of liquid assets for a licensed corporation which does not repledge securities collateral	30
	(ii) for the purposes of calculation of liquid assets for a licensed corporation which repledges securities collateral ”.	60
(3)	In Schedule 2, Table 2 is amended –	
	(a) in the heading, by repealing “HONG KONG,” and “(SHARES NOT STRATIFIED ACCORDING TO STOCK INDICES)”;	
	(b) by repealing the entry relating to item 1 and substituting the following in the second and third columns –	
	“Shares which are listed on a specified exchange in the United Kingdom (other than the London Stock Exchange plc-SEAQ International), the United States of America (other than the Nasdaq Stock Market, Inc.-	

Nasdaq National Market) or Japan (other than the Japanese Association of Securities Dealers Automated Quotations) -

(a) being a constituent of the FTSE-100 Index, Nikkei 15
500 Index or Standard & Poor's 500 Index; or
(b) being any share not referred to in paragraph (a) 20”;

(c) in the entry relating to item 2, in the second column, by adding
“, not being stratified according to stock indices” at the end.

(4) In Schedule 2, Table 3 is amended in the entry relating to item 5, in the second column, by repealing “Table 1 or 2” and substituting “Table 1, 1A or 2”.

(5) In Schedule 2, Table 7 is amended in the entry relating to item 1, in the third column, by repealing “40%” and substituting “100%”.

**Proposed Amendments to the
Securities and Futures (Client Securities) Rules¹**

1. Treatment of client securities and securities collateral by intermediaries licensed or registered for dealing in securities and their associated entities

Section 7(2)(b) of the Securities and Futures (Client Securities) Rules is amended by adding “subject to section 8A,” before “deposit”.

2. Treatment of securities collateral by intermediaries licensed for securities margin financing and their associated entities

Section 8(2) is amended by adding “, subject to section 8A,” before “deposit”.

3. Section added

The following section is added—

“8A. Repledging Limit

- (1) This section applies to –
 - (a) an intermediary licensed for dealing in securities;
 - (b) an intermediary licensed for securities margin financing; and
 - (c) an associated entity of an intermediary referred to in paragraph (a) or (b),that repledges securities collateral of such intermediary.
- (2) On each business day, an intermediary or an associated entity of an intermediary to which this section applies shall ascertain the aggregate market value of the repledged securities collateral, which shall be calculated by reference to the closing prices on that business day.
- (3) If the aggregate market value of the repledged securities collateral calculated pursuant to subsection (2) exceeds 140% of the intermediary’s aggregate margin loans on the same business day, the intermediary shall by the close of business on the following business day withdraw, or cause to be withdrawn, from deposit an amount of repledged securities collateral such that the aggregate market value of the repledged securities collateral at the close of business on the second-mentioned business day, which is calculated by reference to the respective closing prices on the first-mentioned business day, does not

¹ Subject to comment by Department of Justice and further change before enactment.

exceed 140% of the intermediary's aggregate margin loans as at the close of business on the first-mentioned business day.

(4) In this section –

“aggregate margin loans” () in relation to an intermediary, means the sum of margin loans owed to the intermediary by its margin clients as at the close of business on a business day;

"business day" (), means a day other than –

- (a) a Saturday;
- (b) a public holiday; or
- (c) a gale warning day or black rainstorm warning day as defined in section 71(2) of the Interpretation and General Clauses Ordinance (Cap 1);

“margin client” () has the meaning assigned to it by section 2 of the Securities and Futures (Financial Resources) Rules (Cap.571 sub. leg. N);

“margin loan” (), in relation to a margin client of an intermediary, means the net amount owed to the intermediary by the margin client arising from the provision of securities margin financing by the intermediary to the margin client, excluding any amounts added to or deducted from such amount in respect of dealings in securities by or for the margin client which are not yet due for settlement according to the settlement date;

“repledge”, in relation to an intermediary or an associated entity of such intermediary, means where –

- (a) the intermediary or
 - (b) the associated entity of such intermediary,
- deposits, causes to be deposited or has on deposit securities collateral of the intermediary as collateral for financial accommodation provided to the intermediary;

“repledged securities collateral” () means any securities collateral which is on deposit as collateral for financial accommodation provided to an intermediary to which this section applies, whether repledged by the intermediary or an associated entity of such intermediary;

“securities margin financing” (), for the purposes of this subsection, has the meaning assigned to it by section 2 of the Securities and Futures (Financial Resources) Rules (Cap.571 sub. leg. N);

"settlement date" () means the date on which payment for any dealings in securities are first due between the parties to the transaction.”.

