

Report of

the Securities and Futures Commission

on the Recommendations made by

the Working Group on Review of the

Financial Regulatory Framework

for Licensed Corporations

23 February 2004

CONTENTS

	<i>Page</i>
PREFACE	1
EXECUTIVE SUMMARY	2
CHAPTER 1 INTRODUCTION AND PURPOSE	10
CHAPTER 2 INDUSTRY OVERVIEW	19
CHAPTER 3 FINANCIAL RISK – POOLING AND RE-PLEDGING – VIEWS AND RECOMMENDATIONS OF THE WORKING GROUP	28
CHAPTER 4 FINANCIAL RISK – WORKING GROUP’S RECOMMENDATIONS ON STRENGTHENING CODE OF CONDUCT	52
CHAPTER 5 INTEGRITY RISK – SOME POSSIBLE MEASURES RECOMMENDED BY WORKING GROUP	56
CHAPTER 6 INSOLVENCY RISK – THE SFC’S PROPOSED APPROACH	59
CHAPTER 7 CONCLUDING REMARKS	64

APPENDIX 1	TERMS OF REFERENCE AND MEMBERSHIP LIST OF THE WORKING GROUP	66
APPENDIX 2	IMPRUDENT PRACTICES AND THE FINANCIAL RESOURCES RULES	69
APPENDIX 3	THE CONCEPT OF PERMITTED BANK BORROWING	77

PREFACE

The purpose of the measures recommended by the Working Group is to benefit Hong Kong's 1,000,000 investors. These measures will also benefit the development of Hong Kong's securities market, and strengthen Hong Kong's position as an international financial centre. These measures would only impact a small handful of firms who would be required to cut down their re-pledging, lend more prudently or put in their own capital. Fair treatment and appropriate protection to investors are pre-requisites to any successful securities market and a healthy brokerage industry.

The SFC proposes to consult the market on the recommended measures, whether they are appropriate, and if so the timetable for implementation. On these issues, the SFC maintains an open mind. The SFC will work with firms affected.

EXECUTIVE SUMMARY

1. The SFC presents this report on the Working Group on Review of the Financial Regulatory Framework for Licensed Corporations (“Working Group”) to the Financial Affairs Panel of the Legislative Council (“FA Panel”). This report includes proposals made by the Working Group to address the risks in securities margin financing and the pooling and re-pledging of client collateral by securities margin finance providers (“SMF providers”). The report also includes the SFC’s views and recommendations on key issues.

Measures proposed by the Working Group

2. The Working Group proposes two core measures and two supplementary measures.

A. Two core measures -

(1) Limit the amount of client collateral that can be re-pledged by an SMF provider to secure its borrowings by imposing a cap on the aggregate value of client collateral that can be re-pledged by a firm at a percentage of the firm’s total margin loans to clients.

- (a) This measure would ensure that at least a portion of client collateral remains with the SMF provider and thus be available for distribution to clients in the event of the SMF provider going into liquidation. This measure does not prevent an SMF provider from re-pledging collateral belonging to margin clients who do not have any current borrowing from the firm. However, it would nevertheless

set some limitations against excessive re-pledging of client collateral.

- (b) The Working Group considered that a limit of between 130% and 150% would be fair to firms while still providing a reasonable degree of protection to the firms' clients. So a firm that lends \$100 million to its margin clients would only be able to re-pledge client collateral worth \$130 million (at 130% limit), or \$150 million (at 150% limit).

(2) Increase the haircut percentages under the Financial Resources Rules ("FRR").

- (a) This measure is designed to encourage SMF providers to adhere to prudent lending ratios against adequate collateral. Those who still choose to lend on non-prudent ratios would have to put in additional capital as buffer against risk.
- (b) The proposed new FRR haircut percentages would still be significantly lower than the average haircut percentages used by banks and brokerages, as illustrated in the Table below.
- (c) Investors would be able to continue trading in the stocks of their choice on margin and SMF providers could still lend against those stocks. The new haircut percentages would not stop these activities.

Table
Current and Proposed FRR haircut rates, and bank/brokers average rates

Stocks and warrants	Existing FRR haircut	Proposed new FRR haircut	Banks' average haircut*	Brokers' average haircut**
HSI / HSHK LargeCap Index	15%	20%	43%	41%
Mkt cap.>\$10 billion & turnover >\$300 million	N/A	20%	56%	56%
HSHK MidCap	20%	40%	57%	57%
MSCI HK / MSCI China Index	N/A	40%	64%	64%
Mkt cap.>\$5 billion & turnover>\$300 million	N/A	40%	74%	70%
Other Hang Seng Composite Index (HSCI) constituents	30%	60%	77%	80%
All other stocks	30%	80%	96%	96%
Warrants	40%	100%	100%	100%

* The 3 banks selected together constitute approximately 54% of bank lending on margin financing as of September 2003.

** Taken over a sample of 12 firms comprising 2 Category A brokers, 6 Category B brokers and 4 Category C brokers. The sampled firms represent 28% of the total amount of margin loans outstanding and 20% of the total number of margin clients in the market as of September 2003.

3. According to the SFC's assessment, under the two core measures, only a small number of SMF providers would need to reduce 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.

B. Two supplementary measures:

- (1) Improve the Code of Conduct disclosure obligations by requiring SMF providers to disclose additional information to its clients and/or the regulator.

- (a) The SFC should be notified if an SMF provider has an unduly large exposure to collateral that is considered to be illiquid or its undrawn credit facilities fell below 20% of total available bank lines.
 - (b) On a regular basis, an SMF provider should notify its clients whether it has in general re-pledged client collateral and remind them to read the disclosure statement on pooling risk and related matters; and
- (2) Stepping up investor education on pooling risk.
- 4. The supplementary measures are aimed at enhancing the awareness of the SFC regarding matters which may be indicative that a firm has a potential cashflow problem or high level of insolvency risk which needs to be addressed, and enhancing the awareness of margin clients of the risks associated with authorizing SMF providers to re-pledge their collateral.

Transitional period

- 5. The Working Group recommends allowing existing firms a period of 12 months within which to attain compliance with the new requirements. The SFC will work closely with firms affected by the proposed measures.

Consultation

- 6. The SFC proposes to consult the public on the recommended measures and other relevant issues, whether they are appropriate and, if so, the timetable for implementation. On these issues, the SFC maintains an open mind.

Background

7. The collapse of C.A. Pacific Securities Limited and C.A. Pacific Finance Limited in January 1998 highlighted the risks to which the pooling and re-pledging of client collateral could expose margin clients. At the time of its collapse, C.A. Pacific Finance Limited had a capital of only \$16 million, but had borrowed \$548 million by re-pledging client collateral of over \$2.5 billion. The two companies had over 5000 clients; compensation claims that were allowed amounted to \$983 million and the Compensation Fund made payments totalling \$300.4 million.

8. In the wake of the incident, the Securities (Margin Financing) (Amendment) Ordinance was introduced whereby all SMF providers, including unregulated finance companies, were brought within the regulatory framework administered by the SFC. While under the new law, margin financing activities were subjected to much stricter rules than those applied to C.A. Pacific, SMF providers continue to be allowed to pool and re-pledge the collateral of their clients. In May 2002, the SFC introduced two new financial resources requirements that were designed to be interim measures only – the 65% gearing ratio adjustment and the illiquid collateral haircut. In the same month the Working Group was formed by the SFC in response to the FA Panel’s suggestion that the SFC should review the practices of pooling and re-pledging client collateral and the risks in securities margin financing activities and examine the effectiveness of the overall financial regulatory framework for the securities industry, with a view to enhancing investor protection.

9. Other major financial markets do not permit the pooling and re-pledging of non-borrowing margin clients’ collateral. The U.S. goes a step further

by imposing a limit on the re-pledging of collateral belonging to borrowing margin clients.

10. In contrast, Hong Kong continues to allow the unrestricted pooling and re-pledging of client collateral irrespective of whether the clients have actually taken any margin loan, provided the margin clients have authorized their SMF providers to do so. The current regime exists due to historical reasons and the lack of infrastructure in the industry to effect the segregation of collateral among the brokers, the banks and CCASS in a timely and efficient manner.
11. While the vast majority of securities firms in all categories operate in a professional manner and follow best market practices, a small number of firms re-pledge excessive amounts of client collateral and thus put their clients at risk.
12. While the interim measures the SFC introduced in 2002 (see paragraph 8) have helped to manage down margin financing risks to some extent, they are still deficient in that an SMF provider may still freely re-pledge client collateral (including that belonging to non-borrowing margin clients) for different purposes.
13. While recognizing that this deficiency should be addressed, the SFC agreed not to do so under the Securities and Futures Ordinance (“SFO”), when the SFC had the opportunity to introduce changes to the FRR, but to await the Working Group’s recommendations and market consultation on these recommendations.

The Working Group's objective

14. The Working Group recognises that the insolvency and liquidation of any SMF provider would cause loss to the firm's clients, harm investor confidence in the securities market and potentially lead to the collapse of other SMF providers as their clients demanded the return of their scrip. Potentially, the systemic security of the securities industry could be threatened, as could Hong Kong's reputation as a competitive international financial centre. Moreover, any such failure could seriously hurt Hong Kong's bid to be, and remain, a premier capital-raising hub for the Mainland.
15. Therefore, with a view to reducing the risks arising from imprudent margin lending and excessive re-pledging, the Working Group's objective was to find and propose viable measures by which to combat these practices. In formulating its proposals, the Working Group has aimed to find measures that would effectively provide better investor protection and reduce the risks yet impose the least burden on the industry.

SFC's Views and Recommendations

16. The SFC notes the Working Group's view that complete segregation of non-borrowing margin clients' collateral would impose substantial financial and administrative costs on SMF providers. However, Hong Kong should be moving towards compliance with international standards in this very important area as a long term objective. Capital should also be tiered according to risks undertaken by firms.
17. The SFC takes the view that more could be done to minimize the risk of brokerage failure and proposes to establish an 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 likely to default on its obligations. One possible advantage of appointing a manager is to explore the feasibility of stemming losses in a problem company and preserving assets on a “going concern” basis so that losses are controlled. If the contagion risk could be contained, this would better protect Hong Kong's reputation as a competitive international financial centre. Therefore, the SFC proposes to revert to the Panel in due course to report on its proposals in respect of the appointment of a manager, before separately consulting the public thereupon.

CHAPTER 1 Introduction And Purpose

Purpose of this Report

- 1.1 This report examines the risks in the securities brokerage business in Hong Kong, particularly those arising from margin financing and the practices of pooling and re-pledging client collateral; reviews the current financial regulatory framework and makes recommendations for measures to help the industry manage these risks. This report will also explore long term solutions that could remove some of these risks so as to position Hong Kong to compete effectively for global market share in the years ahead.

- 1.2 This report also seeks to highlight that in the event that any securities margin financing provider (“SMF provider(s)”) were to fail as a result of its adoption of imprudent business practices, it could affect a large number of investors and adversely impact confidence in Hong Kong’s securities market. The current regulatory framework for SMF providers must therefore be strengthened to contain such risks. Subject to the Financial Affairs Panel (“FAP”) Members’ views, the Securities and Futures Commission (“SFC”) proposes to consult the public on the issues and recommendations outlined in this report.

Reasons for Review of the Financial Regulatory Framework

- 1.3 In the wake of the collapse of C.A. Pacific Securities Limited and its finance arm in January 1998, the Hong Kong Government and the SFC introduced the Securities (Margin Financing) (Amendment) Bill 1999 (“SMF Bill”) into the Legislative Council whereby the provision of securities margin financing by unregulated finance companies was

brought within the regulatory framework administered by the SFC by requiring all SMF providers to be licensed.

