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

A Consultation Paper on the Review of the Financial Resources Rules

檢討財政資源規則諮詢文件

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TABLE OF CONTENTS

I. INTRODUCTION

1. The Financial Resources Rules ("FRRs") applicable to securities and futures intermediaries, which substantially revamped the then existing net capital and liquidity margin requirements for securities dealers and introduced for the first time financial requirements for futures dealers, securities and/or futures advisers, came into force on 1 December 1993.

2. The objective was to formulate risk-based financial resources rules to ensure that dealers have, at all times, sufficient readily realizable assets to meet liabilities as they fall due plus a "cushion" to cover unexpected market and credit risks and to set a basic solvency test for the advisers.

3. As the FRRs have been in operation for some three years, the Commission conducted a thorough review of the FRRs to cater for:

   a) changes in market practices and strategies;
   b) diversification into new products, e.g. new derivative products; and
   c) anomalies and deficiencies identified in operating the rules.

   This document sets out the results of the review.

4. In the process of the review, discussions were conducted with staff at both the SEHK and the HKFE as well as selected securities and futures dealers on an informal and without prejudice basis to solicit their comments on the operation of the FRRs to date and to seek their advice on different proposals to address identified deficiencies. We would like to take this opportunity to record our thanks to them for their advice and guidance.

5. On the basis that particular aspects of the Leveraged Foreign Exchange Trading (Financial Resources) Rules ("LFET(FR)Rs") are firmly based on the FRRs applicable to securities and futures intermediaries, consequential changes are also proposed to the LFET(FR)Rs. This consultation paper will not address fundamental issues which have already been discussed in the recent review of the leveraged foreign exchange trading regulatory system.

The SFC invites interested parties to submit written comments on this document by 30 April 1997. Comments should be sent to:

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for the attention of the Secretary to the Commission.

The Consultation Paper is available on the SFC Internet website at http://www.cuhk.edu.hk/sfc. Interested persons may also submit comments on the Paper by e-mail to sfc@hk.super.net.

II. THE REVIEW

6. The Review concluded that the FRRs (for the avoidance of doubt, all reference to FRRs is made to the Financial Resources Rules applicable to securities and futures intermediaries) have operated satisfactorily over the past three years and that there did not appear to be any need for fundamental changes to their general structure and approach. However, our discussions with the industry in the course of the review have indicated that some FRR applications may be too conservative. These include the 5% liabilities test for securities dealers, the treatment of hedging or arbitrage programmes and the list of recognized stock markets. Each of these areas has therefore been carefully reviewed.

7. Besides these areas, we also considered the need for changes to the financial regulatory framework to accommodate the changing profile of our intermediaries and to amend provisions which were initially incorporated as short term measures. An example of the former is the growing sophistication and integration of the market, which have given rise to the need to facilitate the ability of intermediaries to deal simultaneously in securities and futures products. An example of the latter is the filing of FRR returns where non-Exchange Member securities and futures dealers are currently required to file quarterly returns whilst Exchange Members file monthly returns.

8. The review, therefore, concentrated on the following areas:

   a) Required Liquid Capital
   b) Position Risk Adjustments
   c) Counterparty Risk Adjustments
   d) Liquidity Adjustments
   e) Requirement for Advisers
   f) Returns & Notifications
   g) Other Technical Issues

   These are discussed in the following sections.

(a) Required Liquid Capital

Standardization of Requirement for Securities & Futures Dealers

9. The current FRRs have separate rules for securities and futures dealers. Securities dealers are required to maintain, at all times, liquid capital of not less than the higher of a monetary floor ($3M for corporations and $0.5M for sole proprietors) and 5% of the firm's total liabilities. Futures dealers are required to maintain Adjusted Net Admissible Assets ("ANAA") of not less than the higher of a monetary floor (which ranges from $0.25M to $12.5M depending on the firm's business operation and clearing rights) and 4% of client funds.

10. As more and more derivative products, which are a cross-breed between securities and futures come onto the market, the delineation between activities conducted by securities and futures dealers is becoming increasingly blurred.

In addition, the growing sophistication of the market effectively requires an intermediary to have the ability to handle portfolios which include both securities and futures products on behalf of their clients. To cater for such developments and to facilitate hedging and other cross-market trading strategies, it would be desirable to enable dealers to deal concurrently in both the futures and securities markets on behalf of their clients. This would, however, require the removal of the existing artificial barriers to the undertaking of such cross market activities which in turn requires changes to the law, particularly the removal of the sole business requirement for Exchange Members. Proposals to amend the law have been included in the Composite Securities and Futures Bill which aims to rationalize and consolidate the existing legislation governing these areas.

11. To enable intermediaries to carry dual licences to participate in both markets concurrently, there will be a need to standardize the capital requirements for securities and futures dealers. In view of the relative sizes of the respective industries, we propose to standardize the liquid capital requirement for all dealers on the basis of the test currently applicable to corporate securities dealers. This should not involve any fundamental change in the nature of the applicable requirements or erode the safeguards inherent in either tests as the liquid capital test for securities dealers and the ANAA test for futures dealers effectively share the same conceptual framework.

12. The implications of standardization for the different categories of intermediaries are discussed below.

<u>*Floor Requirement*</u>

(i) Sole Proprietors

13. The proposal involves standardizing the floor requirement at $3M for all dealers, irrespective of whether they deal in securities or futures and whether they are corporations or sole proprietors, except for introducing brokers who will continue to be subject to the $0.5M floor requirement as in the present regime.

