



SECURITIES AND FUTURES COMMISSION
證券及期貨事務監察委員會

Consultation Conclusions and Further Consultation on Proposed Changes to the Securities and Futures (Financial Resources) Rules

24 July 2017



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Foreword

On 17 July 2015, the SFC issued a consultation paper on proposed changes to the FRR. Those proposals aim to formulate capital and other prudential requirements for activities involving OTCD (such activities referred to as “**OTCD activities**”) engaged in by LCs as part of the reform of the OTCD market, and to update the requirements in certain areas of the FRR which are not specific to OTCD activities in light of recent market developments. This paper summarizes the comments received on the consultation paper and the SFC’s responses thereon, and to further consult the public on certain modified and additional proposals prompted by the feedbacks received and some additional technical changes proposed to streamline the FRR. In addition, this paper summarizes the comments received on an earlier consultation on a proposal to update the list of specified exchanges in the FRR, including the addition of the now defunct Hong Kong Mercantile Exchange Limited (“**HKMEx**”) to the list, which was put on hold following the latter’s cessation of business, and our responses thereon. Please refer to Part III of this paper for details. This paper also includes a set of draft amendments to the FRR for implementing those changes which are not specific to OTCD activities (including the aforesaid proposal to update the list of specified exchanges) for consultation. For details, please refer to Appendix 1.

Interested parties are invited to submit written comments on the modified and additional proposals and the draft amendment rules by any one of the following methods on or before 23 August 2017.¹

By mail to: Intermediaries Supervision, Intermediaries
Securities and Futures Commission
35/F Cheung Kong Center
2 Queen’s Road Central
Hong Kong

Re: Consultation Conclusions and Further Consultation on
Proposed Changes to the Securities and Futures (Financial
Resources) Rules

By fax to: (852) 2523 4598

By online submission: www.sfc.hk/edistributionWeb/gateway/EN/consultation/

By email to: frr_consultation@sfc.hk

Any person wishing to comment on the proposals should provide details of any organization whose views they represent.

Please note that the names of commentators and the contents of their submissions may be published, in whole or in part, on the SFC’s website and in other documents to be published by the SFC. In this connection, please read the Personal Information Collection Statement attached to this paper.

If you do not wish your name and/or submission to be published by the SFC, please state that you wish your name and/or submission to be withheld from publication when you make your submission.

¹ Copies of both the consultation paper and the conclusions paper are accessible via the SFC’s website at www.sfc.hk.



Abbreviations and acronyms

ATS	Automated trading services
BMRA	Basic Market Risk Approach
BOCCRA	Basic OTCD Counterparty Credit Risk Approach
CCP	Central counterparty
CEM	Current Exposure Method
CFA	Client facing affiliate
CFTC	Commodity Futures Trading Commission
CIS	Collective investment schemes
CMS	Capital Market Services
CPMI	Committee on Payment and Market Infrastructures
CPSS	Committee on Payment and Settlement Systems
CVA	Credit valuation adjustment
ETF	Exchange traded fund
FRR	Securities and Futures (Financial Resources) Rules
FX	Foreign exchange
GCP	General clearing participant
HKEX	Hong Kong Exchanges and Clearing Limited
HKMEx	Hong Kong Mercantile Exchange Limited
HSHKLCI	Hang Seng Hong Kong LargeCap Index
HSHKMCI	Hang Seng Hong Kong MidCap Index
HSMI	Hang Seng Composite MidCap Index
IOSCO	International Organization of Securities Commissions
LC	Licensed corporation
LFE	Leveraged foreign exchange
MAS	Monetary Authority of Singapore



NDF	Non-deliverable forward
OTC	Over-the-counter
OTCD	Over-the-counter derivatives
PDPO	Personal Data (Privacy) Ordinance (Cap. 486)
PFE	Potential future exposure
PFMI	Principles for financial market infrastructures issued by CPSS and IOSCO
PICS	Personal Information Collection Statement
QCCP	Qualifying central counterparty
RA	Regulated activity
RBA	Risk booking affiliate
RCCP	Regulated central counterparty
RLC	Required liquid capital, as defined in section 2(1) of the FRR
SBL	Securities borrowing and lending
SEC	Securities and Exchange Commission
SFAO	Securities and Futures (Amendment) Ordinance 2014
SFC	Securities and Futures Commission
SFO	Securities and Futures Ordinance
SMRA	Standardized Market Risk Approach
SOCRA	Standardized OTCD Counterparty Credit Risk Approach



I. Executive Summary

1. On 17 July 2015, the SFC issued a consultation paper on certain proposed changes to the FRR which aimed to provide for capital and other prudential requirements for OTCD activities engaged in by LCs, and to update the requirements in certain areas of the FRR which are not specific to OTCD activities in light of recent market developments.
2. A total of 17 submissions were received from various market practitioners, professional firms and industry associations. Four respondents requested that their submissions be published without disclosing their names. A list of the respondents (other than those who requested that their names not be published) is set out in Appendix 2.
3. The key comments received, together with the SFC's responses thereon, are discussed in detail in Part II. The full text of the submissions (other than those who requested that their submissions not be published) can be viewed on the SFC's website at www.sfc.hk.

Key comments on proposed changes related to OTCD activities

4. In respect of the proposed capital regime for OTCD activities carried out by LCs, respondents were supportive of implementing a prudent and internationally consistent capital regime and benchmarking the capital requirements to international standards, and adapting the requirements to local market characteristics. Most of the comments were in respect of the level of minimum capital required of OTCD dealers, especially those central dealing desks of fund managers whom the respondents suggested should be subject to lower minimum capital requirements than ordinary OTCD dealers.
5. Taking the limited scope and risk of such a business model into consideration, we have proposed lower minimum capital requirements (i.e. a HK\$30 million paid-up share capital requirement and a HK\$15 million floor RLC) for fund managers' central dealing desks which meet certain conditions. Details of the proposal are discussed in Section A of Part II.
6. Comments on the proposed market risk and counterparty credit risk frameworks were generally technical in nature. Respondents also opined that a longer transitional period would be necessary for implementing the proposed changes.
7. After due consideration of the comments received and the regulatory objectives of the proposals, modifications have been made to some proposals and additional proposals have been introduced, which are summarized below:
 - (a) relaxing the OTCD de minimis thresholds by setting the thresholds at 50% of the transitional, instead of the final, US registration thresholds, and including only OTCD activities involving products falling within the definition of "OTC derivative product" under the SFAO in the calculation of an LC's OTCD activity level for comparing with the OTCD de minimis thresholds for the purpose of applying OTCD de minimis reduction;
 - (b) requiring LCs seeking to rely on OTCD de minimis reduction to notify us in writing within one business day of applying the reduced capital requirements confirming that their activity level does not exceed any of the OTCD de minimis thresholds, to carry out a comparison of their OTCD activity level with the OTCD de minimis thresholds on a semi-annual basis, as well as to notify the SFC in writing within



one business day of becoming aware that their activity level exceeds any of the OTCD de minimis thresholds, and allowing a three-month grace period for LCs which cease to qualify for OTCD de minimis reduction to acquire capital;

- (c) refining the definitions of “equity” and “marketable debt securities” for greater clarity;
- (d) modifying the general interest rate risk charge calculation for onshore and offshore interest rate risk exposures denominated in a controlled currency;
- (e) renaming “controlled currency” as “non-freely floating foreign currency” and refining its definition to better reflect the policy intent;
- (f) deeming onshore and offshore positions in a non-freely floating foreign currency (e.g. positions in CNY and CNH are the onshore and offshore positions in Renminbi) to be positions in the same currency for foreign exchange risk charge calculation purpose such that opposite onshore and offshore positions can be offset, subject to a foreign exchange risk charge which equals 1.5% of one side of the matched positions, to cover execution risk and basis risk;
- (g) introducing for BMRA a similar market risk capital charge on non-standard instruments as that proposed under SMRA;
- (h) allowing LCs, subject to the SFC’s approval, to use Basel’s latest capital calculation approaches to calculate capital charges for market risk and/or counterparty credit risk;
- (i) allowing LCs to calculate PFE for OTCD transactions on a portfolio basis by reference to the net initial margin requirements on the portfolio;
- (j) updating the conditions for applying a lower risk weight to exposures to a clearing member of a Regulated CCP to align with the latest Basel standards and allowing a lower risk weight to be applied to exposures to a clearing intermediary which is a client of a clearing member of a Regulated CCP under certain conditions;
- (k) exempting exposures to clearing members of Regulated CCP from CVA Charge provided that the exposures qualify for a 2% risk weight in SOCCRA;
- (l) allowing LCs to make a deduction for the amount of CCR Charge already imposed on the current exposure to a counterparty in the calculation of the Counterparty Concentration Charge in respect of that counterparty and in the calculation of Liquidity Adjustment concerning the same exposure;
- (m) fine-tuning the three-tier sliding scale for determining the Counterparty Concentration Charge percentage;
- (n) fine-tuning the specified liquidity risk management measures, such as elaborating on the qualifying criteria for assets constituting liquid reserve and specifying the timeframe for establishing liquid reserve and submitting emergency funding plan;
- (o) excluding collateral posted by LCs from the application of Counterparty Concentration Charge, Liquidity Adjustment and specified liquidity risk management measures;