1.4 During the Bills Committee discussion of the SMF Bill, concerns were expressed by committee members regarding the risks posed to investors by SMF providers pooling and re-pledging client collateral (“pooling risk”). It was accepted at that time that imposing a ban on pooling and re-pledging – which was the established practice in the industry – would be tantamount to prohibiting a substantial number of firms from engaging in securities margin financing. It was therefore agreed that such practices should not at that stage be banned but that SMF providers should, under the SFC Code of Conduct, be discouraged from borrowing against client collateral more than 120% of the amount of loans they had granted to their margin clients, and the SFC would review the effectiveness of this non-statutory provision and the risks posed by pooling and re-pledging in two years.

1.5 FAP Members in the May 2002 meeting also suggested to the SFC that in the long run it was necessary for the SFC to review the arrangement for firms to pool and re-pledge client collateral, as well as the need to tailor regulatory capital requirements for firms based on the risks arising from their line of business and the regulated activities for which they were licensed.

Review of Regulatory Framework is Timely and Necessary

1.6 In international and regional markets, the regulatory policy is to require intermediaries to maintain sufficient capital to buffer against risks. The higher the risks, the higher the capital needs to be. If a broker’s capital is inadequate, the loss arising from its insolvency is ultimately borne by its creditors, including the investors who place assets with the firm. Whereas

a firm's cash clients would be secured creditors in a liquidation of the firm, its margin clients would be unsecured creditors. Generally speaking, the higher the risks to investors, the lower the confidence in the market and the incentive to invest.

- 1.7 No other major financial market permits the pooling and re-pledging of non-borrowing margin clients' collateral (being collateral belonging to margin clients who have no current borrowing from the firm). The U.S, in fact, goes a step further by imposing restrictions on the amount of which can be re-pledged by a broker (re-pledging limit of 140% on a per-client basis).
- 1.8. In contrast, Hong Kong at present allows the unrestricted pooling and re-pledging of client collateral, provided the clients have authorized their broker to do so, irrespective of whether the client has any current borrowings from the firm. At the time of the C. A. Pacific collapse, over 5000 clients were affected and C.A. Pacific Finance Limited had capital of only \$16 million, but had borrowed \$548 million against client collateral of over \$2.5 billion.
- 1.9 Hong Kong broadly adheres to international practice by requiring brokers to maintain sufficient capital to buffer against risks. It follows that the higher the risk, the higher the capital needs to be. However, the capital requirements for licensed corporations have not been revised in a long time and are thus lagging behind market developments and risks within the securities industry. Under the FRR, the liquid capital requirement for a licensed brokerage is \$3 million. This level was set in 1993, when the FRR were first introduced. Agency brokers' paid-up share capital is \$5 million, an amount set more than 15 years ago. In contrast, broker capital

requirements elsewhere in the region are very substantial (see Table 1 below).

Table 1
Comparison of capital requirements for brokerages

	Hong Kong	Mainland	Taiwan	Singapore
Initial capital requirement	HK\$10 million (HK\$5 million for agency only broker)	RMB500 million (approximately HK\$470 million)	NT\$1 billion (approximately HK\$230 million)	S\$5 million (approximately HK\$23 million)

- 1.10 The Working Group is in full agreement that when a broker defaults, client collateral that is pooled and re-pledged by the broker would be at risk. If a broker's capital is inadequate and it becomes insolvent, the loss is ultimately borne by its creditors, including investors who have placed their assets with the broker.
- 1.11 When implementing the SFO, the SFC had the opportunity to introduce changes to the FRR. However, as the Working Group was then examining the overall regulatory structure and capital, the SFC agreed to defer amending the FRR until the Working Group had made its recommendations.
- 1.12 The SFC is aware that among some members of the industry there is a belief that brokers should be allowed to operate on a small scale with a smaller capital outlay, should they choose to do so. Historically, Hong Kong has permitted these entrepreneurs to operate in this manner, and their nimble size allows them the flexibility to conduct business with lower costs, which means that they can pass their savings on to their

clients. Some also point out that where the size of their business is small, there is no commercially sound reason for them to be heavily capitalized.

1.13 The flipside of such an approach is that smaller brokerages that do not invest resources in the improvement of their internal control systems and IT infrastructure are thereby more exposed to risk of fraud or mismanagement. This is reflected in the fact that the majority of disciplinary cases taken against brokers by the SFC reflect weak internal controls. At the same time, smaller brokers are facing increasing competition from banks and selective brokers that are able to offer a wider range of services through electronic channels.

1.14 The SFO mandates that the SFC is responsible for fostering market confidence and enhancing investor protection. Consequently, it is incumbent upon the SFC to review the present framework for regulatory capital requirements and the practices of pooling and re-pledging client collateral, and to recommend solutions for the medium and longer term benefit of the market, participants and investors, as a whole. Any structural defects that permit brokerage failure to affect Hong Kong's reputation as the premier capital formation centre of China should be remedied.

The Establishment of the Working Group to assist in the Review

1.15 The SFC established the Working Group to assist in reviewing the financial regulatory framework. The Working Group's remit is to examine the risk levels in the industry, particularly pooling risks, assess the adequacy of the present system of financial requirements imposed upon licensed corporations and recommend comprehensive solutions for the control or effective management of the risks in the industry. Controlling or managing such risks would be beneficial not only to

investors but also to the entire brokerage industry. In the globalized market, and against the backdrop of the liberalization of mainland China's economy, it is crucial that the brokerage industry is equipped to inspire confidence in investors, in Hong Kong and elsewhere, to capture the opportunities emanating from the mainland and to sustain Hong Kong's position as an international financial centre in the challenging years ahead.

1.16 Membership of the Working Group is broad based, consisting of 13 individuals chosen either for their expertise and experience in the industry or for their capacity to speak for the interests of investors (such as members from academia, the Investment Funds Association and the Consumer Council). The Working Group is chaired by the SFC's Executive Director of Intermediaries and Investment Products. The terms of reference and membership list of the Working Group are set out in **Appendix 1**.

1.17 Over a period of 22 months, the Working Group held 14 meetings. It has examined the various risks in the operations of securities firms, in particular SMF providers, and it has considered different means by which risks arising from the imprudent practices of some SMF providers could be contained (though not eliminated). In the process, the Working Group has examined the regulatory approach adopted in different major markets, including the U.S., the capital requirements of securities firms in the region (mainland China, Taiwan and Singapore) and reviewed the powers currently available to the SFC in managing down the risk levels of licensed corporations.

1.18 In this report the SFC will set out the main views that were reached by the Working Group members by way of a general consensus. Where there were strong dissenting views, this report seeks to also capture them in an attempt to give FAP Members a fuller account of the range of issues and

concerns. As the statutory regulator charged with responsibility for enhancing investor protection and market integrity, the SFC also gives its independent view, assessment and recommendations on some of the issues and proposals.

Findings by the Working Group on Primary Causes of Broker Default

1.19 The Working Group has closely examined the risk profile of licensed brokerages and, in particular, the practices of pooling and re-pledging client collateral by some SMF providers. It identified **financial risk** (brokerage insolvency) and **integrity risk** (fraud and misappropriation of client assets) as the principal causes of brokerage default.

Capital adequacy and internal control system

1.20 In their early deliberations, a number of Working Group members favoured increasing capital requirements for brokers, in particular, SMF providers, and requiring them to rigorously follow robust risk and internal control measures. It was felt that this would accord with world trends and practice. As SMF providers that pool and re-pledge client collateral, are de facto operating like banks, they should have substantial capital outlays if they pool and re-pledge client assets. These members believe that a regulatory framework that relies on the use of the more macro tools of capital adequacy and internal controls would be preferable to using measures that impose restrictions on different activities. However, others in the Working Group oppose this approach, being concerned that any wholesale increase in capital could drive the smaller brokers, especially SMF providers out of business. Members eventually agreed that rather than an increase in capital, the Working Group should examine specific measures that would require only those SMF providers who undertake excessive risks to increase their capital or be subject to other kinds of

lending and borrowing restrictions. Despite such opposition, some members of the working Group remained convinced that the long term solution lies in capital adequacy and effective risk management.

Focused Measures proposed by Working Group

1.21 In the view of the Working Group, the risks in the industry (which are described in **Appendix 2**) posed by the imprudent practices of some SMF providers can be controlled or managed down by a combination of targeted measures which include –

- (a) two core measures, both of which will be subject to a proposed 12 month transitional period (save for the increase in the haircut percentages applied to warrants), to deal with the imprudent practices at their source by –
 - (i) introducing a limit on the amount of client collateral that can be re-pledged by a firm to secure its borrowings; and
 - (ii) managing down the amount of inadequately collateralized margin loans by increasing the haircut percentages applied by firms to client collateral in computing their liquid capital under the FRR;
- (b) the supplemental measure of introducing amendments to the Code of Conduct whereby SMF providers will disclose certain information to their clients and report to the SFC when they cross certain thresholds; and
- (c) the supplemental measure of stepping up investor education.

SFC's views

- 1.22 The SFC believes that the proposed measures are useful for the industry in managing down excessive risks. The reality, however, is that as the Hong Kong market continues to grow, it is the brokerages with good risk management, knowledge and skills that will emerge as the winners.
- 1.23 While market capitalization and turnover (2003) have increased 12 times and 20 times respectively from the days of open outcry on four different exchange floors (1986), the market practice of brokers operating on lean capital, and SMF providers funding their working capital by re-pledging margin client collateral (so that the provider can operate on a very cost effective basis) has not changed. While this practice makes commercial sense for a brokerage (enabling it to operate on a large scale through risking clients' assets), it effectively transfers the brokerage's risks to, or puts at risk the assets of, its clients. When a broker holds client assets, any loss due to fraud, misappropriation or default by a broker with an insufficient capital buffer to withstand demands on its liquidity could lead to the loss of client assets; to the detriment of investors. When an SMF provider re-pledges client collateral with a bank, any default by the SMF provider could lead to the bank foreclosing on the collateral and disposing of it to reduce the firm's indebtedness. The loss, again, will be borne by the investor. In the securities market today, it is not acceptable that investors should be made to bear these risks. It is equally not acceptable that other brokers, and the market as a whole, should suffer the reputational, or even systemic, damage caused by brokerage default.

CHAPTER 2 Industry Overview

Hong Kong as an international financial centre

- 2.1 Hong Kong is widely recognised as a major international financial centre with an integrated network of financial institutions and markets providing local and international investors with high quality and efficient services, and a wide range of products.
- 2.2 The Hong Kong securities market is the 8th largest in the world and the largest in Asia ex-Japan¹ in terms of market capitalization. As of the end of 2003, market capitalization amounted to HK\$5,548 billion (US\$715 billion), with a total turnover of HK\$2,584 billion (US\$332 billion) for the year.
- 2.3 The financial services industry is one of the key sectors of Hong Kong's economy. It contributes 13% of Hong Kong's GDP (in value-added terms) and employs about 6% of its workforce.²
- 2.4 From 1986 to 2003, mainland companies raised a total of HK\$786 billion (US\$101 billion) directly or indirectly through Hong Kong. Apart from mainland companies, their mainland shareholders are also beginning to use the facilities of Hong Kong's financial market to place out shares in their Hong Kong listed companies. On 16 December 2003 alone, Bank of China successfully placed 10.12% (worth HK\$14.66 billion) of the existing issued capital of Bank of China Hong Kong, its Hong Kong listed subsidiary. As the mainland market continues to open up, the challenge for Hong Kong is to capture the many opportunities created in the process of this liberalization. In short, Hong Kong's future as an international

¹ Ranking as of end November 2003.

financial centre depends on its success as “the premier capital formation centre of China”. (Paragraph 17 of the Address by the Chief Executive, the Honourable Tung Chee Hwa, at the Legislative Council Meeting on 8 January 2003.)

- 2.5 To succeed, Hong Kong needs not only a vibrant and healthy stock market but, just as importantly, a financially sound, professionally competent and efficient brokerage sector to support it and to serve Hong Kong’s institutional and retail investors³.