14. The main implication of this would be in relation to sole proprietors, who currently enjoy a much lower requirement of $0.5M. This level is not risk-based and tends to depart from the fundamental objective of the FRRs, which is to link capital with risk. From a risk point of view, the recent cases of Wei Xin, Cheong Woon and CK Securities indicate quite clearly the unique risks associated with sole proprietors which do not apply to corporations. The very nature of a sole proprietorship makes its business and financial position opaque. This renders effective monitoring, and thereby effective regulation, of its financial soundness, much more difficult. As such, sole proprietors should logically attract a higher floor requirement than corporations and not the other way around.

15. There are two additional reasons which argue for the removal of the preferential treatment for sole proprietors:

a) as a number of cases in 1994 and 1995 have demonstrated, sole proprietorships are subject to vagaries, untimely death, hidden exposures arising from unregulated activities etc., which expose clients to a higher degree of risk than is applicable to body corporates; and

b) the current \$0.5M floor requirement has been seen to be a disincentive towards incorporation.

16. Based on the foregoing, we are of the view that the current preferential treatment for sole proprietors should be removed and that they should be subject to the standard floor requirement applicable to all dealers. As at 30 September 1996, the proposal would mean 74 sole proprietors, out of a total population of 150, having to inject additional capital into their business.

17. As we wish to grant relief to any securities dealers who trade only for their own account and whose business activities do not pose any risk to the system or the investing public, we propose to reduce their floor requirement to the \$0.5M level through the waiver system.

18. For those sole proprietors who have to increase their current level of capitalisation, we propose to require them to comply with the new standardized floor requirements in two stages: first to increase their capital to meet a \$1.5M floor within one year of the implementation date of the new requirement and then to increase their capital to the standard \$3M floor by the end of the second year. (On this transitional base, 110 of the 150 sole proprietors will not be affected by the current proposals until the end of the first year from implementation date as their current capital base is already in excess of the \$1.5M level.)

19. We believe that the above proposals will go a long way towards minimizing any hardship to affected sole proprietors.

(ii) Futures Dealers

20. Standardization of the floor requirement will also affect futures dealers, especially the non-clearing members (subject to a floor requirement of \$1.25M) and futures traders or brokers which trade for their own account only (subject to a floor requirement of \$0.25M). As at 30 September 1996, out of a total population of 135 HKFE Members, there were 21 non-clearing members and 2 traders/brokers. Based on their respective ANAA positions as of the same date, the proposal would result in a breach by 11 of these futures dealers.

21. Out of the 25 non-HKFE Members (3 of which are classified as introducing brokers and thus subject to a separate floor requirement of \$0.5M), 19 were carrying ANAA above \$3M as at 30 September 1996 and thus should be little affected by the proposed increase in the floor requirement.

22. In all, the proposal should not have as great an impact on futures dealers as on their securities counterparts. The above notwithstanding, we explore the possibility of setting lower floor requirements in different situations as follows:

23. As regards those futures dealers who only trade for their own accounts, we are sympathetic to the argument that because they trade only for their own account and their positions are fully margined, the floor requirement element of their capital base does not need to equate that of brokers who deal with the public. We believe that the floor requirement should therefore be set at the $0.5M level on the basis of waivers, which is consistent with the proposed treatment of securities dealers.

24. As for the non-clearing member future dealers, we believe that as they are required to clear through another member who would thus be responsible for monitoring and managing their risks, the nature of the risks associated with their businesses is akin to that of an introducing broker, who is currently allowed a lower capital requirement (at $0.5M) through the waiver system. We believe that the same relief should be available to such non-clearing member future dealers, whether they are HKFE members or otherwise. (We also believe that similar relaxation should be available to non-clearing member securities dealers should the SEHK decide to introduce such a class of members. This again could contribute towards reducing the impact of the current proposals for sole proprietors.)

25. Finally, as regards general clearing members, whilst standardization may appear to have the effect of a dramatic cut of the current $12.5M floor to the proposed $3M, there should not be any real impact since the $12.5M floor requirement is a requirement laid down by the HKFECC which will continue.

26. Appropriate transitional arrangements will also be put in place in consultation with the HKFE, HKFECC and non-member futures dealers to give affected futures dealers time to apply for the necessary waivers, where applicable, or to bring their liquid capital up to the requisite level.

Variable Parameter

27. Three issues have been raised in regard to the 5% liabilities test, or the variable parameter, applicable to securities dealers:

a) the current test is computed on a trade-date basis (as opposed to a settlement date basis) which is subject to distortions if a dealer puts through exceptionally large transactions on a one-off basis;

b) the test is historically-based (the total liabilities figure is taken as an average of the preceding four quarter-ends) and may not reflect current circumstances. It also includes client monies held with segregated trust accounts; and

c) the linear relationship between risk and volumes does not take into account the fact that large clients, usually high networth individuals and/or institutional investors, tend to be more creditworthy.

28. In response to (a), we propose to retain the trade-date basis as it properly reflects a dealer's exposure to counterparty risks prior to settlement. To deal with the problem of one-off transactions, we propose to accept standby guarantees/subordinated loans to cover such sudden blips in trading volumes.

