

Questions about

Financial Resources Rules

| | <i>Question</i> | <i>Answer</i> |
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| 1. | Where can the FRR be found? | It is available on the SFC’s website at www.hksfc.org.hk under the “Update for Intermediaries” section. Alternatively, it is included in the 20.4 Gazette and can be purchased from the Government Publication Centre, address: G/F, Low Block, Queensway Government Office, 66 Queensway, Hong Kong. |
| 2. | Where can we obtain a copy of the FRR return? | The FRR return is attached to the revised FRR (schedules 7 – 13). This can be downloaded from the SFC’s website. Hard copies of the return (Chinese and English) are available at the Licensing counter for collection. |
| | CAPITAL ACCOUNT/LIQUID CAPITAL REQUIREMENT | |
| 3. | Can a dealer include his HKEC shares for meeting the <u>capital account</u> requirement? | Yes, these can be included at valuation in accordance with generally accepted accounting principles (as advised by the dealer’s auditor). |
| 4. | Can a sole proprietor or a partnership put in a property or HKEC shares to meet the <u>capital account</u> requirement? How should such assets be valued? | Yes, these assets can be injected into a business for meeting the capital account requirement. The valuation basis should be in accordance with generally accepted accounting principles as advised by the auditors. |
| 5. | Can share premium be used to meet the minimum <u>paid up share capital</u> requirement? The Companies Ordinance is apparently not clear on this point (as advised by a reputable law firm in HK). | No. The dealer can consider capitalizing the share premium account into paid-up shares. |
| | SECURITIES MARGIN FINANCING | |

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| 6. | <p>What if a dealer lends to clients but not for the purpose of acquiring listed securities?</p> <p>Will this dealer be subject to the relevant FRR provisions?</p> | <p>FRR only permits prescribed assets to be included in liquid assets and only receivables from margin clients (defined to be a dealer’s clients on whose behalf the dealer acquires securities) can qualify. Hence, when a dealer can lend to clients for other purposes, such loans are excluded in full from liquid assets.</p> <p>So, if a client deposits securities and draws money out (i.e. not for the purpose of buying shares), the loan will not qualify as liquid assets at all.</p> <p>Furthermore, it should be noted that a Stock Exchange Participant (under Rule 356 of the SEHK Rules) is subject to the sole business requirement and can only engage in Securities Margin Financing (“SMF”) that is incidental to dealing in securities.</p> |
| 7. | <p>Some clients do not directly provide collateral to the dealer. They may instead leave the securities with an overseas related company (not in an account in the dealer’s name) and rely on a cross guarantee. These securities are held separately in a special account so that the HK entity will know what collateral it can count on.</p> | <p>The dealer may not be able to meet the requirement in the definition of “collateral”. The dealer should be advised to provide further information on the arrangement to the Commission for consideration.</p> <p>Also, there is a potential problem complying with s81A; the dealer should consult its legal adviser accordingly.</p> |
| 8. | <p>If SMF relates to shares listed overseas, what haircut rates are they subject to and how can they be grouped into related securities?</p> | <p>The haircut rates are laid down in Schedule 1. The dealers or financiers should put in appropriate procedures for the purpose of identifying related securities overseas.</p> |
| 9. | <p>Must an exempt dealer which conducts SMF apply the concentration discount fact (“CDF”) and adjust for concentration of margin clients?</p> | <p>Exempt dealers are not required to comply with the FRR at all, hence no need to apply the CDF and adjust for concentration of margin clients.</p> |
| 10. | <p>Can dealers provide funding to clients for them to meet margin requirements for futures and options trading?</p> | <p>The FRR will disallow all such receivables. In addition, SEHK Participants cannot provide funding to clients for them to meet margin requirements for futures and options trading under Rule 356 (i.e. the sole business requirement).</p> |

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| | CDF/CONCENTRATION OF MARGIN CLIENTS | |
| 11. | <p>When calculating the financial adjustments for concentration in margin clients, if:</p> <p>(a) a margin client with debit balance is related to another margin client with credit balance, can their balances be offset with each other?</p> <p>(b) a margin client is related to another cash client, should their balances be aggregated?</p> | <p>Their balances cannot be offset with each other.</p> <p>Their balances should not be aggregated.</p> |
| 12. | In calculating the CDF, should market value of collateral provided from margin clients with credit balances be included? | Yes, when calculating CDF, market value of collateral provided by <u>all</u> margin clients should be included. |
| 13. | A dealer may receive a large deposit of a single stock from a client who borrows very little, if at all. If such collateral is included for the purpose of computing the CDF, it may have an adverse effect on other margin clients who happen to have deposited the same securities. This situation is outside the dealer's control but he will suffer a FRR hit all the same. | The dealer should always be mindful of the FRR implication of large deposit of single stock by low usage clients. He should consider suggesting to the clients to lodge the stock for safe custody instead of as collateral in these circumstances. |