State of the brokerage industry

- 2.6 As at the end of September 2003, there were 453 securities brokers (participants of the Stock Exchange of Hong Kong) and 125 futures brokers (participants of the Hong Kong Futures Exchange). Within the securities industry, there were 242 firms that were providing securities margin financing. The securities market has developed on what is essentially a two-sector structure. One sector is composed of international brokers of world repute serving primarily an institutional network and accounting for roughly half the market share and trading mostly Hang Seng Index stocks. The other sector is composed of a large number of small and medium sized local brokerages. The majority of these serve the retail market, trading both Hang Seng and non-Hang Seng Index stocks. While the international brokers have helped anchor Hong Kong’s position as an international financial centre, local brokers play the important role of serving smaller investors and providing liquidity to the market.

² Figures are sourced from the Hong Kong Yearbook 2002.

³ Approximately 59% of Hong Kong’s market turnover was attributable to institutional investors (HKEx’s Cash Market Transaction Survey for year ending September 2002), and there were approximately 1.1 million retail investors (HKEx’s Omnibus Retail Investor Survey 2002, end 2002).

- 2.7 Risks exist in the brokerage industry. These include market risk, credit risk of clients, liquidity risk, concentration risk, operational risks and systemic risk. The risks of SMF providers that lend against client collateral, and rely on pooling and re-pledging client collateral to finance their business and lending operations, are even higher.
- 2.8 To buffer against risks, a brokerage needs to maintain adequate liquid capital and a robust risk management system, carry on its business with prudence and skill, and uphold the integrity of its staff and management. Otherwise, the risks assumed and created by the brokerage are passed on to their clients.
- 2.9 In Hong Kong, prudential regulation of brokers' financial adequacy is modelled on the U.S. system – which measures the net assets of a broker, adjusted for quality by a range of calibrations such as the application of haircuts to certain assets and collateral. These measures and requirements are set out in the FRR. Essentially, the FRR use a combination of required level of capital, application of haircuts to assets, provision for liabilities and limits on gearing to ensure that brokers are financially sound and able to withstand market and credit risks. The SFC also requires brokers to have in place robust risk management and internal control systems, and to operate under business conduct practices stipulated in relevant rules, codes and guidelines.
- 2.10 The vast majority of brokers operate prudently, responsibly and with integrity. They have adequate risk management systems in place, and maintain sufficient capital under the FRR.
- 2.11 Current capital requirements for brokers under the FRR are out of step with the levels of risk assumed by brokers in the conduct of their business. The FRR liquid capital requirement for a licensed brokerage is \$3 million.

This level was set in 1993, when the FRR were first introduced. Agency brokers' paid-up share capital is \$5 million, an amount set more than 15 years ago. Elsewhere in the region, brokers capital requirements are very substantial (see Table 2 below).

2.12 The number of brokers in these markets is also substantially smaller than in Hong Kong, so that the scale of systemic risks is smaller.

Table 2

	Hong Kong#	Mainland	Taiwan	Singapore
Initial capital requirement*	HK\$10 million (HK\$5 million for agency only broker)	RMB500 million (approximately HK\$470 million)	NT\$1 billion (approximately HK\$230 million)	S\$5 million (approximately HK\$23 million)
Number of brokers	436	127	154	61

* The level of initial capital requirement for the different jurisdictions mentioned above is for brokers who are allowed to carry activities similar to those of brokers in Hong Kong, including agency broking, proprietary trading, underwriting and (in the case of Singapore and Taiwan) securities margin financing.

The capital requirements for licensed banks, restricted licensed banks and deposit taking companies in Hong Kong are HK\$300 million, HK\$100 million and HK\$25 million respectively.

What the SFC has done since March 2000

2.13 After the SFC took over from the SEHK the front-line regulation of all brokers in March 2000, it reviewed the financial condition of brokers with higher risk profiles because of their thin capital, imprudent lending practices and excessive re-pledging of client collateral. The SFC immediately put in place a program of intensive supervision and moral suasion to persuade these brokers to manage down their exposures by

injecting capital, reducing margin loans, taking better quality collateral and, where necessary, taking measures to address pooling risks.

2.14 So far, the SFC has managed down some of the risks in the industry, by persuading -

(a) 14 SMF providers to increase their paid-up share capital by an aggregate of \$782 million and 12 SMF providers to inject approved subordinated loans by an aggregate of \$358 million thus ensuring that these firms have prudential capital buffers;

(b) 14 SMF providers to take various supplementary measures to reduce the risk arising from pooling of client collateral, this being the result of the use of Code of Conduct requirements and intensive moral suasion, as currently the law does not directly mandate segregation of non-borrowing margin clients' collateral.

Investor Compensation

2.15 To ensure there would be a safety net for investors, the SFC went before LegCo in June 2001 to ask for a market levy of 0.002% to be paid to the Compensation Fund. Under the SFO, compensation payment is increased to an upper limit of \$150,000 per client. Research shows that at this level, at least 80% of all claimants would be fully compensated in the event of a brokerage failure.

2.16 The funds managed by the Investor Compensation Corporation (which succeeded the Compensation Fund) have reached \$1 billion. However, as some investors have exposure exceeding \$150,000, not all would receive full compensation. Moreover, there would be a net loss in the market whenever a brokerage fails.

2.17 The purpose of the FRR regulatory framework is to prevent brokerage failure by requiring brokers to maintain adequate capital buffer, rather than to clean up after a brokerage has failed, by which time loss to investors would have crystallized.

Risks to clients and the industry by imprudent SMF providers

2.18 Of the 242 SMF providers, 151 finance their lending business out of their own funds. Only 91 SMF providers re-pledge their client collateral to finance their operations. Of this group, a small number maintain very low excess liquid capital to buffer against risks. Their weak capital position, coupled with reliance on bank lines secured by client collateral, makes these firms particularly susceptible to market volatility and hence pose serious risks to their clients.

2.19 For an explanation of the practices of pooling and re-pledging, and how the FRR works to regulate broker capital and risks, see **Appendix 2**.

2.20 Apart from utilizing bank borrowings obtained through re-pledging their clients' collateral, many of these identified firms also finance the activities of their connected parties, such as buying the listed securities of group companies or diverting funds to treasury hubs within the group. As these connected parties and group companies are not subject to any regulation, such financing may undermine the financial strength of the securities firms. Whereas this practice in itself may not trigger a breach of FRR capital requirements, there clearly are conflicts of interests issues, especially when these SMF providers are not as independent or rigorous as they should be in assessing the credit of their group companies or connected parties.

2.21 While the SFC's existing powers and sanctions have proved adequate in the vast majority of cases in respect of most firms (that value their licensed status, carefully guard their market reputation and honour their clients' trust), the SFC does not have clear and effective legal powers in situations where a firm's lending and/or re-pledging activities pose serious risks to investors, to require firms to take immediate action, such as injecting additional capital or segregating non-borrowing margin clients' collateral. Instead, the SFC has to resort to a program of close supervision and intensive moral suasion, combined with the imposition of licensing conditions (which is a lengthy process) or the issue of restriction notices (which could have adverse consequences for firms rather than the intended remedial effect).

What Happens When A Brokerage Fails

2.22 When a brokerage fails, especially one with a large client base, losses to investors could be very substantial. Where a large number of investors is involved, the failure could have a systemic impact on the market through a contagion effect; as clients of other firms demand the return of collateral and scrip on a scale beyond the firms' capacity to deliver. In the resulting collapse of additional SMF providers, even more investors would sustain losses and the price of some stocks that are subject to selling pressure could drop dramatically, thereby causing loss to even more investors. SMF providers that have a large client base are effectively comparable to banks because they utilize the assets of their clients and borrow against such assets; the ramifications of their failure are also comparable to those of the failure of banks.

2.23 What happened in the C.A. Pacific case is perhaps a good illustration of the serious consequences of a broker failure. Provisional liquidators were appointed in January 1998 after the firm collapsed. Due to the scale and

complexity of the task, five years later, the liquidators have yet to complete the distribution of securities or cash (including dividends and the proceeds of corporate actions) to the firm's clients and creditors. The total losses sustained by its clients have yet to be confirmed. The costs of the liquidation (fees of the liquidators and their professional advisers) are currently estimated at HK\$118 million. As explained earlier in this report, C.A. Pacific Finance Limited had borrowed \$548 million against client collateral of over \$2.5 billion. As at 31 March 2003, payments made out of the Unified Exchanges Compensation Fund (which have a maximum of \$150,000 per claimant) in relation to C.A. Pacific amounted to \$300.4 million in relation to the total admitted amount of accepted claims of \$983 million.

2.24 Apart from financial difficulties, another cause of broker default is fraud on the part of owners, management or staff of brokerages. In fact, of the broker failures reported in the years 1996 through 2002, the majority of them were fraud related. In the 15 months to March 2003, there were 9 reported cases of misappropriation of client assets, with a total reported loss of \$186.6 million. Three cases involved fraud on the part of the proprietor.

2.25 In the period 1996 to 2002, there were a total of 11 defaulting brokers and 7,199 investor claims for compensation as a result (see Table 3). As at 30 September 2003, payments made out of the compensation fund to these claimants amounted to HK\$541.9 million.

Table 3
Unified Exchange Compensation Fund Claims History since 1996

Name of brokerage	Year	No. of allowed claims	Total payments up to 30 Sept 03 \$ million
1. Wei Xin Securities Ltd*	1996	8	8.0
2. Cheong Woon Securities Co.*	1996	32	8.0
3. C.K. Securities Co.*	1996	53	8.0
4. Foreground Sec. Co. Ltd	1998	59	9.8
5. C.A. Pacific Securities Ltd	1998	3,922	300.4
6. Forlux Securities Co. Ltd	1998	430	31.1
7. Chark Fung Securities Co. Ltd	1998	2,089	129.1
8. Win Successful Securities Ltd	2000	285	26.0
9. Ying Kit Stock Co.	2002	157	15.0
10. Teil Stock Investment Co.	2002	11	0.001
11. Lawsons Securities Co.	2002	153	6.5
Total		7,199	541.9

* These cases were subject to \$8 million per-defaulting broker limit. The per-defaulting broker limit was not applied to subsequent cases and payments were instead capped at \$150,000 per claimant.

2.26 When one broker fails, the reputation of the brokerage industry as a whole suffers. Brokers themselves have commented that when one brokerage fails, clients of other brokerages move their business to bigger firms or banks.

2.27 While the increase in compensation fund payments to \$150,000 may result in at least 80% by number of all claimants being fully compensated for the losses incurred, the compensation fund remains a last resort in terms of investor compensation and should in no way replace a broker's obligation and commitment to act honestly and prudently so as not to put its clients at risk.

2.28 The introduction of an investor compensation scheme has also resulted in an element of moral hazard. Unfortunately, in some of the recent broker failures resulting from fraud and misappropriation, it appeared that some brokers felt that they could take risks with client assets just because the compensation fund was there to provide a safety net.

CHAPTER 3 Financial Risk – Pooling and Re-Pledging – Views And Recommendations of The Working Group

I. Pooling and Re-pledging not Inherently Risky

3.1 The Working Group is unanimously of the view that pooling and re-pledging client collateral are not inherently unsafe practices; provided they are undertaken prudently and subject to adequate risk management and internal controls. Pooling risk only becomes an issue when carried on imprudently (as described in **Appendix 2**). The Working Group notes that banks effectively pool depositors' assets, yet, neither the banking regulators nor the banking community have any real concerns about this practice. The Working Group believes this is because banks are generally very well capitalized, and they - in common with many of the larger licensed brokerages - typically invest heavily in sophisticated risk management systems and apply rigorous internal controls.