29. In response to (b), we propose to use the computation date as the new reference date, as this more accurately reflects the current risks faced by dealers. This could have some impact on the capital requirements for firms whose business volumes fluctuate substantially. However, to offset this, we propose to allow dealers to exclude client monies held with segregated trust accounts from their calculations of total liabilities since such monies are fully protected and its relative size does not pose any additional risks which require to be covered by capital. We are also aware of dealers who maintain client monies with execution brokers (particularly those overseas) and to a lesser extent clearing houses to facilitate trading and settlement. With the same rationale, we propose to exclude these balances from the calculation of total liabilities provided that they are maintained with a clearing member under an omnibus client account or with a clearing house in respect of client open positions.

30. With the proposed exclusion of client monies from total liabilities calculations, the 4% segregated funds test applicable to futures dealers would become irrelevant. It is therefore necessary to substitute it by another variable parameter which will equally effectively capture the risks associated with the size/volume of business of futures dealers. We propose to use the aggregate of margin requirement in respect of clients' futures and options positions and total liabilities as the basis for calculating the new variable parameter for them.

31. In response to (c), i.e. the non-linear relationship between risk and volumes, we are sympathetic to the arguments advanced. We, therefore, propose to reduce the percentages applied to total liabilities progressively as follows:

[Total Liabilities + Margin Requirement in respect of Clients' Futures/Options Positions] (A)	***Required Liquid Capital as a % of (A)***
Not More than $300 million	*5%*
$300 million to $1,500 million	*4%*
Above $1,500 million	*3%*

(b) Position Risk Adjustments

Equities & Debt

32. Under the existing FRRs, equities and debt are subject to different haircuts depending on their nature and where they are listed or traded. Equities which are not listed on a recognized stock market and debt which are not regarded as "qualifying"[1] are subject to a 100% haircut. This has been criticized as being unreasonable.

33. We are sympathetic to the argument that equities are unlikely to have zero value purely on account of their jurisdiction of listing and therefore propose to relax the current system somewhat by adding a regression scale to the existing recognized markets concept. This involves reducing the maximum haircut for equities to 75% and adding an interim tier above this floor at a 50% haircut for equities listed on markets not included in the current list of recognized stock markets but which are FIBV Members. To assist dealers in their analysis, a member list will be published from time to time via the SFC Bulletin. Equities listed on all other markets would then be subject to the maximum 75% haircut.

34. We have also undertaken a brief review of the current list of recognized markets and are of the view that it remains largely appropriate. The only proposed change to the list is the addition of SEAQ International to the two OTC markets currently recognized by the FRRs.

35. To ensure that only the necessary amount of capital will be required to be committed to the businesses, we propose to relax the present haircuts for equities which are constituent shares of the Hang Seng Index, FTSE-100 Index, Nikkei 225 Index or Standard & Poor's 500 Index from the existing 15% to 10% and from 20% to 15% for other shares listed on the SEHK and the OECD stock markets to reflect current volatilities.

36. As the existing FRRs do not address depository receipts, we propose to apply the same haircut as the underlying equities to ADRs, GDRs and IDRs on the grounds that their price is expected to track that of the underlying equities.

37. As regards debt, the current FRRs only give value (subject to haircut) to debt securities which must either be listed in Hong Kong, issued or guaranteed by an OECD country, Hong Kong or Singapore, or have an investment grade credit rating by Moody's or Standard & Poor. These qualifying criteria are considered onerous as they exclude, say, regional corporate bonds which have become increasingly popular amongst securities dealers for their attractive yields. Whilst we do not think it appropriate to dispense with the qualifying criteria altogether (as unlike equities, we cannot rely on the listing status to ensure at least some level of marketability and liquidity), we are prepared to

[1] Under the existing FRRs, a qualifying debt must be listed on the SEHK, issued or guaranteed by the Hong Kong Government or by any government or central bank of an OECD country or Singapore, or issued by an institution which has an investment rating by Moody's or S&P.

relax the current haircuts somewhat by expanding the qualifying criteria. To provide some relief, we propose to build additional tiers into the existing framework to expand the coverage of the qualifying criteria and to include, inter alia, debt issued by companies which are listed on recognized stock markets as qualifying. We believe that, as with equities, the ability to obtain a listing on a recognized stock market should be recognized as a litmus test of a degree of quality for the purposes of haircut treatment.

38. To avoid unnecessary complexity to the existing haircut structure, we propose to deal with haircuts on the basis of two components - the "issuer" haircut and the "maturity" risk. This is set out below:

"Issuer" Haircut Table

Issuer	Haircuts
Tier 1 gov't or central bank - HK, Australia, Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the UK and the US issuers[2] with AAA rating	0%
Tier 2 majority owned (75%) companies of Tier 1 entities gov't or central bank - Austria, Denmark, Finland, Greece, Iceland, Ireland, Luxembourg, New Zealand, Norway, Portugal, Singapore, Spain and Turkey issuers with AA or A rating	2%
Tier 3 majority owned (75%) companies of Tier 2 entities gov't or central bank - Malaysia , the People's Republic of China, the Philippines, South Korea, Taiwan and Thailand issuer with BBB rating companies listed on recognized stock exchanges (Tier 1)	5%
Tier 4 majority owned (75%) companies of Tier 3 entities companies listed on recognized stock exchanges (Tier 2)	10%
Tier 5 majority owned (75%) companies of Tier 4 entities	15%
non-qualifying categories, e.g. intercompany debts, subordinated debts, IOUs	100%

[2] whilst we acknowledge that credit rating is normally given to issues and not issuers, we have always set our qualifying criteria making reference to an issuer. The purpose is to reduce compliance work so that preparers of a computation need not look up the individual credit ratings and to avoid the problem of recent issues yet to be rated by an agency. For the avoidance of doubt, where an issuer is given different ratings for its short term and long term issues, preparers can use either rating for the purpose of analysing the haircut.