- (p) reducing the haircut percentage for exposures to clearing members of Regulated CCP fulfilling certain conditions under BOCCRA;
 - (q) allowing LCs using SOCCRA to adopt Basel comprehensive approach (subject to certain modifications) to calculate the capital requirements for repurchase (“repo”) transactions and securities borrowing and lending (“SBL”) (collectively “repo-style transactions”);
 - (r) updating the criteria for approval of use of an internal models approach to reflect the latest Basel standards, such as allowing the use of expected shortfall as the measurement of market risk and requiring the use of a non-model-based approach to calculate the capital floor, and modifying the proposal on applying a leverage ratio requirement on LCs with approval to use the internal models approach; and
 - (s) modifying the transitional arrangements for compliance with the new minimum capital requirements for some regulated OTCD activities and for adoption of SMRA and SOCCRA, including extending the transitional period from six months to one year.
8. Separately, we noted in a survey on intermediaries’ OTCD activities conducted in 2016² (“**OTC Derivatives Activities Survey 2016**”) that some OTCD dealers induced clients to enter into OTCD transactions with their affiliates. It was further noted that there existed arrangements whereby all or part of the trading losses caused by market movements on the proprietary transactions booked in the affiliates could be transferred to and shared by the OTCD dealers. The entering into such trading loss sharing arrangements by the OTCD dealers rendered them de facto indemnifying their affiliates’ proprietary trading losses, which could result in negative impacts on their liquid capital.
9. It is plausible that similar trading loss sharing arrangements also exist in LCs not dealing in OTCD. In order to ensure that LCs entering into such arrangements have sufficient capital to cover the risks they undertake, we propose to require such LCs to provide liquid capital for the market risks of proprietary transactions of affiliates covered by the arrangements in a timely manner.

Proposed changes not specific to OTCD activities and additional technical changes

10. Respondents generally welcomed the proposals not specific to OTCD activities except the proposed cap on LCs’ uncollateralized receivables from affiliated banks and brokers, which was generally considered to be too restrictive. After due consideration of the comments received and the underlying regulatory objectives of the proposed cap, we plan to replace it with a proposed control requirement which requires LCs to properly manage their financial exposures to affiliates in the same manner as exposures to independent third parties, undertaken on an arms-length basis by the LCs, in order to balance the operational needs of LCs and investor protection while raising their awareness of the importance of interconnectedness risk management.
11. We have also made the following modifications to certain proposals not specific to OTCD activities:

² The SFC conducted a survey in June 2016 to collect information about activities concerning OTC derivative products or transactions engaged in by intermediaries and their affiliated corporations.



- (a) allowing LCs to calculate haircut percentage for a basket of equities/debt securities or an index representing a basket of equities/debt securities underlying equity-linked instruments or index funds tracking an equity or debt securities index on a weighted average basis with the SFC's approval;
- (b) defining the haircut percentage for an index fund (including ETFs) that tracks debt securities index to be equal to the haircut percentage for its underlying debt securities index, in addition to the original proposal of applying similar approach to an index fund that tracks equity index; and
- (c) capping the maximum haircut amount on long holding of a security or investment with leverage at 100% of the market value of the security or investment.

12. In addition, the following summarizes key additional technical changes proposed in light of the comments received and market developments:

- (a) adding four Mainland commodity exchanges (namely, Dalian Commodity Exchange, Shanghai Futures Exchange, Shanghai International Energy Exchange and Zhengzhou Commodity Exchange) to the list of specified exchanges in Schedule 3 to the FRR;
- (b) clarifying the treatments of receivables from and cash deposited with clearing houses or dealers relating to clearing of securities and other transactions;
- (c) allowing LCs to include in liquid assets client monies received for settling outstanding securities transactions of the clients;
- (d) allowing an LC, who acts as a main underwriter, to include in liquid assets outstanding underwriting fee receivable up to the amount of the sub-underwriting fee payable by it, if the settlement of the latter is contingent upon the collection of the underwriting fee by it;
- (e) allowing an LC to exclude the amount of recognized liabilities arising from a tenancy agreement entered into by it in respect of its business premises from its ranking liabilities up to the amount of recognized assets arising from the tenancy agreement which is not included in its liquid assets, and to exclude such recognized liabilities from its variable RLC calculation, in view of a recent change in accounting standard;
- (f) rationalizing the definitions of "qualifying debt securities" and "special debt securities", including substituting the term "structured note" for "indexed bonds" to cater for evolving market developments and to provide greater clarity, and replacing listing status by marketability as a qualifying criterion;
- (g) assigning a 20% haircut to constituents of the Hang Seng Composite LargeCap Index and exempting them from being classified as illiquid collateral for FRR purpose;
- (h) applying a 1.5% capital charge in the form of ranking liabilities on one side of the matched onshore and offshore positions in a non-freely floating foreign currency that have been set off in net position calculation to cover execution and basis risks;



- (i) recognizing credit ratings issued by Fitch Ratings, in addition to credit ratings issued by Moody's and Standard & Poor's, in order to align with the practices of other jurisdictions; and
- (j) permitting the use of fair value determined in accordance with generally accepted accounting principles for valuation of trading positions etc.³ in the absence of a published market price to align with the latest accounting standards.

Conclusion on a previous consultation

- 13. Part III of this paper summarizes the responses to an earlier consultation on proposals to add certain commodity exchanges, including the now defunct HKMEx, to the list of specified exchanges in the FRR⁴ and to update the names of certain exchanges specified in the FRR that have changed their names. A total of five submissions were received from professional bodies, market participants and other interested parties. The respondents generally supported the proposal. A list of the respondents who submitted their views on that consultation is attached in Appendix 3 (other than those who requested that their submissions not be published). The full text of their submissions can be viewed on the SFC's website at www.sfc.hk.
- 14. The list of exchanges specified in the FRR and the names of the exchanges on the list will also be updated to reflect market developments and changes in the exchange names since the aforesaid consultation. We also propose to include a new provision in the FRR to ensure that a reference to an exchange or a clearing house in the FRR will survive any subsequent name change or succession of the exchange/clearing house by another exchange/clearing house (whether by reason of merger, amalgamation or otherwise).

Consultation on draft amendment rules

- 15. Given the volume and complexity of the capital requirements proposed for OTCD activities, the related rule drafting process will take time to finish. On the other hand, the rule drafting for those changes not specific to OTCD activities is simpler. In light of a respondent's suggestion to prioritize the finalization of those changes not specific to OTCD activities in order that the industry can benefit from those changes earlier, we have drafted the FRR amendments for implementing the changes which are not specific to OTCD activities and attached the same in Appendix 1 for consultation.
- 16. The drafting of the FRR amendments for implementing the changes related to OTCD activities is in progress. Once these draft FRR amendments are ready, we will consult the public.

³ Subject to similar exceptions as in the current FRR.

⁴ The consultation was conducted on 4 May 2011, and the conclusion was put on hold due to the cessation of business of HKMEx.



II. SFC's responses to the comments received

A. Capital regime and minimum capital requirements for LCs engaging in OTCD activities

17. We proposed in the consultation paper to apply the FRR's liquid capital regime to LCs engaging in OTCD activities and supplement the liquid capital requirement with a fixed-dollar baseline capital requirement (which may be a paid-up share capital or tangible capital requirement, depending on the nature of the OTCD activity conducted by the LC).
18. We received support for implementing a prudent and internationally consistent capital regime, which is adapted to local market characteristics, for LCs conducting OTCD activities. Respondents' comments on the proposed capital regime were mainly centered on the level of the proposed minimum capital requirements.

Proposed minimum capital requirements for RA11 dealers⁵ and Non-RA11 OTCD dealers⁶ (collectively "OTCD dealers")

19. For ease of reference, the minimum capital requirements for the different types of OTCD dealers as proposed in the consultation paper are summarized below:

Type of OTCD dealers	Minimum paid-up share capital requirement	Minimum tangible capital requirement	Minimum liquid capital requirement = The higher of (i) variable RLC; and (ii) the following floor RLC
LC dealing in OTC derivative products and not approved to use the internal models approach			
- RCCP-cleared OTCD dealers ⁷	HK\$30 million	Not applicable	HK\$15 million
- Where the LC is not an RCCP-cleared OTCD dealer and qualifies for OTCD de minimis reduction	Not applicable	HK\$500 million	HK\$78 million
- In any other case	Not applicable	HK\$1 billion	HK\$156 million
LC dealing in OTC derivative products and approved to use the internal models approach	Not applicable	HK\$2 billion	HK\$156 million

⁵ RA11 dealer refers to an LC which is licensed for Type 11 RA, permitting it to deal in OTC derivative products.

⁶ Non-RA11 OTCD dealer is an LC licensed for Type 1, 2 or 3 RA which deals in OTC derivative products but is exempt from licensing for Type 11 RA because it is already licensed for the first-mentioned RA.

⁷ RCCP-cleared OTCD dealers refer to LCs which engage in dealing in or trading of OTCD and all such OTCD transactions are cleared through a Regulated CCP and the LC does not provide clearing or settlement agency services for OTCD transactions.