Pooling and re-pledging contribute to liquidity

3.2 The Working Group believes that the pooling and re-pledging of client collateral contributes to the liquidity of the cash market and facilitates investors in trading in securities at times when they lack the funding to finance their purchases in full. Therefore, the Working Group considers that it is not appropriate to impose a total ban on the pooling and re-pledging of client collateral, but that appropriate measures should be explored to counter indiscriminate re-pledging of client collateral.

Re-pledging non-borrowing margin clients' collateral not allowed in other markets

- 3.3 The Working Group began by considering the restrictions imposed in other jurisdictions on the re-pledging of client collateral. Members noted that other developed jurisdictions, in establishing a threshold for permissible re-pledging of client collateral, drew a distinction between margin clients who have borrowed and those who have not. **None of these jurisdictions permits the re-pledging of collateral of margin clients who have no current borrowing from their SMF provider.** In those jurisdictions, the collateral of clients who have no borrowings from the firm is required to be segregated and kept in safe custody (similar to the treatment accorded to the securities of cash clients in Hong Kong). The Working Group accepts that this represents international best practice.
- 3.4 The main advantage of this approach is that the amount of client collateral available to be re-pledged to banks is significantly reduced and the amount of client collateral preserved intact for return to clients is increased to the same extent. Firms would also be deprived of their capacity to maximize their borrowings against the typically more marginable collateral of non-borrowing margin clients, and from using such collateral to indirectly fund imprudent lending against collateral of low marginable value provided by more speculative margin clients. In addition, non-borrowing margin clients would be afforded a degree of protection almost equivalent to that afforded to clients holding cash accounts.
- 3.5 A few members of the Working Group voiced their support for this option. However, most members agreed that such segregation could not be implemented at the present time, as compliance would be quite costly for most firms. To comply with such a measure, firms would have to (i)

acquire and maintain sophisticated IT systems to identify collateral of borrowing and non-borrowing margin clients that was being re-pledged; and (ii) constantly incur fees for moving securities in and out of accounts held with the financial institutions to which the collateral is re-pledged.

3.6 While the Working Group generally feels that such segregation is not a realistic option at present, at least if it were implemented on a real-time basis, one member of the Working Group feels strongly enough to suggest that a commitment should be made to ban the re-pledging of non-borrowing margin clients' collateral in the future. In this, Hong Kong lags behind other major financial centres. Investor protection and Hong Kong's reputation should not be put at risk just because it would come as a cost to the industry. One other member suggested that it might be feasible to implement such a ban if it were reckoned on an historical basis rather than a real-time basis.

3.7 At present, although many SMF providers finance their lending business with their own funds and consequently do not re-pledge client collateral, those that do re-pledge are only subject to a 65% gearing ratio adjustment, discussed in **Appendix 2**. This measure has in fact reduced the level of gearing in the industry. This ratio requires a broker to finance from its own funds its margin lending. However, a broker may still re-pledge all available client collateral and use the borrowings for different purposes. If this broker were to fail, its margin clients might well find that all their collateral were re-pledged with banks and not available for distribution back to the clients.

3.8 As an example, an SMF provider with aggregate margin loans of \$100 million and total client collateral worth \$500 million is at liberty to re-pledge the entire \$500 million of client collateral. The effect of the current gearing ratio adjustment is that the firm would have to fund \$35

million of its margin loans out of its own resources. Yet the broker could re-pledge all \$500 million of client collateral and obtain bank borrowings in excess of aggregate margin loans and apply these borrowings for different purposes. A number of Working Group members believe that if limits were imposed on the amount of client collateral that could be re-pledged to banks by SMF providers, this could provide a greater measure of protection to their clients than that which is presently available.

3.9 The Working Group has examined three main options to minimize pooling risk and wishes to make clear that none of these options constitutes a complete solution to either pooling risk or financial risk; yet each option has its own merits and weaknesses, as discussed below.

Methods to Minimize Pooling Risk

(i) Option 1 – A per-client re-pledging limit

3.10 The Working Group looked elsewhere for examples of how re-pledging limits could be fashioned, and noted that the U.S. imposes a stringent 140% re-pledging limit on its brokers on a per-client basis⁴. This has an effect similar to the segregation of non-borrowing margin clients' collateral, plus the additional safeguard that a cap is imposed on the value of client collateral that can be re-pledged in respect of each client. This measure would effectively limit the amount of collateral that each client could stand to lose in the event that the firm became insolvent. It would also prevent the occurrence of a situation whereby one client stands to lose more relative to his borrowings than another.

⁴ In the U.S., the rules also prohibit a securities firm from lending to a margin client a sum in excess of 50% of the value of the securities that the client intends to acquire. Additionally, the client has to maintain a fixed level of deposit as a percentage of the value of the securities purchased.

3.11 However, the practical and operational difficulties associated with complying with a per-client re-pledging limit would be essentially the same as those in the case of a ban on the re-pledging of non-borrowing margin clients' collateral. Accordingly, the Working Group did not see the introduction of a per-client re-pledging limit as being a realistic option given the present market infrastructure.

(ii) Option 2 - A per-firm re-pledging limit

3.12 The Working Group went on to consider whether a re-pledging limit could be applied on an aggregate per-firm basis (that is, by setting a cap on the value of client collateral that can be re-pledged at a percentage of aggregate margin loans), as this would reduce the practical difficulties while still affording a reasonable measure of protection to margin clients. The Working Group considered that a per-firm limit of between 130% and 150% would be fair to firms while still providing protection to the firms' clients. However, at least one member of the Working Group felt very strongly that a limit of 100% should be adopted as this would accord a greater degree of protection for the firms' clients.

3.13 The following illustration will demonstrate how this measure would work. An SMF provider lends an aggregate of \$100 million to all its margin clients and takes \$500 million of client collateral. Under the proposed per-firm limit of, say 130%, the firm would be allowed to re-pledge client collateral worth not more than \$130 million. In this way, the remaining \$370 million of client collateral could be kept intact in the event of the SMF provider's insolvency.

Limitations of the per-firm re-pledging limit proposal

3.14 The Working Group wishes to stress that under the per-firm re-pledging limit, firms would **still** be able to re-pledge client collateral of any margin client, borrowing or non-borrowing. It would be expected that SMF providers would continue to re-pledge the client collateral of higher marginable value, so as to maximize their borrowings. Therefore, this measure would not restrict, but might in fact encourage, the re-pledging of non-borrowing margin clients' collateral.

3.15 However, most members of the Working Group believe that despite this concern, the restriction would yield some overall positive effect in that SMF providers that accept client collateral of predominantly low marginable value would have to either cease to engage in imprudent lending or finance a larger portion of their total margin loans out of their own resources. Moreover, this would also ensure that at least a portion of client collateral would be held by the SMF provider and thus be available for distribution to clients in the event of the firm going into liquidation.

Impact Analysis

3.16 According to calculations based on data extracted from the September 2003 financial resources returns⁵, a small number of SMF providers that re-pledge client collateral would be impacted such that they would need to provide other forms of security, or pay down their bank loans (which may involve injection of additional shareholders funds), in order to comply with a re-pledging limit of between 130% to 150%. Given the market upturn in the last 6 months, these firms should have the financial means necessary to do so. The SFC will work closely with these firms during the transitional period.

⁵ This analysis was conducted on the assumption that the loan and collateral portfolio of all 91 SMF providers remained the same after end September 2003.

- 3.17 Some Working Group members expressed concern that imposing a re-pledging limit could restrict SMF providers in lending against less liquid collateral or stocks of lower marginable value, and that the liquidity of these stocks could be affected. Working Group members generally agreed, however, that firms that wished to lend against such collateral should do so out of their own resources, having regard to the fact that lending against such stocks was a riskier affair both for the margin client and the firm. Firms should bear this risk; not pass it on to their clients.
- 3.18 Of course, the impact on affected SMF providers could be lessened if the re-pledging limit were set at a higher percentage; as that would allow firms to re-pledge more collateral and thus increase their borrowings against it. However, members recognized that the higher the percentage at which the limit is set, the lower the corresponding degree of protection afforded to the firms' margin clients. Some members also reminded the Working Group that in the U.S., the 140% limit is applied on a stringent per-client basis and that it is combined with other restrictions as well. As such, it would be difficult to defend a per-firm limit (which allows a firm to re-pledge collateral belonging to non-borrowing margin clients and is less stringent than a limit set on a per-client basis) that is equal to or even higher than 140%. Still, members are keenly aware that even a per-firm re-pledging limit could impose a gearing ratio tighter than the current 65% on SMF providers that lend against stocks of lower marginable value.

A flexible mechanism

3.19 Working Group members also recognized that the imposition of a per-firm re-pledging limit would pose practical problems for affected SMF providers, as the fluctuation in value of (i) the client collateral re-pledged by a firm; and (ii) the aggregate of margin loans granted by the firm, would affect the maximum value of client collateral that could be re-pledged and thus impact a firm's compliance with the limit. Under a 130% limit, an SMF provider with aggregate margin loans of \$100 million would be able to re-pledge up to \$130 million of client collateral. Any firm that re-pledged collateral close in value to that limit would risk breaching the limit if the value of re-pledged collateral rose above \$130 million or its aggregate margin loans fell below \$100 million. In either event, the firm would have to adjust the amount of collateral re-pledged to the bank and in the process would have to pay stock transfer fees to banks.

3.20 However, some flexibility could be introduced by giving firms a grace period within which stock transfers would not be required to be made (for example, exceeding the re-pledging limit for, say, up to 3 consecutive business days would not be regarded as a breach of the re-pledging limit). Another method might be to devise a mechanism whereby firms whose re-pledged collateral exceeds 130% by virtue only of a move in the market could be regarded as complying with the re-pledging limit provided an adjustment was made within a certain period of time.

(iii) Option 3 - Permitted bank borrowing ("PBB")

3.21 While all members of the Working Group agreed that the 130% to 150% per firm re-pledging limit was acceptable, some members felt that the concept of PBB should be explored. This is explained in further detail in **Appendix 3**. PBB is conceptually sound and is a refinement of the

existing 65% gearing ratio adjustment as (i) it operates on a client-by-client basis; and (ii) takes into account the different quality of collateral received. Some SMF providers may in fact be adopting PPB as part of their internal credit control procedures now. PBB also offers greater operational flexibility as it can save substantial stock transfer fees that are likely to be incurred if the re-pledging limit is to be imposed.

3.22 However, just like the gearing ratio adjustment, PBB merely requires firms to put up additional capital. It does not put any physical restrictions on the re-pledging of client collateral. In the case of liquidation, the amount of capital that an SMF provider maintains will be made available to not only the margin clients, but to the general creditors. The re-pledging limit, on the other hand, effectively ensures that a portion of client collateral remains with the firm and is available only to margin clients. In addition, there are practical concerns noted by members of the Working Group in that:

- (a) the PBB concept might be difficult to implement as it would impose a heavy compliance burden in terms of the constant monitoring of changes in the account balance and collateral position of each of the SMF provider's margin clients; and
- (b) there was no standard source for bank marginable values of stocks that all SMF providers could apply in their calculations.

While the Working Group was not inclined to adopt this measure, it would like the PBB concept to be discussed in the public consultation as well so that the wider views of the market could be gauged.

3.23 In the Working Group's view, neither the re-pledging limit nor the PBB provides the optimal solution for pooling risk. However, recognizing that there is a trade-off between the degree of protection afforded to investors, on the one hand, and the compliance burdens imposed on firms on the other, it takes the view that a balance can and should be found which will

afford greater protection for the interests of margin clients whilst imposing reasonable and workable limitations on the industry. The per-firm re-pledging limit favoured by the Working Group is intended to benefit the entire industry while imposing operational limitations only upon a specific group whose practices pose risks to the industry. In the process, Hong Kong's regulatory requirements in this area will be brought closer to international best practice.