"Maturity" Haircut Table

	fixed coupon bonds / normal floating rate bonds	zero coupon bonds / inverse floaters / perpetual bonds
< 1 year	1%	1%
1-3 years	3%	3%
3-5 years	4%	5%
5-10 years	7%	10%
> 10 years	10%	22%

39. Some dealers have indicated that they sometimes have problems establishing the market value of debt which are not actively traded. To avoid requiring them constantly to ask for quotations from market makers to ensure that they are in compliance with the FRRs on a continuing basis, we propose to allow them to compute a "fair" value on the basis of generally accepted pricing models in the absence of market value. Given the spectrum of such models, the question of whether a particular pricing model adopted will satisfy the requirements of the FRRs will have to be dealt with on a case-by-case basis.

40. It is a recognised market trend that more and more derivatives products are packaged in the form of a debt issue. Dealers are required to analyse the inherent risk of each position and classify it into debt and derivatives accordingly.

Hedging/Arbitrage Programmes

41. In the main, the FRR approach has hitherto been to recognize hedging and arbitrage programmes through the waiver system. We believe that this approach remains appropriate because of the range of hedging techniques available and the need to ensure the efficacy/efficiency of the method employed, including the technical abilities of the people designing/implementing such programmes, before granting concessionary treatment.

42. The above notwithstanding, we propose to provide allowances within the FRRs for the following strategies, which are fairly straightforward and do not require a great deal of technical know-how:

a) hedging exchange-traded stock options with the underlying securities;
b) hedging stock futures with the underlying securities; and
c) hedging exchange-traded stock options with stock futures.

43. In particular, where a dealer hedges exchange-traded stock options with the underlying securities by holding the following positions,

a) long securities (or futures), long put;
b) long securities (or futures), short call;

c) short securities (or futures), long call; and
d) short securities (or futures), short put

we propose that the financial adjustment be computed as the higher of the excess of the would-be haircut on the underlying securities over the in-the-money amount (if any) and 10% of the would-be haircut on the underlying securities. This would reduce the depth of the normal haircuts depending on how deep the option is in-the-money, but subject to a floor of 10% of the normal haircuts. Where the option is out-of-money, then the underlying securities will be subject to the full normal haircuts but there will be no position risk adjustment for the option.

44. Other more complex hedging/arbitrage activities will continue to be dealt with through the waiver system but greater effort will be made to inform the market of waivers granted (via publication in the SFC Bulletin) to improve transparency and to level the playing field.

Issuer of Non-Collateralised Warrants

45. The existing FRRs do not contain any provision to capture the additional risk associated with the issue of non-collateralised warrants. We propose that the market value of any outstanding non-collateralised warrants should be included in ranking liabilities and to make a position risk adjustment which will be the higher of 10% of the would-be haircut on the underlying shares and the excess of would-be haircut over the out-of-money amount.

46. Positions in the underlying securities or assets will be subject to the normal FRR treatment separately. Dealers may continue to apply to the Commission for hedging allowances on a case-by-case basis.

Concentrated Position Risk Adjustments

47. We propose to streamline the existing concentrated position risk adjustment so that where a dealer's exposure[3] to any one issuer exceeds 25% but is below 50% of its required liquid capital, there will be an additional haircut of 5% on such exposure. Where the exposure exceeds 50%, the haircut will be increased from 5% to 10%. Specific exemptions will apply to government issues or securities which do not qualify as liquid assets in the first place.

Underwriting Commitments

48. The existing FRRs apply a 10% haircut to net underwriting commitments in respect of shares (to be) listed on a recognized stock market and 50% in all other cases. This is unduly harsh for dealers which underwrite or sub-underwrite debt issues. To rectify this, we propose to set the financial adjustment at 50% of the normal haircut. Moreover, we propose that such an adjustment will not apply until two business days after the date when the dealer

[3] defined as "net aggregate market value" of all long and short positions in shares, debt issues, warrants (including covered and non-collateralised warrants) and options

enters into the underwriting or sub-underwriting agreement and the date when the principal underwriting agreement is signed, whichever is the later.

Futures & Options Traded on Recognized Exchanges

49. We propose to amend the FRRs to accommodate net margining provided that it is in accordance with the requirement(s) set by the relevant clearing houses (instead of naming individual clearing houses, they will be redefined to be houses responsible for clearing trades executed on recognized futures and options exchanges currently listed on Schedule 2 to the Commodities Trading Ordinance) or members. Currency futures will not, however, be included in this as they are more appropriately dealt with in the context of the net foreign currency positions of dealers.