Proposed minimum capital requirements for OTCD dealers approved to use internal models approach

20. Respondents' comments were mainly centered on the proposed HK\$2 billion minimum tangible capital requirement for LCs approved to use the internal models approach. Some respondents argued that HK\$2 billion is too prudent, mainly for the following reasons:
- (a) the HK\$2 billion net asset requirement for issuers of listed structured products under the Listing Rules of HKEX was not considered as an appropriate benchmark because the scale of business of an RA11 dealer is not necessarily comparable to a listed structured products issuer;
 - (b) the proposed amount is higher than similar capital requirements proposed by other jurisdictions;
 - (c) a higher minimum tangible capital requirement will discourage the use of internal models; and
 - (d) model risk can be mitigated through supervision and model validation.
21. Two counterproposals suggesting HK\$1 billion and HK\$775 million respectively as the minimum tangible capital requirement for LCs approved to use the internal models approach were received.
22. We maintain our view that the proposed HK\$2 billion minimum tangible capital requirement for LCs approved to use the internal models approach is appropriate for the following reasons:
- (a) according to the OTC Derivatives Activities Survey 2016, the majority of the responding OTCD dealers have outstanding OTCD positions of comparable size to that of a listed structured product issuer; accordingly, it is justifiable to refer to the HK\$2 billion net asset requirement for listed structured product issuers as a benchmark;
 - (b) as explained in the consultation paper⁸, it is justifiable to set the tangible capital requirement for OTCD dealers at a level higher than the corresponding capital requirement proposed by the SEC for registered standalone security-based swap dealers because of the potentially higher model risks caused by the potentially wider scope of application of internal models in regulatory capital calculation by OTCD dealers than the latter. In addition, the SEC applies a notification requirement on dealers approved to use internal models whereby the dealers are required to notify the SEC when their tentative net capital falls below US\$5 billion (equivalent to HK\$39 billion). It is understood that, given this notification requirement, such dealers would maintain their capital above this notification threshold, rendering this threshold their de facto minimum capital requirement;
 - (c) it is essential for such LCs to maintain sufficient capital as backstop for model risks to ensure their financial stability. It is understood that regulators in other

⁸ Please refer to paragraph 130 of the consultation paper.



jurisdictions also take a very prudent stance on model approval, with approval granted sparingly and only to well-capitalized and well-managed banks and financial institutions; and

- (d) LCs seeking approval for use of the internal models approach are already required to adopt similar model validation and supervision standards as the Basel Capital Accord. Accordingly, there is little (if any) room to require them to adhere to a higher standard.

23. One respondent suggested permitting LCs to use parental guarantee to fulfill the tangible capital requirement. We do not consider parental guarantee acceptable for this purpose because it is generally not accepted as a substitute for regulatory capital and may not be reliable in a crisis situation.

Proposed tangible capital requirement for OTCD dealers not using internal models approach

24. There is support for our proposal, whereas some respondents queried whether the requirement is necessary or the proposed amount of HK\$1 billion is too much. Their bases of query mainly included the following:

- (a) a benchmark referred to in the consultation paper, namely the MAS S\$200 million group shareholders' funds requirement⁹ for CMS license applicants, only applies to firms dealing with retail investors, and no such requirement applies to CMS licensees dealing with institutional investors or to entities engaging in intra-group derivative transactions;
- (b) the proposal is modelled on the SEC's tentative net capital requirement for internal model users, which is designed to provide a capital cushion against model risk, but an RA11 dealer not using internal models is not subject to model risk, and the SEC and the CFTC did not propose to apply a similar tangible capital requirement to swap dealers that do not use internal models; and
- (c) the proposal does not take into account the possibility of an LC adopting a booking model whereby its market risks are transferred to its affiliate(s). The respondent counter-proposed that the tangible capital requirement should be set between HK\$100 million and HK\$500 million if the LC adopts such a booking model.

25. We have the following responses:

- (a) the abovementioned MAS requirement is a relevant benchmark because under our regime, OTCD dealers are not forbidden to deal with retail investors. We also maintain that our proposed tangible capital requirement should apply to OTCD dealers, whether they deal with retail investors or not, in order to address the risks and concerns discussed in paragraph 140 of the consultation paper;
- (b) our proposed capital regime for OTCD dealers allows them to use a Basel-like approach to calculate liquid capital, whereas similar approaches would only be available in the US to dealers who are approved to use internal models and maintains at least US\$100 million tentative net capital. It is therefore considered

⁹ Equivalent to approximately HK\$1.1 billion.



justifiable to apply a substantial baseline capital requirement to OTCD dealers who will be using the Basel-like capital approach. The consultation paper has also explained that a higher amount than the aforementioned SEC tentative net capital requirement was proposed because RA11 dealers can deal in OTCD of a potentially wider range of underlying assets than their US counterparts; and

- (c) while passing its market risks to affiliates may reduce the LC's market risk exposure, the risk mitigation effect of such a practice has already been taken into account in the proposed Basel-like market risk capital framework. On the other hand, such a practice may come with additional risks, such as counterparty concentration risk, as such back-to-back transactions are often entered into with one or only a few affiliates. As discussed in paragraph 140 of the consultation paper, the counterparty credit risk capital charges calculated by the Basel-like approach may not be sufficient for covering the actual loss when a major counterparty defaults. With counterparty credit risk being concentrated in only a few affiliates, the interconnectedness risk of the LC will also increase. Maintaining a substantial tangible capital would help to cover such a residual risk.

- 26. One respondent suggested that the amount of tangible capital requirement for RA11 dealers not using the internal models approach should be set with reference to the results of the impact study conducted by us. Another respondent suggested validating the sufficiency of the proposed tangible capital requirement under abnormal or extreme conditions by conducting a scenario analysis.
- 27. The results of the impact analysis have already been duly taken into consideration when the proposal was made. Please refer to paragraphs 212 to 214 of the consultation paper for details. Moreover, according to the OTC Derivatives Activities Survey 2016, the average outstanding OTCD positions (in notional amounts) of those OTCD dealers who reported entering into OTCD contracts under their own names and planning to conduct the same when the licensing regime becomes effective is HK\$431 billion. The proposed HK\$1 billion tangible capital requirement represents only 0.2% of their average outstanding positions.
- 28. In light of the above, we maintain our view that it is necessary to subject OTCD dealers not using the internal models approach to the HK\$1 billion minimum tangible capital requirement.

Proposed floor RLC for OTCD dealers not using internal models approach

- 29. One respondent opined that the proposed HK\$156 million floor RLC for RA11 dealers is too high because CFTC does not have any liquid capital requirement for registered standalone swap dealers¹⁰.
- 30. As we pointed out in the consultation paper, the proposed US\$20 million benchmark is considered appropriate because the scope of activities of RA11 dealers is comparable to or even broader than that of a SEC-registered standalone security-based swap dealer and a CFTC-registered swap dealer cum futures commission merchant, both of which would be subject to a US\$20 million minimum net capital (or its equivalent) requirement under the SEC/CFTC's proposed rules.

¹⁰ It should be noted that CFTC-registered standalone swap dealers, while not being subject to a net capital requirement, would be required to meet a tangible net equity requirement of at least US\$20 million under the CFTC's proposed rules.



Additional proposal – minimum capital requirements for fund management central dealing desks

31. One respondent advised that it would not be proportionate to apply the same capital requirements of OTCD dealers to central dealing desks¹¹ of fund management companies as the latter's associated financial, market and counterparty credit risks are much lower than an ordinary OTCD dealer because:
- (a) central dealing activities are carried out only for asset management clients of the fund management company or of an affiliated fund management company. The role of the central dealing desk is merely passing on the orders of the fund managers to other brokers or counterparties for execution without the central dealing desk itself contracting as a counterparty to the OTCD transactions executed;
 - (b) the settlement of the OTCD transactions so executed is performed directly between the broker/counterparty concerned and the asset management client's custodian; and
 - (c) the central dealing desk does not carry any associated positions on its book and is therefore not exposed to any market or counterparty credit risks in relation to the OTCD transactions so executed.
32. The respondent suggested exempting central dealing desks from the proposed minimum capital requirements if their OTCD dealing is limited in the following ways:
- (a) it is not a counterparty to the OTCD transactions dealt with by it and does not carry any client position or margin on its own book; and
 - (b) it is not a member of an approved exchange or designated clearing house.
33. Alternatively, the respondent suggested substantially reducing the minimum capital requirements for fund management companies licensed for Type 11 RA if they are so licensed merely for the purpose of routing OTCD orders to brokers on behalf of overseas affiliates and clients.
34. Another respondent representing the fund management industry advised that some Non-RA11 OTCD dealers may engage in only limited (both in scope and frequency) OTCD activities, and suggested that they should be subject to the minimum paid-up share capital requirement and floor RLC applicable to RA11 dealers that engage in only cleared transactions.
35. We take this opportunity to clarify that fund management companies licensed for Type 9 RA are already exempt from licensing for Type 11 RA (and similarly for Type 1, 2 or 3 RA as far as their OTCD dealing is concerned) if their OTCD dealing is incidental to the performance of their licensed Type 9 RA.
36. Regarding OTCD dealers having a limited level of OTCD activities, our proposals already included a mechanism to reduce their capital requirements, namely the OTCD de minimis

¹¹ The central dealing desk may be a department of the fund management company or a separate legal entity within the same group as the fund management company placing orders to it.



reduction, whereby the applicable minimum capital requirements for an OTCD dealer with fewer activities would be reduced by half.