Transitional Period

3.24 The Working Group recommends that existing firms that would be impacted by the measure(s), if adopted, should be granted a transitional period within which to achieve full compliance with the new requirements. The Working Group suggests a single stage transition of 12 months.

Public Consultation

3.25 The Working Group recommends seeking the public's views on the merits of -

- (a) a per-firm re-pledging limit, the percentage at which this limit should be set and the appropriate transition period;
- (b) whether the PBB concept could be adopted as a viable alternative.

SFC's views

3.26 The practice of SMF providers of re-pledging client collateral (irrespective of whether the client has any outstanding borrowings from the firm) to finance their working capital has historically been permitted in Hong Kong. However, in today's market Hong Kong simply cannot afford to blindly continue this practice if it is demonstrably inequitable, if

it could cause serious loss to investors, and if it is a practice shunned by other major jurisdictions.

3.27 Although compliance will come at a cost, Hong Kong should nevertheless strive towards the ultimate goal of complete segregation of non-borrowing margin clients' collateral, the international norm.

3.28 The segregation of non-borrowing margin clients' collateral is international practice, and is fair and reasonable for all parties. There is no reason why a broker should be entitled to use a client's securities collateral to obtain financing when that client has not borrowed from the broker. The SFC will explore with the market and the HKEx a solution whereby the present infrastructure could be improved to facilitate such segregation.

3.29 In the SFC's view, the optimum means by which to control pooling risk is to increase regulatory capital requirements and tier them in proportion to the risks arising from the business conducted by each firm and for SMF providers that re-pledge client collateral to invest in the necessary systems that will segregate non-borrowing margin clients' collateral.

3.30 Although the Working Group generally recommended a *per-firm* re-pledging limit of 130% to 150%, the SFC would like to point out that a per-firm re-pledging limit does not give margin clients the same degree of protection as would a *per-client* re-pledging limit. Therefore, it is important that, if a per-firm re-pledging limit is adopted, the limit is set at a percentage that will afford sufficient protection for the firms' clients.

3.31 The SFC acknowledges the concern expressed by some Working Group members that setting a re-pledging limit would have an impact on an SMF provider's ability to re-pledge and borrow, and thus incur a regulatory

cost. In particular, it is conceivable that some firms, depending on the quality of client collateral and the banks' lending ratios, may find themselves having to finance a higher percentage of their loan book out of their own resources, and end up with a gearing ratio of 65% or less. Reconciliation of what are often the competing interests of investors and market operators is often difficult. Protection of investors and market confidence must imply a regulatory cost. Yet, in the long term, greater investor protection and market confidence work in favour of the greater interest of market operators. The SFC, however, is prepared to explore with the industry in the public consultation, how individual firms might be affected, and how the re-pledging limit mechanism be fine tuned to assist these firms.

II. Applying Higher Haircut Percentages To Client Collateral

3.32 In the Working Group's view, the imposition of a re-pledging limit alone would be insufficient to effectively combat the imprudent practices resorted to by a minority of SMF providers. The Working Group believed that, in the final analysis, the key to stabilizing the financial volatility of an SMF provider is that it has to have adequate capital, and in this respect the quality and liquidity of assets is crucial.

3.33 Under the FRR, margin client receivables are capped at the amount of the aggregate value of collateral, as reduced by a haircut percentage before they are recognized as part an SMF provider's liquid assets. The haircut percentages are effectively a risk management tool designed to adjust the quality of an SMF provider's assets that are accepted as regulatory capital under the FRR.

3.34 The FRR prescribe a set of haircut percentages for different securities. These percentages, however, are on average, significantly lower than

those assigned by banks⁶. With certain categories of stocks, the difference is as much as 47 and 66 percentage points, as shown in Table 4 below.

Table 4
Disparity between FRR haircut percentages and bank/brokers average rates

Stocks	Existing FRR haircut	3 Banks' average haircut*	Brokers' average haircut**
HSI / HSHK Large Cap Index	15%	43%	41%
HSHK MidCap Index	20%	57%	57%
Other HSCI constituents	30%	77%	80%
All other Main Board / GEM	30%	96%	96%
Listed Warrants	40%	100%	100%
"illiquid collateral"	80%	no such category	no such category

* The 3 banks selected together constitute approximately 54% of bank lending on margin financing as of September 2003.

** Taken over a sample of 12 firms comprising 2 Category A brokers, 6 Category B brokers and 4 Category C brokers. The sampled firms represent 28% of the total amount of margin loans outstanding and 20% of the total number of margin clients in the market as of September 2003.

3.35 Noting that the current FRR haircut rates (except that for "illiquid collateral") were set in 1999, the Working Group believes that they may not be adequate for risk management purposes in today's market. Not only are the FRR haircut rates significantly lower than those of banks and our sample brokers, but out of the 1,300 stocks and warrants listed on the main board and GEM, the latter assigns to a large number of them a zero marginable value. Although, the Working Group agrees that the haircut rates under the FRR need not be as conservative as those applied by banks; it considers they should be adjusted to align more closely with commercial rates in order to enhance the credibility to the computation of liquid assets. This in turn would provide more assurance not only to

⁶ For purposes of drawing up this comparison (Table 5), the average lending ratios of three banks in Hong

regulators but especially to investors, that a firm in compliance with the FRR is in a reasonably sound financial condition.

Proposed new haircut percentages

3.36 The Working Group believes that assigning haircut percentages by reference to different indices, as under the FRR, is generally fair and has the benefit of being simple and easy to understand. It would be impracticable to assign percentages to each individual stock. However, it considers that a couple of minor variations could be introduced with a view to refining the assignment of haircuts, provided these do not unnecessarily complicate matters.

3.37 Thus, the HSHK MidCap tier could be extended to include constituent stocks of the MSCI Hong Kong Index and the MSCI China Index (both compiled by Morgan Stanley Capital International Inc.). The Working Group believes these two indices are widely used and accepted in the market. Adding them would bring an additional 30 stocks within the HSHK MidCap tier. Therefore the Working Group proposes to amend the haircuts as shown in Table 5, below.

Kong have been used.

Table 5
Current and Proposed FRR haircut rates, and bank/brokers average rates

Stocks and warrants	Existing FRR haircut	Proposed new FRR haircut	Banks' average haircut*	Brokers' average haircut**
HSI / HSHK LargeCap Index	15%	20%	43%	41%
HSHK MidCap	20%	40%	57%	57%
MSCI HK / MSCI China Index	N/A	40%	64%	64%
Other HSCI constituents	30%	60%	77%	80%
All other stocks	30%	80%	96%	96%
Warrants	40%	100%	100%	100%

* The 3 banks selected together constitute approximately 54% of bank lending on margin financing as of September 2003.

** Taken over a sample of 12 firms comprising 2 Category A brokers, 6 Category B brokers and 4 Category C brokers. The sampled firms represent 28% of the total amount of margin loans outstanding and 20% of the total number of margin clients in the market as of September 2003.

3.38 It will be noted that prudent SMF providers already lend at rates quite similar to the average bank marginable rates. The Working Group takes the view that the amended FRR haircuts would serve to ensure that all SMF providers adopt a realistic risk management measurement in relation to their lending. When an SMF provider lends against client collateral at a rate that is lower (better) than the relevant FRR haircut rate, the firm should obtain additional collateral or collateral of higher marginable value from margin clients, failing which the firm would need to use more of its own capital to finance its margin loans.

3.39 The following is a simple illustration of how the new haircut rates would work in comparison with the current rates. An SMF provider lends \$90 to its margin client against some HSHK MidCap securities with a market value of \$100. Under the FRR, these securities currently attract a haircut of 20% and are thus counted as \$80 worth of liquid assets. The

consequence for the SMF provider would be that it would need to finance the remaining \$10 (i.e., \$90 loan less \$80 that can be included in liquid assets) out of its own capital. If the applicable haircut rate for the securities were to be increased, as proposed, to 40% (thus valuing the securities at \$60 for FRR purposes) the firm would need to fund a total of \$30 (instead of \$10) out of its own capital.

- 3.40 In the course of deliberations, one member of the Working Group suggested that the haircut for GEM stocks should be 60% instead of 80%, so as to lessen the impact on SMF providers that hold large volumes of GEM stocks. Another member suggested that the haircut for blue chip stocks should be higher than 20% as that would be too generous.

"Illiquid collateral"

- 3.41 Having regard to the fact, discussed in **Appendix 2**, that an 80% haircut for "illiquid collateral" is often insufficient for risk management purposes, the Working Group considered whether that haircut should be increased as banks on average would haircut such stocks at 90% or 100%. Some members, however, were concerned that this might be too drastic a step to take as it would limit the ability of some SMF providers in making business out of such stocks.

"Labelling" effect on stocks

- 3.42 The Working Group also considered whether a system of haircuts tiered by reference to different indices might create a negative "labelling" effect, whereby stocks subject to the steepest haircuts are considered to be unsuitable for investment. It was speculated that, in an extreme case scenario, investors might rush to sell such stocks in a bout of panic.

3.43 The Working Group believes that, for the reasons below, the labelling effect should not occur, and the type of reaction that followed the release by the HKEx in July 2002 of the consultation document proposing the de-listing of stocks that met certain criteria should not occur in this instance:

- (a) applying a FRR haircut to a stock is not a judgement on whether the stock in question would be a good investment choice but a risk management measure based principally on the liquidity and volatility of the stock. Of course, the effect of the new haircut percentages would be that some stocks have a lower, perhaps even a zero, marginable value, however, this merely reflects the reality that different stocks have different collateral value assigned by banks;
- (b) the haircut proposal should be carefully presented to the public. This proposal does not prohibit investors from buying or selling stocks with higher haircut percentages, or borrowing on margin to buy these stocks. The purpose of this proposal is to require SMF providers to adopt better lending discipline;
- (c) similarly, it should be emphasized to the public that banks, and many SMF providers, are already imposing haircuts that are more stringent than those proposed for the FRR;
- (d) one member of the Working Group also made the point that data suggests that the recent increase in trading volume is mostly attributable to cash clients, therefore, the Hong Kong market is no longer as reliant on margin financing as it was in 1997/1998. According to this view, the impact on the market of adopting the proposed new haircut percentages would not be significant; and
- (e) stocks have for many years been tiered according to stock indices and this has not produced any discernible "labelling" effect.

3.44 The Working Group recognized that the effect of the proposed percentages might be that trading in stocks which are assigned higher

haircut percentages would be affected. However, banks and most SMF providers already assign steep or 100% haircut percentages to these stocks. Requiring SMF providers to adopt haircut percentages that are closer to those adopted by these lenders is a prudent way forward in the interest of the industry and the market.

Adjustment when a stock drops out of an Index

3.45 Because FRR haircut percentages impact the calculation of firm's liquid capital, the Working Group recommends that provision should be made to avoid the possibility of a firm suddenly breaching its liquid capital requirement as a result of a stock being moved out of an index and thus qualifying for a more severe haircut. This could be achieved by temporarily regarding the applicable haircut as unchanged, and applying the higher haircut rate only 3 months after the end of the calendar month in which the stock is moved out of the index.

Mechanism for Moving Up the Haircut Table

3.46 Whereas the Working Group unanimously agreed that haircut percentages should continue to be tiered according to the Index of which the securities are a constituent stock, and that the tiering criteria and system should be kept simple, some members believed that there should be a mechanism to lower the haircut percentage for selected stocks. These members considered that the haircut percentages should be specified according to not just the relevant index to which it belongs but other factors, such as the stock's liquidity and market capitalization⁷ although a few members preferred reference to market capitalization alone and others felt that additional criteria were of limited utility.

⁷ The Working Group was not unanimous in deciding on this additional factor. An alternative factor that was not agreed was NAV.

