

For 7 July 2003

Legislative Council Panel on Financial Affairs

**Review on the Financial Regulatory Framework
for Securities Dealers and Securities Margin Financing Providers**

INTRODUCTION

This paper seeks to provide Members with the background of the Review on the Financial Regulatory Framework for Securities Dealers and Securities Margin Financing Providers (the Review) conducted by the Working Group on the Review of the Financial Regulatory Framework for Intermediaries (the Working Group) convened by the Securities and Futures Commission (the SFC) . At the meeting to be held on 7 July 2003, the SFC will –

- (a) brief Members on the risks facing the practitioners and investors in the securities market;
- (b) update Members on the progress made by the Working Group in conducting the Review to address the risks under paragraph (a); and
- (c) seek Members' views as input to assist the Working Group in taking forward the Review and finalizing proposals for public consultation.

BACKGROUND

Background of the Review

2. In the context of the Securities (Margin Financing) (Amendment) Bill 1999 introduced to address the inadequacy of the then regulatory framework exposed by the CA Pacific case in early 1998, some LegCo Members requested, and we agreed, that the effectiveness of the regulatory measures in dealing with the risks arising from the practice of

some securities margin financing providers pooling and re-pledging their margin clients' securities for obtaining loan facilities be reviewed in two years' time.

3. In May 2002, the SFC introduced two interim measures under the then Financial Resources Rules for reducing the financial risk posed to securities margin financing providers and their clients as a result of the former's aggressive lending and funding practices. During the consultation on these measures, the industry requested the SFC to examine two areas of concern, namely -

- (a) the need to tailor regulatory capital requirements to firms based on the risk level of the line of business; and
- (b) the practice of firms being permitted to pool their margin clients' securities and re-pledge them as collateral to their banks for obtaining bank loan facilities.

These concerns are fundamental issues underlying the overall regulatory framework. In that context, the SFC undertook to this Panel in May 2002 that it would review the regulatory framework for managing brokers' financial risks in other securities market jurisdictions and the adequacy of the existing regulatory framework.

4. We have reported progress to the legislature in the context of the Financial Resources Rules made under the Securities and Futures Ordinance in September and December 2002 that the SFC has formed the Working Group to take forward the Review with a view to releasing a White Paper for consultation in 2003.

The Working Group and the Review

5. The Working Group, chaired by the SFC's Executive Director of Intermediaries and Investment Products, is 15-member strong including brokers of different sizes, fund managers, academia, the media and the Consumer Council. It has considered the risks facing practitioners and investors in the securities market, as well as the capital requirements for securities dealers and securities margin financing providers in other jurisdictions. While the consensus view is that taking no action is not an

option, the Working Group recognizes the importance of gaining wider public views before finalizing any proposed changes to the financial regulatory framework for the purpose of public consultation.

THE WAY FORWARD

6. The Administration and the SFC recognize the contributions of small brokers to the economy and affirm their role in maintaining the liquidity and vibrancy of the market. We are equally concerned about investor protection. It is therefore of paramount importance to institute a financial regulatory framework that strikes an appropriate balance among protecting investors, minimizing systemic risks and allowing brokers' continued servicing of retail investors to keep the market buoyant. This is no easy task. With the views of this Panel, the SFC will report back to the Working Group and finalize the Review and the consultation proposals.

**Securities and Futures Commission
Financial Services and the Treasury Bureau
28 June 2003**