37. In light of the above submissions, we agree that the business model and associated risks of the OTCD dealing carried out by central dealing desks of fund management companies are different from a typical OTCD dealer as highlighted by the respondents. If a central dealing desk only assumes a very limited role in the OTCD transactions it handled and has limited or no liability in respect of those OTCD transactions, it would be justifiable to apply lower minimum capital requirements to it.
38. Accordingly, we propose to introduce lower capital requirements for any OTCD dealer meeting the following conditions (such dealer is referred to as “**OTCD central dealing desk dealer**”):
- (a) in respect of any dealing in OTC derivative products (including similar dealing which falls within Type 1, 2 or 3 RA for the purpose of this proposal) it carries out, other than those carried out incidentally to any Type 9 RA for which it is licensed,
 - (i) it only handles, in an agency capacity, orders placed by
 - an asset management company which is within the same group as it and is licensed for Type 9 RA; or
 - an asset management company which is within the same group as it and carries on a business in a specified jurisdiction¹² outside Hong Kong which, if carried on in Hong Kong, would constitute Type 9 RA, under an authorization (however described) by an authority or regulatory organization in that jurisdiction;for client accounts in the course of carrying on the Type 9 RA or that business;
 - (ii) it does not hold client assets;
 - (iii) it is not a contracting party to any OTCD transactions executed in the course of such dealing¹³, whether as principal or agent;
 - (iv) it will not incur any liability to the contracting parties¹⁴ to the OTCD transactions executed in the course of such dealing except for its own negligence, willful default or fraud; and
 - (v) it does not carry out any market making activity in such dealing itself or on behalf of the asset management company referred to in (i) above or the clients of that asset management company.

¹² It is proposed that specified jurisdictions include Australia, Canada, China, France, Germany, Ireland, Japan, Luxembourg, Malaysia, Netherlands, Singapore, Switzerland, Taiwan, the UK, the US and any other jurisdiction specified by the SFC.

¹³ In the case where a fund manager holds delegated authority as an agent to sign OTCD contracts on behalf of its clients and as a result its name appears in the OTCD contract as a signing agent for its clients, the fund manager will not be considered as a contracting party to the OTCD contract for the purpose of determining whether it fulfils this condition.

¹⁴ Signing agents will not be considered as contracting parties to OTCD transactions for the purpose of determining whether an LC fulfils this condition.



39. Since OTCD central dealing desk dealers are not allowed to be the contracting party to any OTCD contract executed in the course of their dealing in OTC derivative products, they will not be exposed to the counterparty credit risk and market risk of such OTCD contracts. Moreover, they are allowed to take OTCD orders from regulated asset managers within the same group only. Given these restrictions, it would be justifiable to subject OTCD central dealing desk dealers to lower minimum capital requirements than ordinary OTCD dealers.
40. Among the various proposed minimum capital requirements for different types of OTCD dealers, the lowest minimum capital requirements are the HK\$30 million paid-up share capital and HK\$15 million floor RLC requirements that apply to RCCP-cleared OTCD dealers. Unlike RCCP-cleared OTCD dealers, OTCD central dealing desk dealers can deal in non-cleared contracts which may involve a wider scope of product types and complexity and a wider range of underlying asset classes. Accordingly, it would seem reasonable to require them to maintain more financial resources than a RCCP-cleared OTCD dealer for running their business, including maintaining suitably qualified staff to understand the products they deal in so as to control their operational risks (such as legal risk, compliance risk, etc).
41. On the other hand, the nature of the dealing activities conducted by OTCD central dealing desk dealers bears some similarities to those of approved introducing agents for Type 3 RA in that their roles are similar to an introducing agent and they are not liable for the market or credit risk or other liabilities arising from the transactions they introduce. Approved introducing agents for Type 3 RA are subject to a minimum paid-up share capital requirement of HK\$5 million and a floor RLC of HK\$3 million. That said, since OTCD central dealing desk dealers can deal in a wider scope of product types and complexity and a wider range of underlying asset classes than approved introducing agents for Type 3 RA, it is justifiable to request them to maintain a higher capital amount.
42. In view of the above, and in the absence of an appropriate international benchmark for the amount of capital that should be maintained for the risks faced by OTCD central dealing desk dealers, it is proposed to subject OTCD central dealing desk dealers to a minimum paid-up share capital requirement of HK\$30 million and a floor RLC of HK\$15 million.
43. As OTCD central dealing desk dealers are not allowed to hold positions in OTCD in respect of their dealing in OTC derivative products, it is proposed to exclude them from the application of SMRA and SOCCRA. Nevertheless, considering that some of them may be interested in adopting SMRA and/or SOCCRA to calculate market and/or counterparty credit risk capital requirements for their proprietary positions, it is proposed to permit these dealers to opt into SMRA and/or SOCCRA using the same mechanism that applies to other LCs.

Question 1:

Do you agree that OTCD central dealing desk dealers should be subject to the proposed HK\$30 million minimum paid-up share capital requirement and HK\$15 million floor RLC?



Modified proposals on reduced tangible capital requirement and floor RLC of OTCD dealers that engage in limited OTCD activities (“OTCD de minimis reduction”)

44. Respondents were generally supportive of the proposal of reducing the tangible capital requirement and floor RLC for OTCD dealers which have a low level of OTCD activities.
45. A few respondents considered the OTCD de minimis thresholds should be set at a higher level or at a level comparable or equal to the US registration thresholds.
46. The design of the OTCD de minimis reduction mechanism inevitably involves a judgmental decision on when an OTCD dealer would qualify for a reduction of minimum capital requirements (i.e. the triggering threshold) and how much the reduction should be. As our minimum capital requirements are benchmarked to those in the US for similar businesses, the percentage of the US registration thresholds at which the OTCD de minimis thresholds are set provides an objective basis for determining the percentage of the full amounts of minimum capital requirements at which the reduced minimum capital requirements should be set when the OTCD de minimis reduction is applied. If the OTCD de minimis thresholds are set at a very high percentage of the US registration thresholds, the reduced minimum capital requirements would be very close to the full amounts of minimum capital requirements, hence the reduction available to the LC would be very small. Therefore, we maintain our view that the current approach (i.e. reducing the minimum capital requirements by 50% when the OTCD dealer’s OTCD activities fall below 50% of the US registration thresholds) strikes a right balance between simplicity and fair treatment of OTCD dealers with a low level of activity.
47. One respondent suggested adopting the transitional US registration thresholds as OTCD de minimis thresholds and reserving the right to lower the OTCD de minimis thresholds when the final US registration thresholds are adopted by the US.
48. We understand that the US registration thresholds adopt a phase-in approach whereby higher thresholds apply during the transitional period¹⁵. On 13 October 2016, the CFTC extended the transitional period to 31 December 2018 from 31 December 2017 so as to allow more time and data to determine an appropriate level of registration thresholds.
49. In light of this development, we agree to benchmark the OTCD de minimis thresholds to the transitional, instead of the final, US registration thresholds. In other words, the OTCD de minimis thresholds will equal 50% of the transitional US registration thresholds. This should avoid leaving a big gap between the US registration thresholds and our OTCD de minimis thresholds. We will continue to monitor the development of the US registration thresholds and adjust the OTCD de minimis thresholds where necessary.
50. One respondent commented that the broader scope of the definition of “OTCD” under the FRR compared to the definition of “OTC derivative product” under the SFAO would make it easier for OTCD dealers to exceed the OTCD de minimis thresholds.
51. We have revisited the need for the FRR to maintain its own definition of “OTCD” and concluded that it would avoid interpretation problems if the FRR adopts the SFAO’s definition of “OTC derivative products” instead of creating its own definition. With this

¹⁵ The US registration thresholds adopt aggregate gross notional amounts of US\$400 million and US\$8 billion respectively for security-based swap dealing and other swap dealing during the transitional period. Upon the expiry of the transitional period, these thresholds will be lowered to US\$150 million and US\$3 billion respectively.



change, only OTCD activities involving products falling within the definition of “OTC derivative product” under the SFAO will be included in the calculation of the LC’s OTCD activity level for comparing with the OTCD de minimis thresholds for the purpose of applying OTCD de minimis reduction.

52. Another respondent commented that the inclusion of non-regulated OTCD activities along with regulated OTCD activities in the calculation of OTCD activity level would reduce the number of local market players eligible for OTCD de minimis reduction.
53. While excluding non-regulated OTCD activities from the calculation of OTCD activity level may theoretically reduce the likelihood of an OTCD dealer exceeding the OTCD de minimis thresholds (thus increasing the likelihood of qualifying for the OTCD de minimis reduction), requiring OTCD dealers to analyze their past 12 months’ OTCD activities into regulated and non-regulated activities may be overly burdensome and not cost-effective given that OTCD dealers’ non-regulated OTCD activities tend to be less significant compared to their regulated OTCD activities.
54. One respondent suggested excluding inter-affiliate OTCD transactions and hedging transactions from the calculation of the activity level of an OTCD dealer in order to align with the calculation methodology adopted by the SEC and the CFTC.
55. While the OTCD de minimis thresholds are based on the US registration thresholds, they are designed for different purposes and, therefore, it may not be appropriate to completely replicate the activity level calculation method of US registration thresholds for OTCD de minimis thresholds. The OTCD de minimis thresholds play a key role in determining the level of capital OTCD dealers should maintain to cover the residual risks of their business. Given this objective, the identity of the OTCD dealer’s counterparties or the purpose of the dealing do not seem to be of significance in the determination of its activity level.
56. A respondent sought clarification on whether the OTCD transactions dealt with by a fund management company incidentally to its Type 9 RA shall be included in the calculation of OTCD activity level if it is also licensed for Type 11 RA.
57. It is clarified that, OTCD transactions which are incidental to the carrying on of the Type 9 RA the LC is licensed for should be excluded from the calculation of its OTCD activity level.
58. Two respondents suggested extending the application of the OTCD de minimis reduction to RA11 dealers approved to use the internal models approach on the grounds that the model risk would be mitigated by other means such as regulatory supervision and model validation and the dealer’s exposures might be limited.
59. We maintain our view that LCs seeking to use the internal models approach should be required to maintain substantial capital in order to cover model and other residual risks and maintain a robust risk management infrastructure.
60. For the avoidance of doubt, the OTCD de minimis thresholds will be defined as:
 - (a) for OTC derivative transactions in credit default swaps, an aggregate gross notional amount of transactions which the LC entered into for its own or its client account or cleared for another person over the preceding 12 months, of HK\$32 billion (equivalent to about US\$4 billion, which is half of the US\$8 billion used in the transitional US registration thresholds adopted by the SEC);



- (b) for OTC derivative transactions in security-based products (i.e. equities or debt instruments as underlying, other than those referred to in subparagraph (a) above), an aggregate gross notional amount of transactions which the LC entered into for its own or its client account or cleared for another person over the preceding 12 months, of HK\$1.6 billion (equivalent to about US\$200 million, which is half of the US\$400 million used in the transitional US registration thresholds adopted by the SEC); or
- (c) for OTC derivative transactions other than those referred to in subparagraphs (a) and (b) above, an aggregate gross notional amount of transactions which the LC entered into for its own or its client account or cleared for another person over the preceding 12 months, of HK\$32 billion (equivalent to about US\$4 billion, which is half of the US\$8 billion used in the transitional US registration thresholds adopted by the CFTC).