- 3.47 Under this approach, the haircut percentage of any given stock would be derived by reference to 2 tables; the first being according to relevant indices, as already mentioned, and the second being framed in terms of market capitalization and liquidity parameters in terms of volume of monthly turnover. In combination, high market capitalization and strong turnover are seen as being indicative of good liquidity and lower volatility and hence deserving of a more favourable haircut percentage.
- 3.48 Requiring a stock to meet both the specified market capitalization and turnover thresholds would have the merit of ensuring that the more liquid stocks would benefit from an arguably fairer assignment of their appropriate haircut rate. These thresholds would, like the "illiquid collateral" computation, be taken from the average over a period of 6 months preceding the month immediately prior to the month in which the calculation is made. This mechanism will shield firms from fluctuations in monthly turnover and market capitalization and make it simpler to determine which stocks are subject to which haircut rate.
- 3.49 The figures proposed for market capitalization and monthly turnover are as shown in the following Table 6.

Table 6 – Combined haircuts

Qualifying Criteria	No. of stocks included as at end of Sept 2003	FRR haircut	Banks' average haircut (*)	Brokers' average haircut (**)
HSI / HSHK LargeCap Mkt cap. >\$10 billion & turnover >\$300 million	34	20%	43%	41%
	16		56%	56%
HSHK MidCap MSCI HK / MSCI China Mkt cap. >\$5 billion & turnover >\$300 million	16	40%	57%	57%
	27		64%	64%
	9		74%	70%
Other HSCI	102	60%	77%	80%
All other stocks	831	80%	96%	96%
Warrants		100%	100%	100%

* The 3 banks selected together constitute approximately 54% of bank lending on margin financing as of September 2003.

** Taken over a sample of 12 firms comprising 2 Category A brokers, 6 Category B brokers and 4 Category C brokers. The sampled firms represent 28% of the total amount of margin loans outstanding and 20% of the total number of margin clients in the market as of September 2003.

3.50 The proposed figures of market capitalization and monthly turnover are based on -

- (a) in the case of the top tier, \$13 billion was the market capitalization of the smallest HSI stock as at 30 September 2003 and \$300 million turnover is almost the minimum turnover of HSI constituent stocks;
- (b) in the case of the second tier, \$6 billion was the average market capitalization of constituent stocks of HSHK MidCap, MSCI HK and MSCI China as at 30 September 2003, and \$471 million is the average turnover of such stocks.

3.51 Newly listed stocks with a high market capitalization need only fulfill the market capitalization requirement until such time as they have the track record of market turnover to compute the necessary historical average. In

addition, when stocks cease to meet the market capitalization and turnover thresholds that qualified them for a more favourable haircut, there could be a cushioning period similar to that for stocks that drop out of an index.

3.52 Under this proposal, although a relatively small number of stocks would meet the additional criteria it is expected that in future more stocks will be able to do so. While the market capitalization and turnover criteria may appear to favour larger stocks, they are solely concerned with a stock's liquidity and volatility. The criteria are not intended as benchmarks by which to determine the quality of a stock or the merits of buying or holding certain stocks and thus should not influence investors in their investment decisions.

3.53 Members of the Working Group, who did not support the two-tables approach, were mainly concerned that brokers would have to bear the administrative and cost burden of checking which stocks were able to qualify for lower haircuts, as their market capitalization and turnover varied constantly. However, it was generally accepted that calculating such figures as an average from historical data, as explained above, would relieve this burden to a considerable extent.

Impact Analysis

3.54 According to an impact analysis conducted by SFC staff (based on FRR figures as of end September 2003) a very small number of firms would be required to enhance the quality of their margin loans by taking additional collateral, or collateral of better quality, failing which they would have to inject additional capital to make up any margin shortfall. The Working Group was unanimous in its view that the new rates are acceptable and that they would not lead to a panic selling by investors, as they do not seek to bar the trading of any particular stocks.

3.55 On the basis of this impact analysis, the Working Group believes that the vast majority of SMF providers are in fact lending prudently by discounting collateral at rates above the current FRR haircut rates, and none of these firms would be affected. The Working Group feels strongly that the risk of credit and lending should be borne by SMF providers, not their clients. The new haircut rates will encourage SMF providers to be more prudent in what they lend against and to temper imprudent lending by encouraging firms to discount collateral at the same or higher rates as the proposed FRR haircut rates.

3.56 A combined analysis on the impact of both the proposed FRR haircut rates and the re-pledging limit was also conducted by SFC staff (using FRR figures as of end September 2003), the total number of firms that would be impacted was still very small. Given the market upturn in the last 6 months, these firms should have the financial means necessary to comply with the new measures. The SFC will work closely with them during the transitional period.

Transitional Period

3.57 In relation to the proposed haircuts, the Working Group recommends a 12-month transitional period for currently licensed firms to attain full compliance. The intention is that existing SMF providers should be provided with an opportunity to adjust their lending practices and, where necessary, their capital structure, to facilitate their compliance with the new haircuts.

Public Consultation of the proposed Haircut Percentages

3.58 The Working Group proposes seeking the public's views on the merits of -

- (a) assigning new haircut percentages for FRR purposes by reference to additional indices and to additional criteria;
- (b) whether a 12-month transitional period for all stocks is reasonable;
- (c) whether a transitional period of shorter than 12 months should be provided for warrants; and
- (d) whether the current 80% haircut for "illiquid collateral" should be increased.

SFC's views

3.59 The SFC fully supports the proposal to revise the haircut percentages currently prescribed under the FRR, and agrees that the revised rates should be more favourable and lenient than those adopted by banks. Brokers are generally more flexible than banks in their business operations and this is one of the areas in which brokers can compete to provide value to investors.

3.60 The 80% haircut rate for illiquid collateral has been in operation since October 2002. From what the SFC has observed, even when discounted at this rate, illiquid stocks generally do not provide any real value or security to SMF providers, especially in the event of a liquidity squeeze. As such, if an SMF provider still wishes to provide financing against such collateral, it would be reasonable that the provider be required to fund the financing through its own means, rather than through the re-pledging of client collateral. The SFC believes that the public should be consulted on whether the 80% illiquid stock haircut should be increased to 90% so as to better reflect the real value of, and counter the risks arising from lending against, such stocks.

3.61 Noting that there will be additional regulatory cost for the industry if the re-pledging limit is imposed and the haircut percentages are increased as

proposed, the SFC will consider relaxing some of the existing FRR provisions (such as the gearing ratio adjustment) that govern securities margin financing to reduce the compliance burden where appropriate.

3.62 Given improved market conditions, the ability of SMF providers and brokers to increase capital has been eased considerably. The industry should use this opportunity to reduce its risks to the investor and to strengthen their own risk management capacity accordingly. The measures recommended by the Working Group are a reasonable solution for the nearer term. Only those business practices that give rise to high risks will be required to take appropriate actions, such as cutting down their re-pledging, lending more prudently or putting in their own capital.

CHAPTER 4 Financial Risk – Working Group’s Recommendations on Strengthening Code of Conduct

4.1 Conscious that not all firms could achieve a complete segregation of non-borrowing margin clients’ collateral, thus necessitating the adoption of other measures, the Working Group went on to consider other best practice measures which could be added to non statutory codes to provide a more comprehensive package to bolster market confidence and investor protection. These include measures whereby:

- (a) the SFC would be alerted to the need to work with the SMF provider to manage down certain risks; and
- (b) other measures that would make clearer to margin clients the effects of pooling and re-pledging client collateral and remind them to examine whether they really need margin financing or whether they should switch to cash accounts under which their securities are segregated and held in separate trust accounts.

Code of Conduct

4.2 The Working Group is generally in favour of introducing Code of Conduct requirements that an SMF provider notify the SFC if:

- (a) it granted margin loans against illiquid collateral to its top 20 margin clients in an aggregate sum exceeding 50% of the sum of its shareholders' funds and approved subordinated loans (if any); or
- (b) its undrawn credit facilities fell below 20% (although one member suggested a lower threshold of 10%) of total available bank lines (calculated at the lower of total bank facilities and the bank’s marginable value of securities that have been or may be re-pledged to secure such bank facilities),

for a continuous period exceeding 2 weeks.

4.3 The Working Group believes that these thresholds should be taken to be best market practice in both cases. The Working Group believes that when a firm crosses either of these thresholds, it should promptly examine its financial situation and take steps to ensure that it remains financially sound. Any persistent non-compliance with these best market practices carrying greater financial risk to the firm will call into question the fitness and properness of the SMF provider, and might give rise to disciplinary action by the SFC.

Investor education

4.4 Working Group members feel strongly that no regulatory framework can be effective unless investors also play their part in understanding their rights and their duties, and in robustly enforcing those rights and performing those duties. While the Working Group accepts that imprudent lending and excessive re-pledging practices unfairly pose unacceptable risks to non-borrowing margin clients, members also point out that these clients chose to authorize their SMF provider to re-pledge their collateral. Hence Working Group believes that more investor education should be done so that Hong Kong's retail investors are fully cognizant of the risks they assume if they authorize their SMF provider to re-pledge their collateral. To this end, the brokerage industry should share the work with the regulator. Therefore, Working Group members agree that SMF providers should take the following steps to enhance the awareness of their clients concerning these matters:

- (a) including in the monthly statements of account a statement, if it were the case, that:
 - (i) the client had authorized the firm to re-pledge his or her collateral to obtain its banking facilities;

- (ii) the firm had, during the period covered by the statement, re-pledged client collateral (note: this does not mean collateral of the client in question, but client collateral in general) to obtain its banking facilities; and
- (b) when it notifies a client that his or her authorization to the firm to re-pledge collateral is due to expire and that such authorization will be automatically renewed for 12 months unless the client objects, to include a reminder:
 - (i) to read the enclosed risk disclosure statement; and
 - (ii) that, if the client does not need securities margin financing, he or she may always switch to a cash account instead of the margin account.

4.5 The Working Group also urges the SFC to expand its investor education efforts, and reminds the SFC that to contain pooling risk, tripartite efforts are necessary by –

- (a) the regulator to regulate and enforce;
- (b) intermediaries to observe best practice and integrity; and
- (c) investors to understand the risks and protect their interests.

Unless investors invest with caution and with full understanding of the risks they assume, the burden on the regulator and the industry could be so excessive that it could hamper development and innovation in Hong Kong's securities market.

SFC's views

4.6 The SFC fully supports these recommendations. A healthy and vibrant securities market does not come without dedicated efforts on the part of the regulator, intermediaries and investors. To this end, the SFC pledges to work together with all parties to raise standards.

CHAPTER 5 Integrity Risk – Some Possible Measures Recommended by Working Group

- 5.1 The history of broker failures in Hong Kong points predominantly to theft and dishonesty on the part of some owners and some of those in management. The Working Group notes that while there have been a number of employee thefts, employers have typically covered client losses, drawing on compensation from broker fidelity insurance and their own reserves. In these cases, the employers themselves have been the victims of the fraud. Clients were mostly spared.
- 5.2 The Working Group has explored measures that could be used to minimize integrity risk. A good number of members believe that one effective measure would be to require brokers to substantially increase their capital. The rationale here is that a person in business should use his own money (rather than his clients') to buffer against the many risks arising from the conduct of that business. Those with substantial capital would, more likely than not, have both the interest and the means to maintain sophisticated and robust management and internal controls which would minimize the incidence of fraud on the part of employees and even those in control or management.
- 5.3 Other members, however, believe that capital alone is an insufficient safeguard against deliberate fraud, especially where the fraud is perpetuated by the owner/management itself. As cases in point, these members note that while Peregrine and Barings were very substantially capitalized, they nevertheless failed in a spectacular manner.
- 5.4 It is worth noting that despite the failures of Peregrine and Barings, all affected clients in those incidents got their shares back because their

securities were properly segregated, and there were therefore no claims made on the Compensation Fund.