50. Where no margin requirement has been made because the dealer has deposited the underlying assets as collateral, the dealer will be required to compute the margin requirement as if he had not deposited the collateral. All long positions in options traded on recognized exchanges shall be marked to market and subject to a 40% haircut unless they have been incorporated in the net margining process, in which case they can be fully counted as liquid assets when the net margin requirement is taken as the position risk adjustment

Physical Commodities

51. We propose to include 60% of the market value of physical commodities, with the exception of gold bullion which only attracts a haircut of 10%, as liquid assets. To stem potential abuse, physical commodities must be of a quality and in a state suitable for delivery under a futures or options contract traded on a recognised futures and options exchange.

Off Balance Sheet Exposures

52. The existing FRRs have provisions to govern OTC options, interest rate agreements (interest rate swaps), forward currency agreements (currency swaps) and foreign exchange forward contracts; other OTC derivative products are not covered by the FRRs. We propose to amend the risk adjustments for swap transactions and foreign currency positions (see attached for details). The fact that genuine exposures in respect of such OTC positions do not attract regulatory capital coverage gives rise to major regulatory concerns. To rectify the above, we propose to require dealers to report the fact of their involvement in OTC derivatives activities to the Commission and to submit regular returns on their OTC derivatives activities. Where these involve substantial portfolios/risks, we will discuss the appropriate capital treatment with them to cover such off balance sheet exposures whose risks have not been covered in the FRRs.

53. Some dealers have the mistaken belief that they are not exposed if they merely facilitate an OTC transaction and do not take up any principal position. This depends very much on the actual terms of the back-to-back arrangement. If

there is no recourse to the dealer, evidently it will not be necessary to recognize any risk. However, where there is recourse to the dealer, it is conceivable that the party carrying the loss may default and the dealer may have to make good the losses to the other party. Under the existing FRRs, all OTC options positions are assumed to be naked with no allowance made for back-to-back arrangements. We consider this unduly harsh and thus propose a new, lower risk adjustment at the higher of the two risk adjustments in respect of the buying and the selling legs of the transaction. We will however stress that this treatment is only appropriate where the dealer concerned has minimised any legal and operations risks. If a dealer can demonstrate to the Commission that the actual default risk (say, of the options writer) is very low, it can apply to the Commission to further reduce the risk adjustment on a case-by-case basis.

(c) Counterparty Risk Adjustments

Cash-Against-Delivery Transactions

54. The existing FRRs contain quite an elaborate framework for computing the risk adjustments attached to trade balances arising from cash against delivery ("CAD") transactions. First, dealers have a choice between the ageing method (progressive haircuts as the period in which trade balances remain outstanding gets longer) and the price difference method (i.e. marking to market). Second, trading receivables from clients and brokers (with a longer grace period for collection) are treated differently.

55. As regards the first issue, the price difference method is the superior method as it more accurately reflects a firm's exposure to potential defaults by a client or a counterparty. The ageing method, while having the benefit of simplicity of application, is arbitrary and does not accurately reflect the risks. In the interest of better overall risk management, we propose to use the price difference method in all cases in the future.

56. As regards the second issue, we propose to standardize treatment of client and broker receivables and discount only those which have been outstanding for more than 2 weeks from settlement date. The only exception will be trade receivables from sole proprietors and partners of a partnership trading for their own account with their own firm. These receivables will be excluded in full on settlement date to avoid such persons effectively financing their personal trading with money from their firms.

57. Standardization of the grace period has two other advantages:

a) most of the smaller firms which trade only in local stocks should have little need, if at all, to compute the adjustment (and thus they will not need to mark to market too many clients' positions which can be onerous if they do not have a direct feed of day-end prices); and

b) it grants relief to dealers trading in overseas markets which may face settlement delays arising from the need to coordinate with the execution brokers, banks and/or custodians.

Free Deliveries

58. Dealers are currently allowed 5 bank trading days to collect receivables arising from free deliveries (i.e. where the dealer has already delivered the underlying securities to the client or counterparty without receiving the sales proceeds) after which they will be excluded in full from liquid assets.

59. In view of the fact that free deliveries carry substantially higher risk than CAD transactions, balances so arising should not automatically be given 2 weeks to settle as proposed for CAD transactions. Instead, we propose to offer the 2-week grace period only to those free deliveries where the local clearing system settles on that basis. All other account receivables arising from free deliveries will be excluded in full on settlement date.

Margin Trading

60. The rules in respect of margin trading are currently silent as to whether a dealer should adopt the trade date or the settlement date accounting for the purpose of risk recognition. We propose to stipulate the use of the trade date basis because it better reflects the risks and will effectively encourage prudent risk management as this will require inadequately capitalised dealers to collect collateral from their margin clients on trade date.

61. One issue that has created a lot of controversy is the pooling of clients' assets for pledging by dealers. Under the FRRs, clients' collateral can only be encumbered by being deposited or pledged with an authorized institution for the purposes of financing the trading of the particular client concerned. The market practice is, however, to deposit or pledge clients' collateral as a pool for financing the dealer's general use.

62. Such a practice is clearly unreasonable and exposes clients to unnecessary and unwarranted risks, particularly since these are unrelated to their activities and not transparent to them. We therefore propose strictly to enforce the above provision to safeguard clients' assets in the future.

Dealers Which Refer Clients' Orders Direct to Other Brokers

63. We propose to clarify in the FRRs so that

a) wherever a dealer is a contracting party, it should always account for the receivables and payables for FRR purposes even though settlement is not effected through it; and

b) where the dealer is not a contracting party but where clients or other brokers have recourse to it in the event of default, it must also reflect the receivables and payables in its FRR computations and be subject to the counterparty risk adjustment.