Additional proposals – implementation requirements relating to OTCD de minimis reduction

- 61. One respondent requested for more time to acquire capital once the OTCD de minimis thresholds are exceeded.
- 62. We stress that an LC applying the OTCD de minimis reduction must closely monitor the level of its OTCD activities against the OTCD de minimis thresholds. It must prudently assess whether and when it will be able to top up its capital to comply with the full amounts of minimum capital requirements (i.e. without the benefit of OTCD de minimis reduction) in case any of those thresholds is exceeded, and formulate its business/capital plan accordingly.
- 63. In view of the magnitude of the increases in capital requirements that would result from exceeding the OTCD de minimis thresholds, we propose to allow a three-month grace period for an LC which ceases to qualify for the OTCD de minimis reduction to acquire capital such that it would only be required to comply with the full amounts of the applicable minimum capital requirements after the expiry of the grace period.
- 64. Moreover, in order to ensure only eligible LCs can apply the OTCD de minimis reduction, we propose to require LCs applying the OTCD de minimis reduction to notify us in writing within one business day of applying the reduction confirming that their OTCD activity level does not exceed any of the OTCD de minimis thresholds.
- 65. Furthermore, in order to reduce the administrative burden and volatility of the capital requirements of LCs applying the OTCD de minimis reduction, we propose to require them to compare their OTCD activity level with the OTCD de minimis thresholds on a semi-annual basis at the end of June and December each year, instead of on a rolling basis. Such dealers would also be required to notify us in writing within one business day of becoming aware that their activity level exceeds any of the OTCD de minimis thresholds and in any event no later than the end of the first calendar month immediately following the cut-off date adopted in the aforesaid comparison exercise. This one-month period is intended for allowing LCs sufficient time to collate transaction statistics for carrying out the comparison exercise.



Proposed minimum capital requirements for Non-RA11 OTCD dealers which are LFE traders

66. We proposed in the consultation paper that LFE traders whose LFE trading is confined to rolling forex trading (which may amount to dealing in OTC derivative products) should not be classified as Non-RA11 OTCD dealers for FRR purposes. In other words, such firms will continue to be subject to the existing minimum capital requirements that apply to Type 3 RA. All respondents welcomed the proposal.

Proposed minimum capital requirements for RCCP-cleared RA11 dealers

67. We received support for the proposed minimum capital requirements for RCCP-cleared RA11 dealers. We will proceed to apply those requirements accordingly.
68. Respondents also supported using a similar concept as qualifying central counterparty (“**QCCP**”) under the Basel Capital Accord as the benchmark for the definition of Regulated CCP. One respondent suggested providing greater clarity on the concept of “central counterparty approved by the SFC”.
69. As stated in the consultation paper, approval of CCPs as Regulated CCPs will be granted based on a set of criteria. The approval criteria will mainly be benchmarked to the qualifying criteria for QCCP under the Basel Capital Accord, subject to some modifications to address the differences between the FRR’s liquid capital regime and the Basel Capital Accord, and include compliance with the PFMI issued by the Committee on Payment and Market Infrastructures (“**CPMI**”) (formerly known as CPSS) and IOSCO.

Proposed minimum capital requirements for RA11 advisers and non-RA11 OTCD advisers¹⁶ (collectively “OTCD advisers”)

70. The minimum capital requirements for OTCD advisers as proposed in the consultation paper are summarized below:

LC advising on, but not dealing in, OTC derivative products	Minimum paid-up share capital requirement	Minimum liquid capital requirement = The higher of (i) variable RLC; and (ii) the following floor RLC
- Subject to the licensing condition of not holding client assets	Not applicable	HK\$100,000
- In any other case	HK\$5 million	HK\$3 million

71. We received substantive support for the proposed minimum capital requirements for OTCD advisers. We will proceed to apply these requirements accordingly.

¹⁶ A Non-RA11 OTCD adviser is an LC licensed for Type 4 or 5 RA which advises on OTC derivative products but is exempt from licensing for Type 11 RA because it is so licensed.



Proposed minimum capital requirements for Type 12 RA

72. The minimum capital requirements for Type 12 RA as proposed in our consultation paper are summarized below:

Type 12 RA	Minimum tangible capital requirement	Minimum liquid capital requirement = The higher of (i) variable RLC; and (ii) the following floor RLC
- Where the LC qualifies for OTCD de minimis reduction	HK\$1 billion	HK\$195 million
- In any other case	HK\$2 billion	HK\$390 million

73. We received support for our proposal to set a higher capital requirement for Type 12 RA than OTCD dealers. One respondent was concerned that the high capital requirements may limit the number of clearing agents available and applying the same floor RLC to both clearing agents and clearing members of OTC Clear may impede the function of indirect clearing.
74. We maintain our view that non-clearing members licensed for Type 12 RA should be subject to substantial capital requirements because the settlement, counterparty and default risks they face are comparable to clearing members. In addition, the proposed capital requirements for Type 12 RA will apply to all clearing agents which are so licensed whether they are OTC Clear members or not. Accordingly, non-clearing members are not disadvantaged compared to clearing members.
75. One respondent suggested differentiating the tangible capital requirement for clearing agents approved to use the internal models approach from those who are not approved to use the internal models approach.
76. As pointed out in the consultation paper, the HK\$2 billion tangible capital requirement for Type 12 RA is already very substantial. We maintain our view that it is not necessary to apply a higher tangible capital requirement for LCs licensed for Type 12 RA and approved to use the internal models approach. In case any LC's model risk justifies a higher capital requirement, we can vary its capital requirement on a case-by-case basis.
77. One respondent raised a concern that the arrangement of clearing services provided by asset managers for funds managed by them or their overseas affiliates might be caught under Type 12 RA, which would result in the substantial minimum capital requirements for Type 12 RA becoming applicable to such asset managers. He considered such assets managers should be subject to lower minimum capital requirements given that they do not carry the risks of the OTCD transactions on their books and are exposed to much lower credit risks. Another respondent further advised that the settlement of OTCD transactions is performed between the brokers/counterparties and the client's custodian. We noted the concerns raised which will be taken into consideration when the licensing requirement is implemented.



Modified proposals on reduced tangible capital requirement and floor RLC of LCs licensed for Type 12 RA and engaging in limited OTCD clearing activities

- 78. We received general support for the proposal to apply an OTCD de minimis reduction mechanism to LCs licensed for Type 12 RA. One respondent suggested increasing the OTCD de minimis thresholds in view of the higher level of OTCD activities carried out by LCs engaging in Type 12 RA.
- 79. As mentioned above, we have modified our proposal related to the OTCD de minimis reduction for OTCD dealers, including benchmarking the OTCD de minimis thresholds to the transitional US registration thresholds, which has the effect of raising the OTCD de minimis thresholds. Similar changes will be made to the OTCD de minimis reduction that apply to LCs licensed for Type 12 RA.
- 80. One respondent sought clarification on whether the proposed OTCD de minimis reduction would be applicable to LCs licensed for Type 12 RA and approved to use the internal models approach.
- 81. We confirm that the proposed OTCD de minimis reduction would not apply to any LC using the internal models approach for the same reasons as not applying the OTCD de minimis reduction to OTCD dealers using the internal models approach.

Proposed new component of variable RLC with regard to OTCD transactions

- 82. We proposed in the consultation paper to include in an LC's variable RLC calculation a certain percentage of the risk margin amounts on OTCD transactions entered into/cleared by the LC.
- 83. Respondents were generally supportive of adding the proposed new component of variable RLC with regard to OTCD transactions.
- 84. Two respondents tried to compare variable RLC with other jurisdictions' capital requirements for counterparty credit risk of CCPs. We clarify that variable RLC aims to capture the residual risk and leverage effect arising from OTCD transactions entered into or cleared by the LC. Counterparty credit risks of CCPs have been covered in the counterparty credit risk framework of the FRR.
- 85. Some suggestions on the charge percentages to be applied in the calculation of the new variable RLC component were received, including applying a single charge percentage for OTCD transactions cleared through different Regulated CCPs so as to align with the approach adopted for the counterparty credit risk framework, and applying a 5% charge on plain vanilla OTCD transactions as they are similar to listed products. There was also a suggestion to reduce all the charge percentages applied in variable RLC calculation, including those charge percentages currently applied to non-OTCD activities, but no justification was provided.
- 86. Our proposal of applying a 5% charge for OTCD transactions cleared through OTC Clear, instead of 8% as in the case of OTCD transactions cleared through other CCPs, is intended to align as far as possible the FRR requirement with OTC Clear's capital requirement on its members so as to minimize the difference between the two capital requirements and reduce the compliance burden of members of OTC Clear. Regarding the 8% charge percentage proposed for other OTCD transactions, it has been



benchmarked to the equivalent US requirements proposed by the SEC and the CFTC and no change is considered necessary.