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| 14. | <p>In respect of related margin clients, are there any guidelines to assist a dealer to identify related margin securities if no proper disclosure has been made? In the case of long-established clients, will the responsibility of identifying related margin clients rest with the dealer or the clients?</p> | <p>For existing margin clients, the dealer should ask the AEs to identify related margin clients within their knowledge and to confirm the same with their respective clients.</p> <p>For new margin clients, the dealer should ask questions as to whether the prospective client is aware of any related parties (as defined in the FRR) to be an existing margin client of the dealer.</p> <p>If the client does not disclose his relationship with another margin client when asked, the dealer will not be considered to be at fault unless the dealer (or the AE) should have known about the relationship with the exercise of reasonable diligence.</p> |
| 15. | <p>How can dealers identify groups of related securities for the purpose of calculating the CDF?</p> <p>Would put warrants be included in the definition of related securities? How about a basket of warrants etc?</p> | <p>For locally listed shares and warrants, to facilitate the FRR computation, the Commission has posted the necessary information for FRR purposes on the SFC's website and updating it quarterly. A dealer or financier can rely on the list to identify related securities until the Commission posts an updated list.</p> <p>No similar services shall be provided for overseas shares and warrants. Dealers are expected to tap similar information with their own resources.</p> <p>All listed shares and listed warrants (put or call) are included in the definition of related securities. Basket warrants, convertible bonds and unit trusts (incl. Tracker Fund) are to be excluded.</p> |
| 16. | <p>What kind of documentation does the Commission expect dealers to collect from our clients for the purpose of identifying related margin clients?</p> | <p>In the context of establishing groups of related margin clients, the Commission would expect dealers or financiers to ask a new margin client, in the account opening form, whether he is aware of any related margin client and to ask the same question to existing clients. In the interim, dealers or financiers should at least ask their AEs if they know of any groups of related margin clients.</p> |
| 17. | <p>Will the SFC provide software (e.g. SPAN system) to dealers on related securities?</p> | <p>No, but the Commission has posted a list of related securities on the SFC's website.</p> |
| 18. | <p>If a very important client sells his securities or repays some of his</p> | <p>The Commission will consider the circumstances of the case, e.g. the transaction</p> |

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| | margin loan, this may affect the dealer's FRR position by triggering the CDF application and the adjustment on concentration of margin clients. The problem may be more acute if there are very few clients. | volume of these margin clients. |
| 19. | If different clients authorise the same person to operate their accounts, will they be treated as related margin clients? If a fund manager operates different accounts, will these accounts be treated as related margin clients? | No. No. |
| 20. | There are 7 margin clients: Mr A, Mrs A, Mr B, Mrs B, Mr C, Mrs C and Co. X where Mr and Mrs A together owning 35% of Co. X Mr and Mrs B together owning 35% of Co. X Mr and Mrs C together owning 30% of Co. X Who will be regarded as related margin clients? | There are 3 sets of related margin clients: Mr and Mrs A + Co. X Mr and Mrs B + Co. X Mr and Mrs C [Given the above, a system should be flexible enough to put individual clients into more than 1 group.] |
| | FRR – GENERAL | |
| 21. | Are there additional financial requirements applicable to SEHK participants? | Yes, the monetary floor of the required liquid capital (i.e. \$ 3 million) under the FRR is to be raised by an additional \$3 million for each branch office which causes the number of branch offices per Stock Exchange Trading Right to exceed 2; and SEHK participants must notify the Stock Exchange directly upon the occurrence of a specified event (just as prescribed under the FRR except that the early warning level is set at 130% by the SEHK instead of 120%). |

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| 22. | Are there additional financial requirements applicable to HKFE participants? | <p>Yes, HKFE participants must</p> <ul style="list-style-type: none"> (a) continue to maintain at least the minimum level of capital set by the Futures Exchange and minimum liquid capital of no less than 50% of that level; (b) continue to maintain a debt to equity ratio of no higher than 2:1; and (c) notify the Futures Exchange directly upon the occurrence of a specified event. <p>Where there is any discrepancy exists between the level of capital, liquid capital or other financial adjustments set forth in the HKFE financial requirements and that set forth in the FRR, the level which is higher or more stringent shall prevail.</p> |
| 23. | If a dealer executes all orders through an affiliated dealer, can the trade receivables and payables between these two dealers be recorded on the net basis? | No, the amount receivable from and payable to each other can only be set off where they relate to the same securities. |
| 24. | How is the application fee charged? \$6500 per application or by modification? | Per issue (e.g. an application may involve more than 1 issue and require more than 1 modification). |
| 25. | Can a time deposit which is pledged to secure overdraft facilities be included as liquid asset? | If the overdraft facilities are provided to the dealer or financier and not to a third party, then the time deposit can be included as a liquid asset. |
| 26. | Please elaborate on whether the relief for offsetting positions is available for client or house positions or both. | The relief for offsetting positions is only available for house positions. |
| 27. | Are bank balances in designated trust accounts and clients' payable which are excluded from the liquid capital computation, necessarily the same? | Not necessarily. It is conceivable that balances held in designated trust accounts (and need to be excluded from liquid assets) may at times be greater than the amounts payable to clients. |
| 28. | If a dealer wants to know whether the Commission has approved another credit rating agency, will the Commission publish the | The Commission is required under section 37 to publish the approval in the Gazette. Moreover, a list will also be posted to the SFC's website. |