Clients' Futures Options Transactions

64. The existing FRRs have a serious flaw in that it does not recognize the risk when a margin deposit falls below the amount of margin called. Moreover, futures dealers are given three days to collect overlosses from clients; this is considered overly generous.

65. To rectify this, we propose to require dealers to provide for any shortfall when margin deposits fall below the margin requirements and to exclude overloss receivables from liquid assets.

Stock Borrowing/Repo Transactions

66. There are currently different sets of provisions applicable to stock borrowing and repos despite their similarity which lead to unnecessary arguments over interpretation. The provisions governing stock borrowing are particularly harsh on borrowers providing cash as collateral and dealers have to make adjustments even with the slightest movement in price of the underlying securities or collateral.

67. We propose to have only one single set of provisions to govern the borrower/buyer and lender/seller (see attached for details). In broad terms, a dealer who has borrowed securities will only need to make adjustments where the market value of collateral provided (excluding bank guarantees) exceeds 110% of the market value of the securities borrowed. This 110% is arrived at by adding a 5% buffer to the market norm of requiring 105% cash collateral. The same principle will apply to dealers in other scenarios.

Cross Margining

68. It is common for a client to have more than one type of transactions with a dealer, e.g. cash transactions, margin transactions, short selling and stock borrowing arrangements. Except for cash transactions, the client is normally required to deposit margin with the dealer to support the transactions. The existing FRRs require calculations to be made either on an account by account basis (e.g. margin transactions) or a transaction by transaction basis (e.g. stock borrowing arrangements).

69. In order to meet the margin requirements in specific accounts, the client may be required to give frequent instructions to transfer collateral from one account to another. Also, the dealer faces an administrative burden to allocate such collateral to individual transactions when calculating liquid capital.

70. To overcome this, we propose to allow a dealer to elect to calculate a single financial adjustment for a client where the dealer has an effective agreement

with that client to set off margins within the following types of accounts or transactions:

a) margin dealing account;
b) short selling account;
c) futures trading account;
d) options trading account;
e) stock borrowing transaction; and
f) repo transaction.

71. This proposal will however not extend to accounts maintained with other group companies.

(d) Liquidity Adjustments

Receivables Outside Ordinary Course of Dealing/Advisory Business

72. At present, futures dealers can include secured receivables as adjusted current assets. Securities dealers can similarly include receivables as liquid assets provided the amounts will become receivable within 2 months and to the extent that they are adequately collateralised (i.e. subject to haircut deductions) by assets which qualify as liquid assets (e.g. shares listed on the SEHK).

73. Such treatment has been subject to abuse whereby schemes have been devised to enable dealers to route funds out of the dealing companies to other affiliates without any intention to recall the money in the short term. Such receivables have in a number of cases become illiquid even though the receivables are said to be recoverable on demand. An example of such receivable is in the form of a rolling balance held with the finance company which acts as the settlement agent for clients of the dealing company. At times, such receivables snowball and become the key component of a dealer's liquid assets. In one instance, for example, a securities dealer with "liquid assets" of $79M had $63M in the form of such receivables, i.e. 80% of its total liquid assets.

74. To plug this loophole, we propose to exclude receivables outside the ordinary course of dealing (the finance company merely acts as the settlement agent and thus any balance with the finance company is seen not to have arisen directly from dealing activities)/advisory business from liquid assets.

Fees, Commissions & Commission Rebates Receivables

75. At present, securities dealers are allowed to include in its liquid assets, fees, commissions and commission rebates receivable in the ordinary course of business of dealing in securities to the extent that such receivables are outstanding for not more than 2 weeks from due date. Similar accruals which have not yet been billed can be included in full and the FRRs are silent as to when a dealer must bill for services rendered and whether the fees etc. are payable upon presentation.

76. There are known abuses where dealers have been found to accrue such charges for extensive periods, delay billing them or set unreasonably favourable payment terms (fees etc. are due only after months) artificially to inflate their liquid assets. We propose to tighten the FRRs to put an end to such abuses.

77. We propose that fees, commissions and commission rebates receivables in the ordinary course of business of dealing in securities, trading in futures or options, or rendering securities or futures advice, may also be included in liquid assets if they are not more than 3 months old.

Maintenance of Assets Overseas

78. The current FRRs have an anomaly by including securities traded on a recognized stock market as liquid assets irrespective of the country's exchange controls but excluding bank balances or amounts receivable in currencies not freely remittable to Hong Kong.

79. To address this anomaly, we propose to exclude from liquid assets all assets held in a currency that is subject to exchange control or assets which are not freely remittable to Hong Kong upon realization or liquidation, unless such remittance approval is purely a matter of routine and does not require more than a week to be obtained.

80. In addition, as more of our registered dealers establish overseas branches to conduct securities or futures operations, we have come to know about the requirements in certain markets that these branches must maintain a certain level of assets at all times in order to obtain the necessary licence or membership. Such assets may be in prescribed form, e.g. bank deposits, government debts, etc. which normally will be included in a dealer's liquid assets. Under the present FRRs, some dealers have indeed tried to argue that the assets should continue to be included in liquid assets for this reason. We do not think this treatment appropriate as dealers are in no position to access these assets for their day-to-day liquidity requirements, unless they are prepared, and have taken steps, to close their branch operations.