87. One respondent suggested that an exemption should be granted to intra-group OTCD transactions in the calculation of variable RLC as such transactions pose limited risks to the financial market. The respondent further suggested exempting bilateral OTCD transactions that are conducted for hedging purpose to incentivize LCs to hedge their risks. The respondent further suggested aligning variable RLC with LCs' operational governance framework.
88. We support LCs managing their risks prudently. In this connection, extensive capital relief for hedged positions has been provided in the proposed market risk and counterparty credit risk frameworks. It would not be necessary to offer further capital relief in the variable RLC calculation. Moreover, given that the objective of the proposed new component of variable RLC is to capture residual risk of LCs' OTCD transactions, it is desirable for it to cover all OTCD transactions entered into or cleared by the LC.
89. Regarding the suggestion of aligning variable RLC with the LC's operational governance framework, we have considered the feasibility of such an approach, but have not identified any reliable basis for making such an alignment.
90. One respondent submitted that the floor initial margin amount (which is one of the parameters used in the calculation of the new variable RLC component), which is calculated based on the potential future exposure calculated by CEM, is likely to be substantially higher than the initial margin calculated by a model developed by an industry body. The main cause of the difference is the lack of netting and diversification benefits in the calculation of floor initial margin amount.
91. The floor initial margin amount is intended to ensure that the risk margin amounts applied in variable RLC calculation in respect of OTCD transactions not cleared through a Regulated CCP is not less prudent than the amount used by the FRR to measure the potential future exposure of the transactions. We maintain our view that the floor initial margin amount should be calculated based on the potential future exposure calculated by CEM in the absence of a margin amount independently calculated by a Regulated CCP.
92. One respondent raised a concern that the arrangement of OTCD clearing services by asset managers for funds managed by them or their overseas affiliates may be considered as "OTCD clearing", hence requiring the OTCD transactions concerned to be included in the calculation of the asset managers' variable RLC.
93. We noted the comment and clarify that OTCD transactions arranged for clearing by an LC (instead of through the LC), which will not be liable to any liability arising from the OTCD transactions when any party involved in the clearing process defaults, shall not be included in the calculation of the LC's variable RLC.



Proposed minimum capital requirements for the new Type 7 activity

94. The minimum capital requirements for the new Type 7 activity as proposed in the consultation paper are summarized below:

The new Type 7 activity	Minimum tangible capital requirement	Minimum liquid capital requirement = The higher of (i) variable RLC; and (ii) the following floor RLC
Provision of ATS for the trading of OTC derivative products	HK\$1 billion	HK\$156 million
Provision of ATS for the novation, clearing, settlement or guarantee of OTC derivative transactions	HK\$2 billion	HK\$390 million

95. One respondent supported the proposed minimum capital requirements for the new Type 7 activity. Another respondent suggested lowering the thresholds to attract more participants and promote competition in the industry. The remaining respondent suggested setting the capital requirements for the new Type 7 activity according to the nature, extent and volume of ATS activities and operational risk of the firm.
96. As OTCD trading and clearing platforms may have significant systemic risk implications, we maintain our view that it is necessary for their operator to maintain substantial capital to ensure they have adequate financial resources to properly maintain the platform and cover the related business risk. Moreover, as discussed in the earlier part of this paper, there is no reliable basis for aligning an LC's capital requirements with its operational governance framework. Similarly, it may not be feasible to constrain the volume of transactions that may be executed or cleared on the platform by the capital amount the operator has.
97. In light of the foregoing, no change to the proposed capital requirements is considered necessary.
98. One respondent sought clarification on whether the proposed minimum capital requirements for the new Type 7 activity would apply to ATS activities which do not involve OTCD transactions. We take this opportunity to clarify that the proposed capital requirements only apply to the new Type 7 activity, which is defined in the SFAO. Type 7 RA not involving the new Type 7 activity will be subject to the existing minimum capital requirements under the FRR.

Proposed minimum capital requirements for the new Type 9 activity¹⁷

¹⁷ The definition of Type 9 RA is expanded to cover the new Type 9 activity, namely OTC derivative products management.



99. We proposed in the consultation paper to subject LCs carrying on the new Type 9 activity to the same minimum capital requirements for Type 9 RA. Respondents were supportive of the proposal.
100. One respondent sought clarification on whether an asset manager who carries on OTCD dealing activities incidental to its Type 9 RA would be subject to the minimum capital requirements, for non-RA11 OTCD dealers.
101. We would like to clarify that asset managers licensed for the new Type 9 activity will be subject to the same minimum capital requirements for existing Type 9 RA. If their dealing in OTC derivative products is incidental to the new Type 9 activity, they are exempt from licensing for Type 11 RA.

Impact analysis

102. We have updated our impact analysis¹⁸ with the information obtained from the OTC Derivatives Activities Survey 2016¹⁹.
103. According to the survey:
- (a) 98 responding firms ("**responding OTCD dealing firms**") reported that they were dealing in OTC derivative products and will continue to carry out such activities when the licensing requirements for Type 11 RA become effective;
 - (b) four responding firms ("**responding OTCD clearing firms**") reported that they were providing client clearing services for OTC derivative transactions and will continue to provide such services when the licensing requirements for Type 12 RA become effective; and
 - (c) three responding firms ("**responding OTCD ATS firms**") reported that they were providing ATS for OTC derivative transactions and will continue to provide such services when the licensing requirements for new Type 7 RA become effective.
104. In addition, according to the financial returns submitted by LCs, six more firms reported that they had proprietary OTCD positions ("**existing OTCD dealing LCs**").
105. We have assessed the impact of the relevant proposed capital requirements on the above responding firms and existing OTCD dealing LCs (collectively referred to as "**covered firms**") by comparing their capital²⁰ with the capital requirements proposed. The comparison results are summarized below:

¹⁸ A similar impact analysis based on the information obtained from an OTCD survey conducted in November 2013 was included in the consultation paper.

¹⁹ For the purpose of the impact analysis, we have taken into account the responses of those existing LCs ("**responding LCs**") and non-licensed corporate affiliates of existing LCs ("**responding non-licensed LC affiliates**") (collectively referred to as "**responding firms**") which reported in the OTC Derivatives Activities Survey 2016 that (i) they were conducting OTCD activities in Hong Kong, including dealing in OTC derivative products, providing client clearing services for OTC derivative transactions, and/or providing ATS for OTC derivative transactions; and (ii) they will continue to conduct such activities when the licensing requirements for Type 11 RA, Type 12 RA and/or the new Type 7 RA become effective.

²⁰ For the purpose of this impact analysis, we have taken into account the paid-up share capital, liquid capital and estimated tangible capital of: (i) responding LCs and their licensed affiliates; (ii) LCs affiliated with the responding non-licensed LC affiliates; and (iii) existing OTCD dealing LCs as reported by them in their financial returns as of 31 December 2016 ("**reference paid-up share**").



Proposed capital requirements	Number (percentage) of relevant covered firms ²¹ that can fulfill the proposed capital requirement and their aggregate OTCD market share ²²	Number of relevant covered firms that could not fulfill the proposed capital requirement	Range of tangible capital/paid-up share capital shortfall ²³ of those firms referred to in column 3 (HK\$)	Range of liquid capital shortfall ²⁴ of those firms referred to in column 3 (HK\$)
OTCD Dealers				
Paid-up share capital of HK\$30 million Floor RLC of HK\$15 million (i.e. proposed capital requirements for RCCP-cleared OTCD dealers not using the internal models approach and OTCD central dealing desk dealers)	93 firms (89%), which in aggregate account for 99.8% of OTCD market share	<ul style="list-style-type: none"> 6 firms were unable to meet both the paid-up share capital requirement and floor RLC 2 firms were only unable to meet the paid-up share capital requirement 3 firms were only unable to meet the floor RLC 	10 million to 25 million	3 million to 11 million
Tangible capital of HK\$500 million Floor RLC of HK\$78 million (i.e. proposed capital requirements for non-RCCP-cleared OTCD dealers which qualify for OTCD de minimis reduction and not using the internal models	63 firms (61%), which in aggregate account for 99% of OTCD market share	<ul style="list-style-type: none"> 29 firms were unable to meet both the tangible capital requirement and floor RLC 11 firms were only unable to meet the tangible capital requirement 1 firm was only 	38 million to 495 million	4 million to 74 million

capital/liquid capital/estimated tangible capital"). The amount of tangible capital was estimated based on data reported by these LCs in their financial returns as of 31 December 2016.

²¹ Relevant covered firms refer to (i) for the impact analysis of the proposed capital requirements for Type 11 RA, the responding OTCD dealing firms and existing OTCD dealing LCs; (ii) for the impact analysis of the proposed capital requirements for Type 12 RA, the responding OTCD clearing firms; and (iii) for the impact analysis of the proposed capital requirements for new Type 7 activity, the responding OTCD ATS firms.

²² OTCD market share of a covered firm is calculated based on the aggregate notional amount of OTCD transactions that it reported to have dealt in/provided client clearing services for OTCD transactions in Hong Kong (where applicable) during the period from 1 January 2015 to 31 December 2015 ("reporting period"). It equals the aggregate notional amount of OTCD transactions of the covered firm divided by the total aggregate notional amount of OTCD transactions of all relevant covered firms during the reporting period.