Tiering Capital Requirements to Risks

5.5 While Working Group members cannot reach consensus as to whether increasing regulatory capital would be an effective measure against integrity risk, they generally agree that, given the very substantial capital requirements of full-fledged brokerage firms in the region, and given the world trend to use capital adequacy as a buffer against risks, Hong Kong should encourage its brokerage industry to move towards tiering the size of capital to the risks each firm undertakes. In this connection, the Working Group agrees that capital should be lower for brokers that do not hold client assets (no integrity risk) and higher for those that do.

A Viable Solution – Investor Participant Accounts

5.6 The Working Group understands that the HKEx has been considering the viability of a user-friendly investor participant ("IP") account model. The principal benefit of IP accounts would be that clients using IP accounts would generally have their securities held directly in their own IP accounts with the Hong Kong Clearing, and not by their brokers. As IP account holders, these clients would enjoy a level of protection from brokers' integrity risk that would not be achievable by other means. Provided the IP accounts are efficient, safe and cost effective, brokers could move their clients to this model and thus effectively remove or reduce to a minimum any integrity risk. As such, these brokers would not be holding client assets and their capital could therefore be lower.

5.7 As the IP accounts model is not yet available, the Working Group feels that it may not be appropriate at this time to require brokers to

substantially increase their capital for holding client assets. The Working Group therefore has made no recommendation in this regard. Recognizing, however, that integrity goes to the very heart of confidence in the industry, the Working Group urges the HKEx to continue to work on an appropriate IP accounts model. The Working Group also supports rigorous enforcement actions and tough disciplinary sanctions against those that betray their clients' trust.

SFC's views

5.8 The SFC agrees that capital adequacy and internal controls are the main tools to guard against integrity risk. In measuring capital adequacy, it is essential to tie it to the magnitude of risk against which capital is required as a buffer. While the SFC believes there is a compelling case for increasing the capital of brokers, it equally recognizes that there should be sufficient flexibility in the capital framework to permit niche players to operate on small capital outlays, provided that the risk of loss of client assets is eliminated or reduced to an acceptable minimum. As such, the SFC fully supports the initiative for the creation of a user friendly IP accounts model which the small brokers could adopt as a business model. The HKEx has been examining different models. However, there is a certain degree of skepticism among some market participants as to the actual utility of this model, and whether it might displace brokers or render some of their functions obsolete. The SFC believes that there is a compelling case for the creation of an IP accounts model for use by investors, and that the availability of such a system is very much an integral and crucial part of Hong Kong's market infrastructure. As such, top priority should be given to this project.

CHAPTER 6 Insolvency Risk – the SFC's Proposed Approach

- 6.1 Whilst the Working Group's proposals would help to reduce the risks of brokerage insolvency, the possibility remains that even brokerages that comply with the new requirements might still give rise to insolvency risk.
- 6.2 To better protect investors from possible losses due to brokerage insolvency, other ways to prevent insolvency risk crystallizing should also be explored. For instance, if positive steps to intervene could be taken earlier in the process before a brokerage is put into liquidation, losses sustained by firms' clients could be avoided or at least minimized, the brokerage industry could be spared contagion damage and Hong Kong's reputation as a competitive international financial centre could be safeguarded.

Limitations of SFC's existing powers

- 6.3 The SFC is equipped by the SFO with various powers which could be deployed with a view to reducing the risk level of brokerages. These powers include (i) imposing licensing conditions, (ii) issuing restriction notices, (iii) seeking the appointment by the court of an administrator and (iv) seeking the appointment by the court of a liquidator. However, none of these powers are totally effective in containing insolvency risk.
- 6.4 Imposing licensing conditions may not be suitable when a firm's owners or senior management, who have allowed the financial instability to arise, cannot be relied upon to correct the situation. Hence, this power may have certain limitations in its ability to impose positive and effective financial obligations on firms in this sort of situation.

6.5 Whilst restriction notices can be issued within a short period of time, their unsuitability in containing insolvency risk lies in the fact that exercise of the power must be publicized by notice in the Gazette. Typically the clients of a firm to which a restriction notice has been issued, will make every attempt to recover their assets from the firm. Any firm in a financially tenuous condition, particularly an SMF provider which must find the money needed to redeem collateral re-pledged to banks, would likely be driven to default on their obligations.

6.6 Under section 213 of the SFO, the SFC is empowered to apply to the court for the appointment of an independent person to administer the property of a firm where the firm has contravened, is contravening or may contravene –

- (a) any of the provisions of the SFO or its subsidiary legislation;
- (b) any notice or requirement (e.g. a restriction notice);
- (c) any term or condition of its license; or
- (d) any other condition imposed under the SFO.

The SFC believes that this power would require some clarification for it to be useful as a pre-emptive measure.

6.7 The SFC's power to seek the appointment of liquidators in relation to a firm which has become insolvent is to be exercised when there are no viable options for the firm to continue as a going concern.

Views of the Working Group

6.8 Although the Working Group has not examined these matters in detail, it has discussed the principles of appointing a manager and made the following observations. A number of members took a positive view that the availability of a mechanism under which a suitably qualified person

("manager") could be rapidly interposed to take over and manage the business of a brokerage that was on the verge of defaulting on its obligations could potentially avert insolvency in some cases.

- 6.9 Some members considered that it would be feasible to clarify or build upon the SFC's existing power under section 213 of the SFO to appoint a person (whether described as a manager or an administrator) to manage the firm's affairs (Please refer to paragraph 6.6 for details of the section 213 power).
- 6.10 One member took the view that the SFC should be given a power that is similar to that of the Hong Kong Monetary Authority under the Banking Ordinance to directly appoint a manager to take over the business of a troubled bank with a view to safeguarding the interests of depositors and the integrity of the banking sector.
- 6.11 Yet another member suggested the compilation of a list of potential "White Knights", who could be given the opportunity to take over a distressed firm.
- 6.12 Other members raised specific issues that may require further clarification. A member took the view that the concept might be more attractive in theory than in practice because of the complex practical issues that needed to be resolved, for example the thresholds for exercise of the power, the basis for ascertaining that a firm was capable of being saved from insolvency, the criteria for establishing the suitability of a person to be appointed as a manager and, crucially, the source of funding for the manager. Without a source of funding for the manager, suitably qualified persons might not be found for the task and clients would end up having

to foot the bill. He also warned that the availability of such a power might give rise to moral hazard.

- 6.13 Members also discussed whether the purpose of interposing a manager was to safeguard the interests of the firm's clients and creditors or to keep the firm running as a going concern. However, the members agreed that the interests of a firm's unsecured creditors, including its margin clients, would definitely be best protected by saving the firm from insolvency.

Views of the SFC

- 6.14 The SFC appreciates the Working Group's input and recognizes that, at this very preliminary stage, these and other issues would require careful consideration before a proposal could be fleshed out and made available for public consultation.

- 6.15 One possible advantage of appointing a manager is to explore the feasibility of stemming losses in a problem company and preserving assets on a "going concern" basis so that losses are controlled. The costs of appointing liquidators can be high; the C.A. Pacific liquidation costs are estimated to be as much as \$118 million.

- 6.16 Furthermore, if the contagion risk is contained by timely appointment of a manager, some SMF providers may be spared reputational damage and Hong Kong's reputation as a premier securities market might not be affected. Such benefits cannot be quantified in purely monetary terms.

- 6.17 Though the SFC recognizes that some moral hazard would inevitably arise if there existed a power to appoint a manager, it believes that this would not be greater than the existing moral hazard arising in

consequence of the existence of the compensation fund which is now administered by the Investor Compensation Company ("ICC").

- 6.18 The SFC proposes to establish an internal working group to examine the various issues, research overseas practices and consider various options. This working group will then report back to the Panel prior to, eventually, holding a public consultation on its proposals regarding the power to appoint an independent third party as a manager to take over a failing securities firm.
- 6.19 The SFC therefore invites the Panel to note and comment on its proposed approach to this matter.

CHAPTER 7 Concluding Remarks

- 7.1 The SFC wishes to take this opportunity to express its gratitude to the Panel for its guidance and constructive proposals over the years. The SFC believes that changes in the global securities industry, increased regional and international competition for pre-eminence in the provision of financial services and the pressing need to ensure that Hong Kong retains its place as a premier international financial centre, combine to present Hong Kong with a number of choices. We believe that the choices it makes will have a direct bearing on the future competitiveness of Hong Kong's securities industry and Hong Kong's place in the top league of securities markets in the next decade and beyond. Therefore, it behoves Hong Kong to make wise choices with a view to safeguarding its future prosperity.
- 7.2 The regulatory options that would be the most palatable to the industry in the near term may be less likely to serve the best interests of the industry, investors or Hong Kong itself in the long term.
- 7.3 In the short term, the SFC believes that the introduction of the measures proposed by the Working Group will, provided the re-pledging limit (if adopted) is set conservatively, in combination serve to moderate the risks in the industry and enhance to some degree the financial soundness of brokerages and the level of protection afforded to their clients. In relation to the 12 month transitional period recommended by the Working Group for the rule amendments discussed in Chapter 3, the SFC agrees with the Working Group that the rationale for granting such transitional period is to give firms a reasonable period of time within which to make such adjustments as may be necessary to comply with the new requirements.

7.4 However, the Working Group's recommendations require changes to relevant rules and codes. Under the SFO, the SFC is required to consult the market on any proposed rule changes. In addition, these changes must be formally drafted and laid before the Legislative Council for "negative vetting" for approximately 7 weeks. As this entire process may take some time, the SFC believes that the market should be consulted on the 12-month transitional period recommended by the Working Group.

7.5 The SFC shares the belief of a number of members of the Working Group that Hong Kong should not only look at near term answers but also long term solutions. These would include tiering capital to risks and adopting the best practice of segregating non-borrowing margin clients' collateral.

APPENDIX 1

Terms of Reference of the Working Group

1. The Working Group has been formed with a view to developing a robust risk-based financial and capital regulatory framework for the regulation of the securities and futures market intermediaries that would both facilitate the development of the industry and its intermediaries in Hong Kong, and provide adequate investors protection.
2. The Working Group will be tasked, among other matters:
 - a) To analyze the major risk areas of the securities and futures industry in Hong Kong from the perspectives of market intermediaries and investors, in particular, to assess the risks inherent in the current regulatory structure under which licensed corporations provide margin financing.
 - b) To review the current law, rules and regulations relevant to achieving the objective of building a robust structure for the industry to move forward and the adequacy of the existing overall regulatory framework in addressing the major risk areas.
 - c) To identify specific impediments in the existing financial regulations for intermediaries to develop their business in Hong Kong and overseas and resolve issues of concern.
 - d) To recommend a robust risk-based financial regulatory framework for Hong Kong including the tools that could be used to address and manage risks.
 - e) Where necessary, to add or invite additional members and form focus groups to address issues identified.

3. The Working Group will determine the tentative schedule to report to SFC.

Membership List of the Working Group

<u>Name</u>	<u>Organization</u>
Alexa Lam #	Securities and Futures Commission
Bruce Bromberg	Morgan Stanley Dean Witter Asia Limited
Stephen Cheung	City University of Hong Kong
Michael Crowl	Goldman Sachs (Asia) L.L.C.
Paul Fan	Paul Fan Securities Limited
Stephen Hui	UOB Kay Hian (Asia) Limited
Vincent Lee	Institute of Securities Dealers Limited
David Parker	Sun Hung Kai & Co. Limited
Lin-yoke Seetoh *	Hong Kong Investment Funds Association
Vera Tam	Consumer Council
Trini Tsang	Hong Kong Securities Professionals Association
Peter Wong	Tai Fook Securities Group Limited
Stephen Wong	HSBC Broking Services (Asia) Limited
Wilfred Wong	Hong Kong Stockbrokers Association Limited

Chairman of the Working Group

* Membership from August 2003

Note: Members participate in their personal capacity and their views do not necessarily reflect the views of organizations they represent/are associated with.