81. Where dealers are required to maintain the same bank deposits and holding in government debts etc (i.e. no switching of assets is allowed), we propose to exclude these assets in full. Where switching is allowed, then the assets will be included in liquid assets as normal. Instead, the dealer will have to make a liquidity adjustment for the amount of assets (in monetary terms) required to be maintained in that country. This amount can however be reduced if the assets used to meet the requirement do not qualify as liquid assets in the first place.

Bank Balances

82. The existing approach whereby a dealer can only include bank deposits (maturing within 6 months) with an authorized institution or a prescribed overseas bank and its branches as liquid assets has been criticized as being too

restrictive and impractical. The most consistent example quoted is Malaysia, where government regulations prohibit foreign banks from setting up branches.

83. It is accepted that bank deposits do not become illiquid simply because of differences in corporate structures. We therefore propose to treat bank deposits held with licensed banks, their branches and their banking subsidiaries on an equal footing. This also applies to Hong Kong offices of restricted licensed banks and deposit taking companies.

Client Payables in Respect of Monies Held

84. At present, all assets must be beneficially owned by a dealer before they can be included in liquid assets. This means that any monies held on behalf of clients cannot qualify as liquid assets. However, the current rules also require the obligation to return such monies to clients into the dealer's liability. This has created unreasonable charges to a dealer's capital base. To overcome this, we propose to allow a dealer not to recognize such liability provided the monies are

a) held in segregated trust accounts;
b) held with a clearing member under an omnibus trust account; or
c) held with a clearing house in respect of client open positions.

Note that the above items are proposed to be excluded from the total liabilities computation concurrently.

(e) Requirement for Advisers

85. The existing requirement for securities and futures advisers is that they must maintain net tangible assets ("NTA") of not less than zero. This effectively allows $2 companies to establish businesses within the financial services industry in Hong Kong.

86. We believe that in a mature and sophisticated market like Hong Kong, such a facility is unnecessary and not conducive to good business practices. In any event, we feel that to provide the necessary confidence to investors dealing with such business, it would not be unreasonable to require them to demonstrate their commitment to the industry on a long term basis by dedicating some meaningful capital to the business. Moreover, it is desirable to have a stronger financial base to compensate for any execution errors or claims against advice negligently given. Pursuant to this, we propose to require advisers to maintain at all times shareholders' funds of $500,000 or above. This requirement is easy to apply - shareholders' funds, unlike liquid capital, can be extracted direct from accounting records without any adjustments.

87. As with the other cases, we will allow a transitional period of 12-month from implementation date to give time for advisers to bring their capital base into conformity with the new requirement.

(f) Returns and Notifications

88. Non-Exchange Members currently lodge quarterly returns as compared to monthly returns by Exchange Members. The need to improve the present filing and notification requirements to enable us to monitor the financial soundness of all intermediaries, and thus to manage the risks in the market, more effectively has been recognized for some time.

89. To rectify this, we propose that all dealers, irrespective of whether they are securities or futures and regardless of exchange membership, should be required to submit monthly FRR returns within 3 weeks of each month-end. This will standardize the different reporting periods and remove anomalies that currently exist in the return dates. This will provide a much better and up-to-date overview of the risks inherent in the market for overall risk management purposes.

90. This should not pose substantial additional compliance costs as under the existing legislation, dealers are already required to maintain proper books of accounts to demonstrate that they have the required minimum liquid capital and are in compliance with the FRRs.

91. In addition, we propose to reformat the computation and require dealers to give proper disclosure of their positions in OTC options and any other derivative products and quantify the value of third parties' securities for which they are accountable. Specific details include:

a) total value of securities held for third parties, analyzing such securities into those held for safe custody purposes and those provided by third parties as collateral to settle margin requirements; and

b) total value of third parties' securities which have been pledged by the dealer to obtain loans and advances (nature to specify).

(g) Other Technical Issues

92. We have also taken the opportunity of the review to re-visit other aspects of the FRRs. A number of technical amendments will be introduced in these respects to fine-tune them (see attached for details).

III. FINANCIAL RESOURCES RULES FOR LEVERAGED FOREIGN EXCHANGE TRADERS

93. As a consequence to the FRR review, we propose to make similar changes to the LFET(FR)Rs in respect of the following position risk adjustments:

a) shares and debt issues;

b) forward agreements and swap transactions; and

c) foreign currency position adjustments.

94. In addition, we propose to rectify the deficiency in the existing LFET(FR)Rs insofar as they do not contain any position risk adjustments for futures and options positions. These will then be brought in line with the FRRs.

IV. CONSULTATION

95. The SFC invites interested parties to submit comments on this Consultation Paper. Comments should be addressed to the Securities and Futures Commission, 12th Floor, Edinburgh Tower, 15 Queen's Road Central, The Landmark, Hong Kong and should reach the Commission before 30 April 1997.

96. The Consultation Paper is available on the SFC Internet website at http://www.cuhk.edu.hk/sfc. Interested persons may also submit comments on the Paper by e-mail to sfc@hk.super.net.

Securities and Futures Commission

March 1997

Other Technical Issues

Swap Transactions

1. The treatment of swap transactions (whether they are interest rate swaps, currency swaps or even swapping of dividend income) is to be amended in the following manner: they must first be marked to market, recognising losses (to be included in ranking liabilities) but not the profits (not to be included in liquid assets). Losses can be set off against profits arising from other swap transactions of the same type (e.g. interest rate swaps against interest rate swaps) and of the same currency.

