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# New Requirements For Securities Firms And New Paid-Up Share Capital Requirement For Sponsors

## Introduction

The Securities and Futures Commission (“SFC”) has gazetted amendments to the relevant rules under the Securities and Futures Ordinance and to the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (the “Code of Conduct”) to implement the measures proposed in the Consultation Conclusions on Proposed Measures to Address Risks Arising from Securities Margin Financing published in April 2006. Amendments to the Securities and Futures (Financial Resources) Rules (“FRR”) will also implement the new HK$10 million minimum paid-up share capital requirement for sponsors recommended in the Consultation Conclusions on the Consultation Paper on the Regulation of Sponsors and Compliance Advisers also published in April this year.

The principal changes will be:

* The imposition of a limit on the amount of margin clients’ securities collateral (“clients’ collateral”) which may be repledged by securities firms that conduct securities margin financing (“SMF providers”). The repledging limit will be 180% of total margin loans for a 12 month period starting on 1 October 2006. It will be reduced to 140% from 1 October 2007.
* New requirements for firms that repledge clients’ collateral to include a risk disclosure statement about pooling risk in annual renewals of clients’ authorities to repledge clients’ collateral and to disclose that they repledge clients’ collateral upon the opening of new margin accounts and in monthly client statements.
* Moderate changes to selected FRR haircut percentages. With the exception of an increase in the haircut percentage for warrants to 100% which will apply to all securities firms, the changes will apply only to SMF providers who repledge clients’ collateral.
* A requirement for firms that repledge clients’ collateral to notify the SFC within one business day if they have used 80% or more of their total bank credit limit for a continuous period of 2 weeks.
* The relaxation of existing FRR requirements including:
  + abolition of the concentration discounting factor;
  + abolition of the ad hoc notification requirement on the amount of concentrated margin client adjustment;
  + the relaxation of the triggering level of the gearing adjustment to 80% from 65% once the repledging limit is fixed at 140% (ie. from 1 October 2007).
* To implement the new HK$10 million minimum paid-up share capital requirement for sponsors being introduced as part of the new eligibility criteria for firms wishing to act as sponsors to companies seeking to list on the Hong Kong Stock Exchange.

Subject to the expiry of Legco’s negative vetting period on 12 July 2006, the amendments relating to the securities margin financing Consultation Conclusions will come into effect on 1 October 2006. The new paid-up share capital requirement for sponsors will come into effect on 1 August 2007. The amendment rules are available on the SFC’s website at www.sfc.hk.

## New Measure Summary

The purpose of this note is to provide a summary of the new measures.

### 1. Securities and Futures (Client Securities) (Amendment) Rules 2006 - Repledging Limit

These will amend the Securities and Futures (Client Securities) Rules to cap the amount of clients’ collateral that can be repledged by a firm for the purpose of securing bank facilities at a percentage of its aggregate margin loans. The limit applies irrespective of whether or not the firm utilizes its banking facilities which are secured by repledging clients’ collateral.

A new section 8A (“Repledging Limit”) to the Rules will require an SMF provider, at the end of each business day (“Day One”), to calculate the aggregate market value of the securities collateral that it and any of its associated entities have repledged as collateral for financial accommodation provided to the SMF provider using the respective closing prices of the collateral on Day One. It must then determine whether that value exceeds 140% of the SMF provider’s aggregate margin loans on the same business day. If it does, the SMF provider must by the close of business on the next business day (“Day Two”) withdraw from deposit repledged securities collateral to ensure that the aggregate historical value (ie. calculated using Day One’s closing prices) of repledged collateral at the end of Day Two, after withdrawal of the shares, does not exceed 140% of its aggregate margin loans as at the end of Day One.

The repledging limit will be introduced in two stages. For SMF providers licensed before 1 October 2006, the repledging limit will be set at 180% for a period of 12 months starting on 1 October 2006. It will then be reduced to 140% from 1 October 2007. The two-stages were adopted in response to industry requests for the new limit to be phased in gradually. For firms licensed to conduct securities margin financing on or after 1 October 2006, the 140% limit will apply from the date of licensing.

The repledging limit is intended to limit the risks faced by the brokerage industry and the Hong Kong market from excessive pooling and repledging of margin clients’ collateral by ensuring that at least a portion of client collateral will be retained by SMF providers and will be available for distribution to margin clients in the event of their becoming insolvent. According to the SFC, the repledging limit will only apply to the 81 (out of a total of 231 SMF providers operating in Hong Kong as at the end of December 2005) that repledge clients’ collateral.