4. Section added

The following section is added—

“14. Transitional

Where —

- (a) an intermediary is licensed immediately prior to 1 October 2006 for dealing in securities; or
- (b) an intermediary is licensed immediately prior to 1 October 2006 for securities margin financing,

for the purpose of section 8A for the period from 1 October 2006 to 30 September 2007 references in section 8A to 140% shall be construed as references to 180%.”.

**Proposed Amendments to the Securities and Futures
(Contract Notes, Statements of Account and Receipts) Rules¹**

1. Preparation and provision of monthly statements of account

- (1) Section 11 of the Securities and Futures (Contract Notes, Statements of Account and Receipts) Rules (Cap.571 sub. leg. Q) is amended by adding –

“(1A) “repledge”, in relation to an intermediary or an associated entity of such intermediary, means where –

- (a) the intermediary or
- (b) the associated entity of such intermediary, deposits, causes to be deposited or has on deposit securities collateral of the intermediary as collateral for financial accommodation provided to the intermediary.”.

- (2) Section 11(3) is amended by adding after paragraph (g) –

“(ga) in the case of an intermediary which is licensed for dealing in securities or securities margin financing where –

- (i) the intermediary or an associated entity of such intermediary has held securities collateral for that account at any time during that monthly accounting period; and
- (ii) at any time during that monthly accounting period, the intermediary or the associated entity referred to in subparagraph (i) has repledged securities collateral of the intermediary (whether or not the securities collateral repledged is the same as that referred to in subparagraph (i)),

a statement in a prominent position –

- (A) whether the client has provided the intermediary or the associated entity referred to in subparagraph (i) with a standing authority as defined in section 2 of the Securities and Futures (Client Securities) Rules (Cap.571 sub. leg. H), which has not been revoked, authorizing it to repledge securities collateral provided by him or on his behalf; and

¹ Subject to comment by Department of Justice and further change before enactment.

(B) that the intermediary or the associated entity referred to in subparagraph (i) has repledged securities collateral of the intermediary during that monthly accounting period;”.

Proposed Amendments to the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission

SCHEDULE 5: Additional requirements for licensed persons providing margin lending

Item 5 – Prudent bank borrowing

5. (b) A licensed person that repledges securities collateral should notify the Commission in writing within one business day whenever for a continuous period of 2 weeks the aggregate outstanding balance of borrowings drawn under its bank credit facilities equals or exceeds 80% of the total credit limit of the bank credit facilities calculated at the sum of:
- (i) the credit limit of each unsecured bank credit facility; and
 - (ii) the lower of
 - (I) the aggregate credit limit of its secured bank credit facilities; and
 - (II) the aggregate amount that the banks are willing to lend against the security pledged to the banks.

Notes:

The licensed person may include as part of the total credit limit the amount that the banks are willing to lend against the listed securities that belong to the licensed person and have not been pledged to the banks, plus the amount the banks are willing to lend against any clients' securities collateral that has not been repledged but may be so repledged as permitted by the repledging limit under the Securities and Futures (Client Securities) Rules.

Item 9 - Information for clients

9. (a) A licensed person that repledges securities collateral should inform a client that it has this practice upon opening a margin account for the client.
- (b) A licensed person that changes its repledging status from non-repledging to repledging should inform all its existing margin clients as soon as practicable.
- (c) A licensed person that repledges securities collateral should ensure that a risk disclosure statement in relation to the provision of an authority to repledge securities collateral as specified in Schedule 1 to the Code is included in a prominent position in the written notice given by it to any

client to renew the standing authority in which the client authorizes it to deposit the client's securities collateral as collateral for financial accommodation provided to it.

Annex 5

The table below shows the **final FRR haircut percentages** and a comparison with the original proposals in the consultation paper and the existing percentages:

Final FRR Haircut Percentages

	Original proposals	Final proposals		Existing percentages (Remark 3)
		Margin Financing	House investment (Remark 2)	
Hang Seng Index constituents	20%	15%	15%	15%
Hang Seng Hong Kong MidCap constituents	40%	20%	20%	20%
MSCI HK & China constituents	40%	30%	30%	30%
Other HSCI constituents	60%	30%	30%	30%
Non-index constituent stocks	80%	60% (Remark 1)	30%	30%
Illiquid collateral	90-100%	80%	N.A.	80%
Warrants (Remark 4)	100%	100%	100%	40%

Remarks

1. The new 60% haircut percentage applies to securities collateral provided by margin clients of firms that re-pledge clients' collateral. The non-index constituent stock collateral provided by margin clients of firms that do not re-pledge clients' collateral will continue to be subject to a 30% haircut.
2. These haircut percentages apply to house investments and other securities transactions for **all** firms.
3. Currently, there is only one set of haircut percentages which apply to both clients' collateral and house investments.
4. The new haircut percentage for warrants will apply to **all** firms (whether or not they re-pledge clients' collateral).