2. In addition, the dealer shall make a position risk adjustment calculated as a percentage of the total notional value of the swap transactions:

Remaining term of agreement	%
Less than 3 months	0%
3 months to 1 year	0.05%
1-2 years	0.1%
Each additional year	0.1%

3. The counterparty risk exposure only arises when the dealer has a "positive value" in its swap transaction. (If the dealer suffers a mark to market loss in its swap, the counterparty will have a mark to market profit, so the counterparty is unlikely to default). Since all profits from swap transactions are excluded from liquid assets, adequate provisions have been made against counterparty default. In case where the dealer has used mark-to-market profits for setting off mark-to-market losses arising from other swap contracts, the counterparty exposure might be understated. A possible solution is to add a further counterparty exposure in these cases, but the calculation will become too complicated. Therefore, it is preferred that no further adjustment is made for ease of computation.

Foreign Currency Positions

4. The following risk adjustment shall be applied to forward contracts, based on the type of counterparty and the remaining term to maturity:

Counterparty	%
Authorized institution, with remaining term to maturity	
less than 3 business days	0%
3 business days or more but less than 1 year	0.2%

Counterparty	%
Authorized institution, with remaining term to maturity	
1 year or more	0.5% plus 0.3% for each additional full year in excess of 1 year, with maximum up to 5%
Other persons, with remaining term to maturity	
less than 3 business days	0%
3 business days or more	5%

Stock Borrowing & Lending/ Repo Transactions

5. The following risk adjustments shall apply to stock borrowing and lending, repurchase and reverse repurchase transactions:

   a) In case the dealer is a borrower of securities or is a buyer of securities in a repurchase transaction, that he shall make a financial adjustment for any excess of the amount of Effective Collateral Given (defined as the market value of collateral excluding any bank guarantees, given under the securities borrowing transaction or the repurchase consideration under the repurchase transaction) over the amount of Modified Value of Securities (defined as 110% of the market value of securities if the securities are shares listed on recognised stock markets or qualifying debt securities and 50% of the market value of all other securities) borrowed/ bought.

   b) In case the dealer is a lender of securities or is a seller of securities in a repurchase transaction, he shall make a financial adjustment for any excess of market value of securities over the amount of Effective Collateral Collected.

      [The amount of Effective Collateral Collected is defined to include the following:

      - the full value of cash collateral and the maximum covered by bank guarantees received under the arrangement;

      - market value of securities collateral (shares listed on recognised stock markets and qualifying debt securities) received under the arrangement;

      - 50% of the market value of all other securities received as collateral under the arrangement; and

- the repurchase consideration under the repurchase transaction.]

Assets Subject to Exchange Control

6. There are the following exceptions to the overall requirement for a dealer to exclude any asset which upon realization or liquidation, will be in a currency which is subject to exchange control or its sales proceeds will not be freely remittable:

   a) where a country only prohibits outward remittance within a prescribed period after the initial injection of fund but has no similar restrictions thereafter, dealers should only need to exclude assets held in that country during that period and not beyond;

   b) whilst a country restricts outward remittance depending on the circumstances (for example, there may be restriction on funds of a capital nature), dealer should only need to exclude assets which upon realization will generate funds incapable of outward remittance; and

   c) whilst a country has to approve outward remittance of sales proceeds of trading positions or dividends earned on investment held, dealers should be able to include investments, trading receivables, bank deposits pending remittance in liquid assets provided that the approval does not normally require more than one week subject to the submission by the dealers of relevant papers (for example, documentation evidencing that the initial purchase consideration has come from the overseas).

Exclusion of long Term Liabilities

7. The existing exclusion of long term liabilities may be open to abuse and requires tightening. As a result, it is proposed that only liabilities not required to be settled within 12 months and are secured on first legal charge on real estate property used in the business for which the dealer is licenced, to the extent of the net realizable value of such property, shall be excluded from ranking liabilities.

Deferred Items

8. For clarification, it is proposed to exclude deferred assets (e.g. deferred tax credits) from liquid assets and include deferred liabilities (e.g. deferred tax liabilities) in ranking liabilities.

Reformatting the Computation

9. The current computation treats assets and liabilities separately, item by item, under different provisions governing liquid assets and ranking liabilities. This has the following practical problems:

   a) dealers may have difficulty identifying all the relevant provisions in respect of a particular transaction;

   b) risks arising from different types of transactions have been assumed to be capable of being analysed and controlled in isolation whilst in reality some transactions will normally go in pairs, e.g. short selling and stock borrowing; and

   c) the FRRs do not generally allow net margining system.

10. The proposed computation shall group together all relevant provisions in relation to the same risk (see below):

Liquid assets (at 100% value)	X
Ranking liabilities (on balance sheet liabilities)	(X)
	X
Deduct risk adjustments:	
Counterparty risks (e.g. mark to market shortfall in overdue receivables)	(X)
Position risks (e.g. 15% on Hong Kong shares)	(X)
Off balance sheet risks (e.g. swaps)	(X)
Liquidity risks (e.g. bank deposits over 6 months)	(X)
Liquid Capital	X
Liquid Capital Requirement	(X)
Excess/(Deficiency)	X

The above should strictly amount to a cosmetic change only.