

The Legislative Council Panel on Financial Affairs

**SFC Report on the
Recommendations of the Working Group
on the Review of the Financial Regulatory
Framework for Licensed Corporations¹**

PURPOSE

The purpose of this Paper is to brief Members on the core measures recommended by the Working Group on the Review of the Financial Regulatory Framework for Licensed Corporations (“Working Group”), and the proposed way forward.

BACKGROUND

2. The Review of the Financial Regulatory Framework for Licensed Corporations was a result of Members' calls for more effective measures to manage default risks in the securities industry, in particular arising from pooling and re-pledging margin clients' securities collateral². This is important in enhancing investor protection and the quality of our financial market.

3. Members have been updated regularly on progress, most recently at the meeting on 7 July 2003, regarding the formation and deliberations of a broad-based Working Group comprised of individuals representing securities firms of different sizes, academia, the Hong Kong Investment Funds Association and the Consumer Council. Taking into account Members' views, the Working Group has further examined different proposals, and has agreed on some recommended measures.

RECOMMENDATIONS BY WORKING GROUP

4. The Working Group proposes two core measures with a view to addressing risks in the securities industry. In order to address pooling risk, the

¹ The title of the Working Group in July 2003 was the "Working Group on the Review of the Financial Regulatory Framework for Intermediaries". This title has been corrected because the scope of the Working Group's review was limited to licensed corporations. This report concerns the same Working Group whose deliberations were reported to the Panel in July 2003.

² Members requested such a review in the context of the discussion on the Securities (Margin Financing) (Amendment) Bill 1999, and during the introduction in May 2002 of interim measures under the Financial Resources Rules.

Working Group recommends the imposition of a limit on the amount of client collateral that a firm can re-pledge to secure its borrowing ("re-pledging limit"). Such a measure would result in firms re-pledging a smaller proportion of client collateral with banks, thus increasing the quantity of client collateral available for distribution in the event of the firm's collapse. It would also prevent firms from over-borrowing against client collateral, thereby encouraging them to adopt more cautious lending and borrowing practices.

5. The Working Group also recommends an increase in the haircut percentage rates prescribed in the Financial Resources Rules ("FRR"), by reference to which firms calculate their liquid assets and liquid capital. This measure is designed to encourage securities margin finance providers ("SMF providers") to adhere to prudent lending ratios by collecting adequate collateral from margin clients. The SMF providers that lend at high lending ratios would be required to use their own capital. The intention is that market and credit risks should be borne by SMF providers, not their clients.

6. In addition, the Working Group also proposes amendments to the Code of Conduct to require greater disclosure regarding SMF activities, and stepping up investor education in order to complement the two core measures outlined above.

IMPACT ON THE SECURITIES INDUSTRY

7 The two core measures proposed by the Working Group would impact only a handful of firms. These firms would be required to cut down their re-pledging, lend more prudently or put in their own capital. However, with the recent increase in market turnover and improved profit levels, these firms should be in a better position to achieve compliance. The vast majority of securities firms, that already conduct their margin financing activities prudently, would not be affected except that their ability to freely re-pledge client collateral would be restricted to some extent.

8. The Working Group recommends allowing a 12-month transitional period for currently licensed corporations to attain full compliance with the proposed measures.

THE SFC'S VIEWS

9. The SFC notes that other major financial centres do not permit the re-pledging of non-borrowing margin clients' collateral (i.e. collateral belonging

to margin clients who have no current borrowings from a firm), and takes the view that Hong Kong should, as a long-term objective, be moving towards compliance with these international standards.

10. In addition to the recommendations of the Working Group, the SFC has also included in the Report its own views in relation to some of the key long-term issues, including considering tiering capital requirements to levels commensurate with the risks assumed by firms, and segregation of non-borrowing margin clients' collateral.

11. The SFC also takes the view that more could be done to minimize the risk of brokerage failure and proposes to establish a new internal working group to examine the complex issues arising in the context of appointing a manager to take over and manage the business of a firm which is considered likely to default on its obligations. If such a firm could be preserved on a "going concern" basis, losses could be controlled and the interests of investors better safeguarded as a result. If the contagion risk could also be contained, this would better protect Hong Kong's reputation as a competitive international financial centre. Therefore, the SFC proposes to report back to the Panel in due course in relation to this matter.

THE WAY FORWARD

12. The SFC intends to commence a public consultation exercise in the second quarter of 2004. Subject to public comments received, the SFC will consult the Administration on the proposed legislative amendments³ before consulting Members on the draft amendments at the next legislative session. In the meantime, the SFC will continue its close monitoring of the industry and will appropriately use all the resources at its disposal in order to protect the interests of investors.

ADVICE SOUGHT

13. Members are invited to offer comments on the proposed measures in addressing the risks in the securities industry in Hong Kong.

Securities and Futures Commission
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³ Implementation of the recommendations contained in the Report would involve amendment of the FRR (new haircut percentages) and the Client Securities Rules (imposing the re-pledging limit).