



## **Consultation Paper on Proposed Guidelines for Securities Margin Financing Activities**

### **The Law Society's Submissions**

The Securities and Futures Commission ("SFC") issued a consultation paper on 17 August 2018 on the Proposed Guidelines for Securities Margin Financing Activities. In response thereto, the Law Society provides the following submissions on the consultation questions posed.

***Question 1:** Do you agree that an securities margin financing ("SMF") broker should control its total margin loans with reference to the amount of its capital?*

**Law Society's response:**

Yes. We also agree that outstanding approved subordinated loans should be allowed in the calculation of brokers' capital.

***Question 2:** Do you agree that the proposed guidelines should provide a benchmark for the total margin loans-to-capital multiple?*

**Law Society's response:**

Yes.

***Question 3:** During the soft consultations, some respondents recommended setting the benchmark for total margin loans-to-capital multiple at two to five times. Within the suggested range of two to five times, what do you think is the appropriate quantitative benchmark for total margin loans-to-capital multiple? Please provide the rationale for your comment or suggestion.*

**Law Society's response:**

Balancing the risk of exposure to high financial risk of the SMF brokers and the practical and administrative needs of brokers, we believe a figure at the higher end of the range should be adopted for the reasons set out in paragraph 26 of the Consultation Paper.

*Question 4: Do you agree that a higher benchmark for total margin loans-to-capital multiple should apply to a broker that does not use approved subordinated loans as regulatory capital than to a broker that does?*

**Law Society's response:**

Yes. Approved subordinated loans are second tier capital, and this qualitative difference should be reflected in the benchmarks applied.

*Question 5: While "group of related margin clients" is defined in section 42(3) of the Securities and Futures (Financial Resources) Rules ("FRR"), do you agree that the coverage of related margin clients should be extended, e.g., to include margin accounts which are held by the same beneficial owner for the purposes of monitoring aggregate credit risk exposures?*

**Law Society's response:**

Yes, though the technical definition of the extended coverage must be clearly defined for certainty.

*Question 6: Do you agree that exposures to different securities held as collateral which are highly correlated should be aggregated for the purposes of monitoring concentration risk?*

**Law Society's response:**

Yes

*Question 7: Do you agree with the definition of "highly correlated securities" set out in paragraph 38 above?*

**Law Society's response:**

We believe more guidance is needed on what constitutes "group affiliations",

“material cross shareholdings” or “significant business affiliations”.

We do not agree with aggregating securities of issuers which are “engaged in the same industry” in the definition of “highly correlated securities” as this would be overly restrictive and problematic in terms of its application.

**Question 8:** *Do you consider that constituent stocks of any other stock indices should also be treated as index stocks for the purposes of paragraph 43 above? Please provide the rationale for your suggestion.*

**Law Society’s response:**

Yes. Index constituent stocks are typically liquid meaning that, when pledged as collateral for margin loans, they can be readily realized should the client default on a margin call.

**Question 9:** *During the soft consultations, some respondents suggested setting X% at between 30% and 50%, and Y% at between 20% and 25%. Within these suggested ranges, what percentages do you consider as appropriate benchmarks? Please provide the rationale for your suggestion.*

**Law Society’s response:**

No comment.

**Question 10:** *Do you think that as a quantitative benchmark, margin client concentration should be measured with reference to the broker’s shareholders’ funds? If not, what is your alternative suggestion? Please provide the rationale for your suggestion.*

**Law Society’s response:**

We agree that measuring margin client concentration with reference to the broker’s shareholders’ funds is a suitable qualitative benchmark.

**Question 11:** *During the soft consultations, some respondents recommended setting the quantitative benchmark for margin client concentration at between 20% and 40% of a broker’s shareholders’ funds. Within this suggested range, what percentage do you think is appropriate for benchmarking purpose? Please provide the rationale for your suggestion.*

**Law Society's response:**

No comment.

*Question 12: Do you have any comment on the basis for determining whether a margin loan is a significant margin loan?*

**Law Society's response:**

No comment.

*Question 13: What should be the appropriate percentage with reference to the broker's shareholders' funds for determining whether a margin loan is significant? Please provide the rationale for your suggestion.*

**Law Society's response:**

No comment.

*Question 14: During the soft consultations, some respondents commented that X% in paragraph 64(b) above should be set at 15% to 20%. What percentage point within this range do you think is appropriate? Please provide the rationale for your suggestion.*

**Law Society's response:**

No comment.

*Question 15: Do you agree that total unsettled margin calls should not exceed the shareholders' funds of an SMF broker? Please provide the reason for your comment.*

**Law Society's response:**

Yes. This will help to constrain potential bad debts on unsettled margin calls to the available funds of the SMF brokers.

*Question 16: During the soft consultations, some respondents indicated that a margin call which has remained outstanding for more than 30 days to 90 days should be treated as a long-outstanding margin call. Within this suggested range,*

*at which point do you think a margin call should be treated as a long-outstanding margin call?*

**Law Society's response:**

We believe the period after which an unsettled margin call be treated as a long-outstanding margin call should be set at some period between 30 and 60 days, that is the lower end of this range. SMF brokers should be encouraged to take appropriate follow-up action on material and significantly overdue margin calls.

***Question 17:** During the soft consultations, some respondents recommended limiting total long-outstanding margin calls to between 20% and 25% of an SMF broker's shareholders' funds. Within this suggested range, what percentage do you think is appropriate? Please provide the rationale for your suggestion.*

**Law Society's response:**

Given the existing high ratio of long outstanding margin calls to the broker's shareholder's funds, we believe a higher ratio (e.g. 25%) will be more realistic in the short term, though a lower rate is more desirable in the long term.

***Question 18:** During the soft consultations, some respondents suggested applying a 15% to 30% hypothetical price drop where the collateral pool mainly comprised index stocks, whereas for a collateral pool comprised few index stocks, the hypothetical price drop should be between 30% and 50%. Do you have any suggestions on the hypothetical price drop percentage to be applied in each of the scenarios (ie, X%, Y% and Z%) suggested in paragraph 85 above? Please provide the reason for your suggestion.*

**Law Society's response:**

No comment.

***Question 19:** As regards the weighting of index stocks in the collateral pool in each of the hypothetical scenarios suggested in paragraph 85 above (ie, 75% and 25%), do you agree with the suggested thresholds as the dividing line for distinguishing a high-quality collateral pool from a low-quality collateral pool? Please provide the reason for your suggestion.*

**Law Society's response:**

No comment.

***Question 20:** Do you consider that constituent stocks of any other stock indices should be treated as index stocks for the purposes of paragraph 85 above? Please provide the reason for your suggestion.*

**Law Society's response:**

Yes. See our response to question 8 above.

***Question 21:** Do you agree that 10% is an appropriate threshold for the definition of "significant group of highly correlated securities"? Please provide the reason for your suggestion.*

**Law Society's response:**

No comment.

***Question 22:** Do you agree that 10% is an appropriate threshold for the definition of "significant re-pledged securities collateral" and "significant group of highly correlated re-pledged securities collateral"? Please provide the reason for your suggestion.*

**Law Society's response:**

No comment.

***Question 23:** Do you think that a six-month transition period is appropriate? Please provide the reason for your suggestion.*

**Law Society's response:**

A longer period than six months may be required to facilitate SMF brokers to not only introduce updated guidance and licenses, but also to be compliant from day one. We suggest nine months.

**The Law Society of Hong Kong  
2 October 2018**