APPENDIX 2

Imprudent Practices And The Financial Resources Rules

1. With a view to facilitating the Panel's consideration of the issues examined by the Working Group, and the options and proposals contained in this report, we set out in this appendix a description of -
 - (a) practices that raise the risk profile of some SMF providers;
 - (b) the function of the FRR;
 - (c) the operation and effect of the gearing ratio adjustment; and
 - (d) the meaning and effect of haircut percentages under the FRR.

Imprudent practices

2. The imprudent practices adopted by a minority of SMF providers include:
 - (a) Imprudent lending;
 - (b) Excessive re-pledging of client collateral;
 - (c) Excessive reliance on bank borrowings;
 - (d) High utilization rate of bank facilities;
 - (e) Thin liquidity; and
 - (f) Insufficient internal controls.

Inadequate risk management systems

3. Some SMF providers adopt imprudent business practices with a view to maximizing their profits from margin lending. These practices give rise to high risks when carried on by firms with insufficient liquidity, poor internal controls and inadequate risk management. It is emphasized that the majority of SMF providers do not engage in these practices, which are described below.

Imprudent lending and excessive re-pledging and related risks

4. Imprudent lending refers to the practice of some SMF providers granting loans to margin clients in an amount that exceeds the marginable value of the client collateral deposited with the firm. Often such firms accumulate high volumes of collateral of low marginable value and have large exposures to particular lines of securities and/or margin clients.
5. The marginable value of a stock is the value that banks that accept re-pledged client collateral as security for loans would be prepared to advance to SMF providers against any given stock collateral. The banks' lending ratio, which is expressed as a percentage of the market value of the collateral, may be as high as 60% in the case of blue chip stocks and as low as 0% for some other stocks. Stocks assigned a high ratio are said to have a high marginable value.
6. Imprudent lending involves a firm in exposing itself to an imprudent extent to the credit risk of their margin clients, because failure by such clients to repay their margin loan or meet margin calls may force the firm to find the liquidity to cover the client's default or else run the risk of defaulting on its own obligations. This is because the realizable value of the collateral provided by margin clients who take excessive loans will be insufficient to discharge the clients' indebtedness to the firm and the firm will be liable for the margin shortfall thus created.
7. This risky practice is typically adopted by firms whose operating income is heavily reliant upon the interest charged on margin loans. Since such firms invariably lack the financial resources out of which to fund their margin lending, it is imperative for them to find a way of funding their loan book. That funding is obtained by re-pledging the client collateral of margin clients, including those who seldom, if ever, borrow from the firm.

These non-borrowing margin clients tend to deposit collateral of higher marginable value (against which banks will generally lend up to 60% of the market value of such securities). Client collateral of very low or zero marginable value that is typically deposited by such firms' borrowing margin clients, is simply accumulated. Ironically, the recipients of excessive loans are therefore more likely to recover their collateral in the event of the firms' liquidation.

8. It follows that SMF providers that engage in imprudent lending fund themselves by re-pledging client collateral in great quantities in order to maximize their bank borrowings. This may involve re-pledging virtually all client collateral of marginable value (i.e., any stock against which banks will lend money). The results of imprudent lending are primarily twofold: the firms tend to lack the reserve client collateral to top up their bank borrowings when the re-pledged collateral drops in value, thus stretching to the limit their ability to meet bank calls, and, because they use the funding obtained to continue imprudent lending against collateral of low marginable value, they lack the liquidity to meet sudden surges in their financial obligations.

9. Another feature of imprudent lending is that such firms tend to operate very close to their financial limits. In some cases, the reliance on bank loans secured by re-pledged client collateral is so great that bank lines are exceeded by up to 50%. Among this group of imprudent SMF providers, one finds examples of firms whose borrowings, secured by client collateral, are used to make unsecured loans to related parties or to finance the activities of their affiliated companies. Such firms, investing most of their working capital in imprudent lending, could be suddenly forced into insolvency whenever their liquidity is put under pressure. Apart from defaults by margin clients, demands by non-borrowing margin clients for the return of their scrip and market fluctuations that cause the value of re-

pledged collateral to drop, will all necessitate the firm finding the resources to top up its bank borrowings or additional collateral to re-pledge to the bank. While staying technically solvent, these firms operate on the verge of insolvency.

10. In a nutshell, the risk of becoming insolvent posed by these imprudent SMF providers increases in direct proportion to their high gearing and low liquidity. In the process, they endanger not only the assets of their clients but also the reputation of Hong Kong's securities industry and pose a threat to Hong Kong's ability to maintain its status as a world class financial centre. The Working Group accepts that resolute action must be taken to combat these risks.

Existing FRR Provisions

11. The FRR, which were not materially amended prior to their issue under the SFO pending the recommendations of the Working Group, prescribe the amount of regulatory capital that licensed corporations are required to maintain. They also provide a framework within which, and a methodology by which, licensed corporations must calculate -
 - (i) the value of their readily realizable, or liquid, assets after taking into account market and credit risks faced by the firm; and
 - (ii) the extent of provision to be made against certain liabilities.
12. The overall objective is that compliance with the FRR (especially the liquid capital requirement) should provide adequate assurance that a firm is in sufficient financial health to justify its being permitted to carry on the regulated activities for which it is licensed. The following paragraphs explain the different means by means of which the FRR are intended to attain this objective and outlines the effect on the risks posed by SMF providers that engage in the imprudent practices described above of the

two measures introduced in 2002, namely, the 65% gearing ratio adjustment and the "illiquid collateral" haircut.

Gearing ratio adjustment

13. The gearing ratio adjustment was introduced with a view to discouraging SMF providers from over-relying on re-pledging client collateral to fund their operations. It requires an SMF provider to take a capital charge in the amount by which its borrowings secured by client collateral exceed 65% of its aggregate margin loans. The result is that the excess amount must be funded out of shareholders' funds.
14. However, the gearing ratio adjustment does not limit the amount of client collateral that a firm may re-pledge to obtain its bank facilities, thus allowing imprudent SMF providers to engage in excessive re-pledging. Also, firms are at liberty to exceed the 65% gearing ratio limit provided they have sufficient capital to ensure compliance with the FRR.

Haircut percentages

15. SMF providers are allowed under the FRR to count as part of their liquid assets the aggregate amount receivable in respect of margin loans granted to their clients. However, this amount receivable is capped at the amount, calculated on a client-by-client basis, of the aggregate market value of client collateral as reduced by an amount calculated by multiplying the market value of the collateral by a percentage discount, called a haircut percentage. For example, a firm lending \$100 million against collateral having a market value of \$100 million and assigned a haircut of 20% can only count \$80 million towards its liquid assets.

16. Since an SMF provider's liquid assets are determined in part by application of the haircut percentages, they directly affect a firm's capacity to comply with its liquid capital requirement.
17. Haircut percentages are said to be low if the application of the haircut results in a relatively small amount of the stock's value being shaved off; high haircut percentages result in a higher amount of value being deducted from a stock's market value. The purpose of applying a haircut to reduce the value of collateral held by SMF providers is to create a buffer against the market risk to which the firm is exposed through its holding of the collateral (which might be reduced in value or effectively lose its value for FRR and bank financing purposes by reason of a drop in share price as a result of market fluctuation or being suspended from trading. Haircutting collateral values is intended to result in a more realistic and prudent valuation of the firm's liquid assets.
18. Although there is no universally agreed basis for determining the appropriate haircut to be applied to any given line of securities for risk management purposes, it is generally recognized that strong liquidity and low volatility are features deserving of a lower haircut as stocks with these characteristics are more likely to retain their value. As it would not be practical to assign different percentages to each individual line of stock, the FRR have always assigned haircut percentages by reference to the Index of which the stock is a constituent.
19. Haircut percentages are also applied by banks when they lend money against collateral in the form of securities. Banks' haircuts dictate whether a stock has a high, a low or a zero marginable value. A review of the average haircuts applied by banks to stock collateral re-pledged to them by SMF providers reveals that the haircuts applied by banks are far more stringent than those provided in the FRR.

The treatment of "illiquid collateral"

20. This measure was introduced in 2002 with a view to mitigating the risks arising from imprudent lending, by singling out some collateral for a haircut more stringent than otherwise applicable. The FRR defines "illiquid collateral" as client collateral which in aggregate is equal to or greater than: (i) the average monthly turnover of that stock calculated over a period of 6 consecutive months preceding the month before the month in which the calculation is made; or (ii) 5% of the market capitalization of that stock. The rationale for the historical basis for the calculation of average turnover is that it is designed to protect calculations from being affected by manipulation of turnover figures. Also, the figures apply for an entire month and this makes firms' calculations much easier.

21. The "illiquid collateral" haircut simply requires that collateral falling within that definition that is held by an SMF provider, to be haircut by 80% in calculating the firm's liquid assets. In reality, however, even this haircut is not steep enough for risk management purposes as many stocks that fall to be classified as "illiquid collateral" tend to have a value less than their haircut value in the case of a forced liquidation. This is because many such stocks have such low turnover by comparison with the amount held by the firm, that there is either no demand for them in the market or else selling any amount of them would depress the prevailing market price. As such, the "illiquid collateral" haircut of 80% is considered by some to be too generous.

APPENDIX 3

The Concept of Permitted Bank Borrowing ("PBB")

1. This concept was proposed by a member of the Working Group as a substitute for the gearing ratio adjustment under the FRR, of which it is a variation. Like the gearing ratio adjustment, PBB would not restrict client collateral being re-pledged to banks, but it would levy a capital charge where an SMF provider borrows from a bank an amount in excess of certain parameters calculated under the FRR, where that borrowing is secured by re-pledging client collateral.
2. Under this concept, margin loans granted by an SMF provider, considered on a client-by-client basis, would be compared to the amount that a bank would lend against the same collateral ("the variable parameter"). If the margin loans were funded by the firm re-pledging client collateral, the firm would sustain a capital charge in the amount by which each margin client's margin loan exceeded the bank's marginable value of that client's collateral. This is illustrated in the Table, below.
3. In the example, an SMF provider grants margin loans of \$100 million to each of its margin clients, A and B, and receives collateral values as depicted in the Table below, which it then re-pledges to a bank in return for a loan.

Table – PBB

	Client A	Client B	Total
	\$million	\$million	\$million
(1) Margin loan	100	100	200
(2) Market value of collateral	150	150	300
(3) Bank's marginable value of collateral re-pledged by SMF provider	105 i.e. 70% of market value	15 i.e. 10% of market value	120
Variable parameter: i.e., the lower of (1) and (3)	100	15	115
By comparison, 65% gearing ratio adjustment under the current FRR: i.e., (1) x 65%	65	65	130

4. The variable parameter for determining the gearing ratio limit is calculated by taking the lower of the margin loan amount, on a client-by-client basis, and the bank's marginable value of the client collateral, and aggregating those for the purpose of calculating the applicable PBB gearing limit. In the example illustrated above, the PBB gearing limit is found to be \$115 million (as the loan to B exceeds the collateral's marginable value by \$85 million), as compared to \$130 million under the existing 65% gearing ratio adjustment. The result of applying the variable parameter is that, as the SMF provider borrowed \$120 million from the bank, it must take a capital charge in the amount of \$5 million which is the amount by which its actual borrowing exceeded its permitted borrowing. That \$5 million would not be counted towards the firm's liquid capital and would have to be funded out of its own resources.
5. The rationale for the PBB concept is that SMF providers that re-pledge client collateral are provided with a financial disincentive to borrow against client collateral more than the amount they actually lend to margin clients or such lower amount they would have lent to their margin clients if they had lent no more than the bank's marginable value of each margin

client's collateral. Any bank borrowings secured by non-borrowing margin clients' collateral would similarly be deducted from the firm's liquid capital.