²³ Tangible capital shortfall is the difference between the proposed tangible capital requirement and the reference estimated tangible capital of a covered firm. Paid-up share capital shortfall is the difference between the proposed paid-up share capital requirement and reference paid-up share capital of a covered firm.

²⁴ Liquid capital shortfall is the difference between the proposed floor RLC and the reference liquid capital of a covered firm.



Proposed capital requirements	Number (percentage) of relevant covered firms ²¹ that can fulfill the proposed capital requirement and their aggregate OTCD market share ²²	Number of relevant covered firms that could not fulfill the proposed capital requirement	Range of tangible capital/paid-up share capital shortfall ²³ of those firms referred to in column 3 (HK\$)	Range of liquid capital shortfall ²⁴ of those firms referred to in column 3 (HK\$)
approach)		unable to meet the floor RLC		
Tangible capital of HK\$1 billion Floor RLC of HK\$156 million (i.e. proposed capital requirements for OTCD dealers not approved to use the internal models approach and not falling within any of the categories mentioned above)	53 firms (51%), which in aggregate account for 96.9% of OTCD market share	<ul style="list-style-type: none"> 35 firms were unable to meet both the tangible capital requirement and floor RLC 15 firms were only unable to meet the tangible capital requirement 1 firm was only unable to meet the floor RLC 	140 million to 995 million	16 million to 152 million
Tangible capital of HK\$2 billion Floor RLC of HK\$156 million (i.e. proposed capital requirements for OTCD dealers approved to use the internal models approach)	43 firms (41%), which in aggregate account for 90.27% of OTCD market share	<ul style="list-style-type: none"> 36 firms were unable to meet both the tangible capital requirement and floor RLC 25 firms were only unable to meet the tangible capital requirement, with 10 of them having a tangible capital of more than HK\$1 billion 	27 million to 1.99 billion	16.3 million to 151.7 million
Type 12 RA				
Tangible capital of HK\$1 billion Floor RLC of HK\$195 million (i.e. proposed capital requirements for LCs which qualify for OTCD de minimis reduction)	All 4 firms (100%)	<ul style="list-style-type: none"> None 	Not applicable	Not applicable
Tangible capital of	All 4 firms (100%)	<ul style="list-style-type: none"> None 	Not applicable	Not applicable



Proposed capital requirements	Number (percentage) of relevant covered firms ²¹ that can fulfill the proposed capital requirement and their aggregate OTCD market share ²²	Number of relevant covered firms that could not fulfill the proposed capital requirement	Range of tangible capital/paid-up share capital shortfall ²³ of those firms referred to in column 3 (HK\$)	Range of liquid capital shortfall ²⁴ of those firms referred to in column 3 (HK\$)
HK\$2 billion Floor RLC of HK\$390 million (i.e. proposed capital requirements for LCs in any other case)				
New Type 7 activity				
Tangible capital of HK\$1 billion Floor RLC of HK\$156 million (i.e. proposed capital requirements for LCs whose business involves the provision of ATS for the trading of OTC derivative products)	2 firms (66.7%)	<ul style="list-style-type: none"> 1 firm was unable to meet both the tangible capital requirement and floor RLC 	964 million	142 million
Tangible capital of HK\$2 billion Floor RLC of HK\$390 million (i.e. proposed capital requirements for LCs whose business involves the provision of ATS for the novation, clearing, settlement or guarantee of OTC derivative transactions)	2 firms (66.7%)	<ul style="list-style-type: none"> 1 firm was unable to meet both the tangible capital requirement and floor RLC 	1.96 billion	376 million

106. It is considered that the impact of the capital requirements proposed for OTCD dealers, the new Type 7 activity and Type 12 RA are acceptable in light of the following:

- (a) 89% of the responding OTCD dealing firms and existing OTCD dealing LCs, which in aggregate account for over 99.8% of the market share in OTCD dealing, can meet the lowest minimum capital requirements proposed for OTCD dealers, whereas those responding OTCD dealing firms and existing OTCD dealing LCs which can meet the highest minimum capital requirements proposed for OTCD dealers in aggregate accounted for 90.27% of the OTCD market share;



- (b) all responding OTCD clearing firms can meet the minimum capital requirements proposed for Type 12 RA; and
- (c) two out of the three responding OTCD ATS firms can meet the minimum capital requirements proposed for the new Type 7 activity.

B. Capital treatments for market risks of OTCD and other proprietary trading positions

107. We proposed in the consultation paper to address market risks arising from proprietary trading of LCs by two approaches of different levels of complexity, namely SMRA and BMRA. Respondents were supportive of the proposed approaches with comments mainly on some technical aspects of the approaches.

Proposed SMRA

Proposed standardized equity risk framework

Proposed specified equity index

108. We proposed in the consultation paper that capital relief be provided to arbitrage portfolios referring to specified equity index. “Specified equity index” is defined to mean the following indices:
- (a) Hang Seng Index;
 - (b) Hang Seng China Enterprises Index;
 - (c) FTSE 100 Index;
 - (d) S&P 500 Index (formerly known as “Standard & Poor’s 500 Index”);
 - (e) Nikkei Stock Average (formerly referred to as “Nikkei 225 Index”);
 - (f) Euro Stoxx 50 Index; and
 - (g) any other index approved by the SFC as a “specified equity index”.
109. Respondents were supportive of this approach and further suggested including certain Mainland China indices (such as A50 and CSI 300) as specified equity index.
110. We have assessed the suitability of classifying FTSE China A50 Index and CSI 300 as specified equity index. However, we noted that there was significant basis risk in arbitrage trading such indices, especially when the Mainland stock market was under stress. Moreover, the Mainland stock index futures market is currently not fully open to overseas investors and trading is subject to a number of restrictions. We will monitor market developments and, where appropriate, approve additional index as specified equity index.

Modified proposal on the definition of “equity”

111. We have modified the definition of “equity” by removing the condition that shares must be held for trading purposes from the definition in order that “equity” will include shares that



are held by the LC as collateral or long term investment. Following this change, “equity” will include shares issued by a corporation, shares in mutual funds and units in unit trusts. We will also carve out investments in subsidiaries from the standardized equity risk framework in order to avoid any inadvertent capital impact that may result from the above change.

Proposed standardized interest rate risk framework

Proposed specific risk charge for non-investment grade and unrated debt securities

112. We explained in the consultation paper that non-investment grade and unrated debt securities may be subject to higher liquidity and credit risks and proposed to follow the SEC’s Net Capital Rules approach to assign specific risk charges to non-investment grade and unrated debt securities based on their initial issuance size. We also proposed that non-investment grade securitization/re-securitization be subject to a 100% specific risk charge given their high liquidity risk.
113. Respondents generally agreed with the need to account for the greater credit and liquidity risks of non-investment grade and unrated debt securities, with one respondent preferring using the Basel approach to determine the specific risk charge percentage for such securities²⁵ and another respondent opining that the correlation between the initial issuance size and specific risk of the debt issuer is not evident. A suggestion to take into account the availability of public information about the issuer in addition to the initial issuance size in determining the specific risk charge percentage to be applied to a particular issue was also received.
114. All of the respondents were supportive of the proposed 100% specific risk charge for non-investment grade securitization/re-securitization.
115. We appreciate the respondents’ support for the proposals and suggestions. The proposal to look at the issuance size of non-investment grade and unrated debt securities is intended to bridge the differences in approach to addressing liquidity risk of lower quality or less liquid debt securities between the FRR and the Basel Capital Accord. While an issue’s turnover in the secondary market would be a better indicator of its market liquidity, secondary market trading data of such debt securities is, however, not readily available. On the other hand, the initial issuance size is itself a thermometer of the popularity of the issue and has good reference value for determining the issue’s market risk.
116. The proposal has also taken into account the concern that information about issuers, particularly for unrated debt securities, may not be publicly available. Requiring LCs to consider only the credit rating status and initial issuance size of the debt securities can ensure level playing among all LCs holding such securities.
117. In light of the foregoing, we will proceed with the original proposals to subject non-investment grade and unrated debt securities to a specific risk charge based on the security’s initial issuance size, and to subject non-investment grade securitization/re-securitization to a 100% specific risk charge.

²⁵ The Basel Capital Accord determines the specific risk charge percentage for debt securities (including non-investment grade and unrated debt securities) by reference to the nature of its issuer, credit quality of the issuer/debt security and, in some cases, residual maturity.



Proposed treatment for correlation trading portfolio

118. The consultation paper proposed not to adopt the existing Basel treatment for a correlation trading portfolio given the concerns over the effectiveness of such treatment.
119. Respondents generally agreed not to adopt the existing Basel treatment for the correlation trading portfolio, noting that such products are not plain vanilla products and should require sophisticated valuation and risk models to manage the gap and basis risks. One respondent opined that not adopting the Basel treatment for the correlation trading portfolio is not in line with international standard.
120. We note that the Basel Committee on Banking Supervision (“**Basel Committee**”) published a revised standardized market risk approach on 14 January 2016 which included a special treatment for the correlation trading portfolio. We will monitor international developments in this area and observe the effects of the new standard after its implementation.