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| | list? | |
| 29. | Where a dealer holds on his own account a short position in securities, he shall include in his ranking liabilities the market value of the short position plus the applicable haircut amounts. Should the haircut amounts be included in the total liabilities calculation when computing the required liquid capital? | No, the haircut amounts are financial adjustments and do not need to be included in the total liabilities calculation. |
| 30. | What haircut is applied to the 7 NASDAQ stocks that are being traded on SEHK? | 30% |
| 31. | A dealer effects a trade in Singapore for his client who pays US\$. Because of the need for the exchange conversion, the trade cannot be settled on a cash-against-delivery basis. Will this be treated as cash-against-delivery or free delivery, and if so, whether 2 weeks will be permitted for collection of debt? | Given that the dealer will need to instruct the local custodian to release the securities to the client on settlement date (irrespective of whether the HK office receives the US\$ consideration), this should be regarded a free delivery receivable. Since it is not the local settlement system that demands free delivery, the dealer should not be entitled to the 2 weeks' grace period. |
| 32. | In relation to s27 of the FRR re: introduction of transactions, can the express agreement contain a carve-out for wilful neglect, gross negligence, fraud etc? | Yes, given that the FRR grants the introducing broker status to dealers with a similar carve-out. |
| 33. | How does the Commission treat book building for FRR purposes? | On the understanding that book building is done on a best efforts basis, i.e. the dealer is not committed to take up unwanted securities, then there is no underwriting commitment and hence no need for the related financial adjustments. |
| 34. | How does the Commission treat placement, on or off balance sheet? | Where there is a commitment to place securities and the dealer is unable to place the full quota, this is treated in the same way as net underwriting commitment. |
| 35. | Can companies circumvent the FRR by putting on total asset swap etc? | It should be stressed that the FRR stipulate substance over form and that dealers and financiers are required to report to the Commission any off-balance sheet exposures that are not fully addressed by the FRR. Given the very wide definition of SMF in the Securities Ordinance, it is unlikely for any convoluted schemes to escape our regulatory net. |

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| 36. | The profit and loss account (Schedule 11) requires a client profile analysis of active clients (defined as clients who have completed at least one transaction during the year). Can the dealer/financier quote the number reported in the last annual licensing survey in this analysis or must he revise this figure on a monthly basis? | The Commission would prefer to have a more current ball-park figure rather than an outdated exact figure. Despite our adoption of the definition from the annual licensing survey, it would be meaningful if dealers could ask their AEs for a rough estimate of active clients. |
| 37. | Accounts payable to clients in relation to dealing in securities include transactions pending settlement whereby only actual cash receipt is paid into the segregated account. Does this mean that there will always be funds not segregated? | Yes. This amount will then have to be included in ranking liabilities. |
| | SUBORDINATED LOANS | |
| 38. | Would the SFC consider allowing shareholders' loans to be converted into an approved subordinated loan immediately when the dealer suspected possible problems complying with the FRR? | If a dealer is concerned that he may have problems complying with the FRR, he should consider putting in place an approved subordinated loan. Moreover, the Department will endeavour to reduce the processing time for subordinated loans to alleviate the dealers' concerns. |
| 39. | Can the new approved standby subordinated loan facility be used in the scenario of underwriting commitment? | The facility is designed to cover sudden increases in required liquid capital whereas underwriting commitment will only increase ranking liabilities and not required liquid capital. Hence, it will be more appropriate for dealers in these circumstances to apply for the revolving subordinated loan. |
| 40. | Will there be a cap on the approved standby subordinated loan facility? | The 1:1 cap is to be retained as the ratio between [the aggregate of all approved subordinated loans (including actual loans + facilities) + approved redeemable shares] and [shareholders' funds] unless the circumstances warrant a relaxation. |
| 41. | Can a dealer/financier obtain proforma subordinated loan agreements and how can he get to know (in general terms) what are needed to accompany an application for approval? | The relevant information has been posted onto the SFC's website. |

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| | TREATMENT OF LOCKED-UP SHARES | |
| 42. | <p>The shares of Stockmartnet Holdings Limited (stock code #8123) were listed on 11 January 2002 on the Growth Enterprise Market of the Stock Exchange of Hong Kong Limited.</p> <p>Under Appendix IV (Promoters and Founding CN Holders) to the Prospectus of Stockmartnet Holdings Limited dated 8 January 2002, the Promoters and the Founding CN Holders cannot sell, transfer, charge, pledge, encumber or otherwise dispose of the shares issued to them until the expiration of the 2-year lock-up period.</p> <p>In the case where the Promoter or the Founding CN Holder is a securities dealer registered with the SFC, how should the #8123 shareholdings be treated under the FRR?</p> | <p>As section 4(2) of the FRR requires a registered person to account for all of his assets and liabilities in such a way that recognises substance over form, we take the view that shares subject to any lock-up restriction must be illiquid as the owner cannot, or has at least undertaken not to, dispose of such shares within the lock-up period.</p> <p>Hence, registered persons are expected to assign nil value to any such holding of shares, whether it is in the form of house positions or securities collateral deposited by margin clients.</p> |