### 2. Securities and Futures (Contract Notes, Statements of Account and Receipts) (Amendment) Rules 2006 - Additional Disclosure Requirements

Amendments to the Securities and Futures (Contract Notes, Statements of Account and Receipts) Rules will impose additional disclosure requirements on SMF providers who repledge clients’ collateral. Where an SMF provider or its associated entity has repledged clients’ collateral at any time during a month, it must include in its monthly client statements to its margin clients a statement that:

* the client has provided the firm or its associated entity with a standing authority to repledge his or her securities collateral; and
* the firm or its associated entity has repledged clients’ collateral (i.e. collateral belonging to any margin clients; not necessarily or specifically that of the margin client to whom the statement is sent) during that monthly accounting period.

This amendment followed general acceptance that steps should be taken to enhance investors’ awareness of pooling risks and enhance transparency of SMF providers.

### 3. Securities and Futures (Financial Resources) (Amendment) Rules 2006

Amendments to the Securities and Futures (Financial Resources) Rules will:

1. implement moderate changes to selected FRR haircut percentages;
2. relax certain FRR requirements; and
3. impose the new HK$10 million minimum paid-up share capital requirement for corporations licensed for Type 6 regulated activity (advising on corporate finance) which act as sponsors in respect of listing applications.

#### Adjustments to the Haircut Percentages

The SFC recognises that the haircut percentages prescribed by the FRR are considerably lower than those generally adopted by SMF providers and banks for in-house risk management purposes which suggests that the existing FRR haircut percentages may not provide adequate risk management for margin financing activities. Nevertheless, the SFC accepts that as part of a package to reduce the risks of repledging, the FRR haircut percentages can be set at levels less stringent than those adopted in the marketplace. Noting that only firms that repledge clients' collateral pose pooling risks, the SFC has differentiated between firms that repledge client’s collateral and those that do not.

Currently, there is only one set of haircut percentages which apply both to clients’ collateral provided by margin clients and to house investments. Under the amended Rules, different haircut percentages will be specified for (i) house investments and other securities transactions (Tables 1 and 2 of Schedule 2 to the FRR will set out the haircut percentages for shares listed in Hong Kong and specified overseas listed securities, respectively) and (ii) calculating the haircut amount under section 22(1)(b)(i) FRR (which will be set out in a new Table 1A to Schedule 2). In the latter case, the haircut percentages apply to shares listed in Hong Kong which are held by a SMF provider as security against amounts owed by its clients in their margin accounts. They serve to adjust for the quality of an SMF provider’s assets the amount of margin client receivables that are recognised as part of its liquid assets. The principal amendments to the haircut percentages are as follows:

##### 1. Haircut Percentages Applicable to Margin Clients’ Collateral

In the case of clients’ collateral, the haircut percentage assigned to non-index constituent stocks (where the gap between the FRR haircuts and those adopted by banks and SMF providers is the greatest) has been raised from 30% to 60% for *firms that repledge clients’ collateral*. The non-index constituent stock collateral provided by margin clients of firms that do not repledge clients’ collateral will continue to be subject to a 30% haircut. A haircut percentage of 30% has also been set for constituent stocks of the MSCI Hong Kong Index and the MSCI China Index (both compiled by Morgan Stanley Capital International Inc.) which would otherwise be subject to the higher percentage for non-index constituent stocks. All other existing haircut percentages on listed shares remain unchanged.

##### 2. Warrants

The haircut percentage for warrants will be increased to 100% from the current 40% (Table 7 of Schedule 2). This will be applied to clients’ collateral provided by margin clients (whether the firm repledges clients’ collateral or not), house positions and other securities transactions. This is the only change which will also affect firms that do not conduct securities margin financing.

##### 3. Illiquid Collateral

The haircut percentage for illiquid collateral has been maintained at 80%.

The table below shows the amended haircut percentages as compared to the existing percentages.

**Amended Haircut Percentages**

**Existing Percentages**

**Margin Financing**

**House Investments**[[1]](#footnote-32)

**Hang Seng Index constituents**

15%

15%

15%

**Hang Seng Hong Kong MidCap constituents**

20%

20%

20%

**MSCI HK & China constituents**

30%

30%

30%

**Other HSCI constituents**

30%

30%

30%

**Non-index constituents stocks**

60%[[2]](#footnote-33)

30%

30%

**Illiquid collateral**

80%

N.A.

80%

**Warrants**[[3]](#footnote-34)

100%

100%

40%

#### Abolition of the Concentration Discounting Factor

The concentration discounting factor (“CDF”) makes additional haircut deduction where firms have particularly large exposures to individual stocks held as clients’ collateral. The CDF will be abolished under section 4(1) of the FRR Amendment Rules which amends section 22(1)(b)(i) of the FRR. All SMF providers (including those that do not repledge clients’ collateral) will benefit from this FRR relaxation.

#### Concentrated Margin Client Adjustment

The SFC will also abolish the ad hoc notification requirement on the amount of concentrated margin client adjustment made under the FRR for all SMF providers. This is reflected in section 6 of the Amendment Rules which repeals section 55(1)(h) of the FRR.

The SFC has however decided to retain the concentrated margin client adjustment. It considers that this helps ensure that the FRR, as a whole, provide adequate risk management against margin lending risks.

#### Gearing Adjustment

The gearing adjustment was introduced in 2002 as an interim measure to manage pooling risks by ensuring that a firm finances at least one third of its total margin loans from its capital. While the SFC considers that the role of the gearing adjustment as a risk management tool will gradually diminish, it considers that it should not be abolished until complete segregation of non-borrowing margin clients’ collateral has been achieved. Accordingly, the SFC has decided only to relax the gearing adjustment at the time when the repledging limit is lowered to 140%.

The triggering level (the percentage of bank borrowing obtained by repledging clients’ collateral above which firms are required to make adjustments to their liquid capital) will therefore be relaxed from 65% to 80% with effect from 1 October 2007 when the repleding limit is fixed at 140% (s5 of the Amendment Rules which amends s 42(2) of the FRR). The existing 65% triggering level will continue to apply until 30 September, 2007 (section 8 of the Amendment Rules). The gearing adjustment does not apply at all to firms that do not repledge clients’ collateral or do not conduct margin financing.

#### Minimum Paid-up Capital of Sponsors

The FRR will be amended to implement the new HK$10 million minimum paid-up share capital requirement for corporate finance advisory firms (ie. licensed for Regulated Activity type 6) who wish to act as sponsors to companies seeking to list on the Hong Kong Stock Exchange. This has been introduced as part of the new regime specifying the eligibility criteria and ongoing obligations for sponsors. Table 1 of the FRR will accordingly be amended to specify the new paid up share capital requirement for firms not subject to the no-sponsor work licensing restriction which will be imposed on firms not meeting the new eligibility criteria.

The new paid-up share capital requirement for sponsors will come into effect on 1 August, 2007. Before then, sponsors wishing to carry out sponsor work will be required to satisfy the SFC that they have already met, or are in a position to meet, the minimum paid-up capital requirement.

To see a full summary of the new sponsor regime, please see [our May 2006 newsletter](/newsletters/hklaw/en/2006/35/nl-hklaw-20060512-35.html).

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

#### Notification to SFC on Bank Line Utilisation

Amendments to Schedule 5 to the Code of Conduct will require a firm that repledges clients’ collateral to notify the SFC in writing within one business day once it has used 80% or more of its total bank credit limit for a continuous period of 2 weeks. The aim of this requirement is to make the SFC aware of a potential liquidity squeeze so that it can take timely action to work with the relevant firm to alleviate the situation.

A firm’s “total bank credit limit” is calculated as the sum of:

1. the credit limit of each unsecured bank credit facility; and
2. the lower of:
   1. the aggregate credit limit of its secured bank credit facilities; and
   2. the aggregate amount that the banks are willing to lend against the security pledged to the banks.

In the calculation of the firm’s total bank credit limit, firms may include the amount banks are willing to lend against the listed securities that belong to the firm and have not been pledged to banks, plus the amount banks are willing to lend against any clients’ collateral that has not been repledged but maybe so repledged as permitted by the new repledging limit under the Securities and Futures (Client Securities) Rules.

#### Disclosure of Repledging Practice

In line with the additional requirements contained in the Securities and Futures (Contract Notes, Statements of Account and Receipts) (Amendment) Rules, Schedule 5 to the Code of Conduct will also be amended to require a SMF provider to:

1. inform clients opening a margin account that it repledges securities collateral if it is part of its practice;
2. inform all existing margin clients as soon as practicable when it changes its repledging status from non-repledging to repledging; and
3. ensure that a risk disclosure statement in relation to the provision of an authority to repledge securities collateral as specified in Schedule 1 to the Code is included in a prominent position in the written notice given by it to any client to renew the standing authority in which the client authorises it to deposit the client’s securities collateral as collateral for financial accommodation provided to it.

### 5. Dropped Proposals

The original consultation paper contained a number of other proposals which have not been adopted. These included the proposal that SMF providers should notify the SFC of their total lending on illiquid collateral. The SFC accepted that the possible benefits of the additional notification requirement on top of the FRR monthly financial returns could be outweighed by the compliance burden placed on SMF providers.

The SFC also decided not to proceed with the proposed tightening of the current 5-day grace period for marking-to-market overdue cash client receivables due to the practical difficulties of implementing a shorter grace period. The Consultation Conclusions however note that delay in settlement by clients may increase the settlement risk faced by brokerages and remind brokerages that they have a responsibility to manage their risks under the Code of Conduct and Internal Control Guidelines.

As mentioned in the original Consultation Paper, the SFC still considers that segregation of non-borrowing margin clients’ collateral remains the most effective way of addressing the remaining risks arising from pooling clients’ collateral. However, in view of its findings and industry operators’ responses indicating that segregation could significantly raise the industry’s operating costs, the SFC has determined that such segregation should only be set as a longer-term objective.

### 6. Summary of Amendments

**Measures**

**Source**

**Existing licensed corporations**

**Firms licensed on or after 1st October**

180% repledging limit

Client Securities Amendment Rules sections 4 & 5

Commence 1st October 2006 for period of 12 months

N.A.

140% repledging limit

Client Securities Amendment Rules sections 4 & 5

1st October 2007

1st October 2007

Annual Reminder of Pooling Ris

Amendment to Code of Conduct for Persons Licensed by / Registered with SFC

1st October 2006

1st October 2006

Revised haircut percentage

Financial Resources Amendment Rules section 10

1st October 2006

1st October 2006

Notification on bank line utilisation

Amendment to Code of Conduct for Persons Licensed by / Registered with SFC

1st October 2006

st October 2006

Disclosure of repledging practice in monthly client statement etc.

Contract Notes, Statements of Account and Receipts Amendment Rules sections 1, 2 & 3

1st October 2006

1st October 2006

Abolition of CDF

Financial Resources Amendment Rules section 4(1)

1st October 2006

1st October 2006

Abolition of ad hoc notification on concentrated margin client adjustment

Financial Resources Amendment Rules section 4(2)

1st October 2006

1st October 2006

65% gearing adjustment

Financial Resources Amendment Rules sections 5 & 8

Existing requirement continues until and including 30th September 2007

N.A.

80% gearing adjustment

Financial Resources Amendment Rules section 5

1st October 2007

1st October 2006

Minimum paid-up capital of sponsor

Financial Resources Amendment Rules section 9 1st

1st August 2007\*

1st August 2007

\*Prior to 1st August 2007, sponsors will be required to satisfy the SFC that they have already met, or are in the position to meet the minimum paid-up capital requirement.

### 7. Summary of Amendments as they affect Different Types of Securities Firms

1. Requirements for SMF providers that do NOT repledge clients’ collateral
   * They will **not** be subject to any of the new requirements applicable to firms that repledge clients collateral, except the increased haircut percentage for warrants (which applies to both clients’ collateral and house investments). The increased haircut will be 100%.
   * They will benefit from the following FRR relaxations:
     + the abolition of the concentration discounting factor; and
     + the abolition of the ad hoc notification requirement on the amount of concentrated margin client adjustment made under the FRR.
   * The 65% gearing adjustment under the FRR does not apply to these firms.
2. Requirements for firms that repledge clients’ collateral to banks
   * They will be subject to a repledging limit of 180% from October 1, 2006. From October 1, 2007, the repledging limit will be reduced to 140%.
   * They will have to apply a 60% haircut deduction (raised from the existing 30%) to non-index constituent stocks held as securities collateral for margin loans. They will also be subject to the new 100% haircut percentage for warrants (whether held as clients’ collateral or house investments). Apart from these changes, the other existing haircut percentages will remain unchanged.
   * They will be required to:
     + include a risk disclosure statement about pooling risk in every annual renewal of the client authority to repledge clients’ collateral; and
     + disclose to their margin clients that they repledge clients’ collateral upon opening new margin accounts and in the monthly client statements.
   * They will have to notify the SFC within one business day if they have used 80% or more of their total credit limit with banks for a continuous period of 2 weeks.
   * They will benefit from the following FRR relaxations:
     + the abolition of the CDF;
     + the abolition of the ad hoc notification requirement on the amount of concentrated margin client adjustment made under the FRR; and
     + the relaxation of the triggering level of the gearing adjustment to 80% from 65% once the repledging limit is fixed at 140% (ie. 1 October 2007).
3. Requirements for securities firms that do not conduct securities margin financing
   * The only change that applies to these firms is the new 100% haircut percentage for warrants.
   * The 65% gearing adjustment does not apply to these firms.

*This note is intended as a summary only of the proposed measures as set out in the Consultation Conclusions on Proposed Measures to Address Risks Arising From Securities Margin Financing. Specific advice should be sought in any particular situation.*

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1. These haircut percentages apply to house investments and other securities transactions for all firms. [↑](#footnote-ref-32)
2. The new 60% haircut percentage for non-index constituent stocks applies only to securities collateral provided by margin clients of firms that repledge clients' collateral [↑](#footnote-ref-33)
3. The new haircut percentage for warrants applies to **all** firms [↑](#footnote-ref-34)