Proposed specific risk charge for non-marketable debt securities

121. In the consultation paper, we proposed, in respect of non-marketable debt securities, a 100% specific risk charge on the higher of the market value of the total long position (excluding physical holding) and total short position on an issue-by-issue basis²⁶ because of the lack of an active and transparent market for such securities, which would create great uncertainty for the pricing and hedging of such debt securities.
122. Respondents generally agreed that a 100% specific risk charge is appropriate for non-marketable debt securities, with one opining that the charge percentage is too high compared to the Basel Capital Accord, which applies a 12% capital charge to non-qualifying debt securities²⁷ with ratings below BB-.
123. We appreciate the respondents’ support for the proposal. The proposal applies a higher capital charge on non-marketable debt securities in order to bridge the differences in approaches to addressing liquidity risk of such debt securities between the FRR and the Basel Capital Accord. In addition, the charge percentage has been benchmarked to the SEC’s Net Capital Rules, which is the closest equivalent of the FRR.
124. One respondent sought clarification on the proposed approach to offsetting long and short positions in the same non-marketable debt security, such as whether long and short positions in debt securities issued by the same issuer but having different maturities can be offset.
125. As explained in the consultation paper, only long and short positions in the same debt securities which can be applied to offset each other in the settlement of the respective positions can be excluded from the calculation of total positions. Positions in debt securities issued by the same issuer but having different maturities cannot be offset. For long and short positions in the same non-marketable debt security where the long

²⁶ Long and short positions in the same debt securities which can be applied to offset each other in the settlement of the respective positions can be excluded from the calculation of total positions.

²⁷ Non-qualifying debt securities are debt securities which are not qualifying debt securities. In the Basel Capital Accord, qualifying debt securities mean debt securities that are issued by Multilateral Development Banks, PSEs of investment grade and other debt securities that are rated investment grade by at least two or more Specified CRAs.



positions cannot be applied to offset the short positions in the latter's settlement, offsetting will not be allowed. In such a scenario, the specific risk charge on these positions (excluding any physical holdings) shall be 100% of the higher of the market value of the total long position (excluding any physical holdings) and total short position.

Modified proposal on the definition of “marketable debt securities”

126. One respondent requested for clarification on the definition of “marketable debt securities”.
127. A definition of “marketable debt securities” has been provided in the consultation paper. In order to align with the FRR's existing policy whereby certificates of deposit issued by an authorized financial institution or an approved bank incorporated outside Hong Kong can qualify as liquid assets²⁸, we propose to modify the definition of “marketable debt securities” to include such certificates of deposit.

Modified proposal on general risk charge calculation for interest rate risk exposures in controlled currencies

128. We observed that interest rate differential may exist between the onshore and offshore money markets of a controlled currency (such as CNY and CNH being the onshore and offshore currency of Renminbi). The existence of such interest rate differential renders it not prudent to allow offsetting of offshore positions with onshore positions in a controlled currency in general risk charge calculation.
129. In view of such a market phenomenon, we propose to modify the calculation of general risk charge for interest rate risk exposures in controlled currencies such that separate maturity ladders should be used for the onshore and offshore positions in a controlled currency respectively so that separate general risk charges would be calculated for the onshore and offshore positions.

Proposed standardized foreign exchange risk framework

130. We received support for the proposed framework, with two respondents opining that the 8% risk charge may be too high for controlled currencies. Clarification was sought on how illiquid investment is assessed in the calculation of net foreign exchange position.
131. In the recent years, significant volatilities in the foreign exchange market (including the exchange rates of some controlled currencies) were observed. It remains our view that the foreign exchange risk charge should remain at 8% given these observations.
132. We would also like to clarify that physical positions in illiquid investments should be assessed based on their liquidity status on the reporting date.

Modified proposal on the definition of “controlled currency”

133. In the consultation paper, we defined “freely convertible currency” as a currency other than a controlled currency and to which the Basel shorthand method shall be applied to determine the foreign exchange risk charge. In order to better reflect that the focus of the definition is on the free movement of exchange rates instead of the “convertibility” of

²⁸ Please refer to the definition of “qualifying debt securities” in section 2(1) of the FRR.



the currency, we propose to rename “freely convertible currency” as “freely floating foreign currency”. Similarly, “controlled currency” shall be renamed as “non-freely floating foreign currency” to better reflect the nature and characteristics of the currency.

134. We further propose to modify the definition of “non-freely floating foreign currency” to reflect our focus on the restriction of the movement of its exchange rate. The modified definition is provided in Appendix 1. A “non-freely floating foreign currency” should also be distinguished from a “pegged currency” (such as HKD, which is pegged to USD, and the CHF before it was unpegged against the Euro), whose exchange rate is pegged to another currency(ies) through market activities by central banks instead of imposing legal or administrative restrictions.

Question 2:

Do you have any comments on the modified definition of “non-freely floating foreign currency”? Could you provide examples of such currencies and related products that may be traded in the OTC derivative market?

Modified proposal on the treatment of opposite onshore and offshore positions in non-freely floating foreign currency

135. In the consultation paper, we proposed that a foreign exchange risk charge shall be separately calculated for each non-freely floating foreign currency, which equals 8% of the net position in the currency. Respondents opined that the onshore and offshore exchange rates of a non-freely floating foreign currency are usually highly correlated and that treating positions in a non-freely floating foreign currency in the onshore and offshore markets as positions in the same underlying currency would encourage and facilitate their hedging of risk exposures. Clarification was also sought on the treatment of non-freely floating foreign currencies.
136. In light of the comments received, we have modified our proposal to deem onshore and offshore positions in a non-freely floating foreign currency as positions in the same currency for foreign exchange risk charge calculation purpose, such that opposite onshore and offshore positions can be offset, subject to a foreign exchange risk charge which equals 1.5% of one side of the matched positions to cover execution risk and basis risk.
137. In the consultation paper, we also proposed to include in the calculation of net foreign currency position net spot positions (which means all asset items less all liability items which are denominated in the same foreign currency) as well as foreign exchange exposures arising from FX derivatives and non-FX derivatives (such as equity derivatives, interest rate derivatives, debt-security derivatives and commodity derivatives). We take this opportunity to clarify that foreign exchange exposures arising from non-FX derivatives do not include any foreign exchange exposures which have already been included in the net foreign currency position calculation in the form of assets or liabilities arising from the non-FX derivatives (e.g. amounts receivable/payable under the derivative such as swap payments, or mark-to-market or fair value of the derivative which is denominated in a foreign currency).



Proposed standardized commodity risk framework

- 138. Respondents generally supported the proposed framework, with one respondent feeling that a 100% capital charge on the gross position of non-tradable commodities might result in a heavy burden on LCs trading such product.
- 139. The proposed treatment for non-tradable commodities is necessary given the price uncertainty and higher risk of illiquidity of such products due to their non-standard structure, quality, etc. It is also believed that the trading of non-tradable commodities will be rare given their non-standardized features which render it difficult to manage or hedge their risks.

Proposed standardized option risk framework

- 140. In the consultation paper, we sought views on our proposal to exclude non-continuous options from the application of the standardized option risk framework, and subject such options to the same capital treatments as proposed for non-standard instruments. We received support for the proposal, though one respondent considered that the delta-plus approach can address the risk of non-continuous options. A respondent added that the internal models approach should be the preferred method for such options.
- 141. As noted in the consultation paper, the European Banking Authority considered that the Basel simplified approach and delta-plus approach may not be appropriate for non-continuous options, and applied a more prudent alternative approach. Likewise, we believe non-continuous options should be better capitalized by using the capital treatments for non-standard instruments. In light of the support received and that no better alternative has been suggested by the respondents, we will proceed to implement this proposal.
- 142. In the consultation paper, we also sought views on whether the delta-plus approach is appropriate for options on volatile stocks and short-dated at-the-money options. Comments received ranged from “the delta-plus approach can address the risk of such options” to “the internal models approach should be the preferred method”. One respondent added that it would be difficult to categorize stocks as volatile stocks and options as short-dated/at-the-money options, and emphasized the importance of preserving the simplicity and flexibility of the capital rules.
- 143. Noting these comments, we decided not to exclude options on volatile stocks and short-dated at-the-money options from the application of the delta-plus approach. Instead, we will monitor the adequacy of the capital requirements of those LCs that have material exposures to such products and the need for additional supervisory measures on a case-by-case basis. Moreover, we will keep this area under review as the OTC derivatives market and international capital standards evolve.

Proposed measures for regulating the market risk of non-standard instruments

- 144. In the consultation paper, we proposed certain prudential and capital requirements, including a Margin-based Charge and a Specified Market Risk Charge, for regulating the market risks of non-standard instruments.
- 145. We received support for the proposal, with one respondent noting that it is reasonable and prudent to impose strict capital requirements for non-standard instruments and suggesting following the UK/Australia/Singapore approach of charging 100% of the



market value of the non-standard instrument to reduce the complication of the calculation. Another respondent suggested reducing the capital charge percentage by half if the instrument is not illiquid. A third respondent suggested that variation margin is a better proxy than the initial margin for assessing the market risk of an instrument.

146. We did not adopt the UK/Australia/Singapore approach because the current market value of an instrument is not a good proxy of its potential exposure to market risk, especially where the LC's potential loss may exceed the current market value of the instrument. Initial margin, instead of variation margin, is chosen as the basis for calculating the proposed capital charges because the initial margin is an estimation of potential future losses due to future market movements, whereas variation margin only reflects the unrealized loss that has arisen due to historical market movements.
147. The liquidity of non-standard instruments has not been incorporated into the formula of Specified Market Risk Charge because a secondary market may not exist for such instruments due to their exotic or bespoke nature.
148. We maintain our view that the proposed Specified Market Risk Charge is suitable for covering the risk of non-standard instruments. If an LC considers the Specified Market Risk Charge as excessive in its case, it may apply for approval to substitute a capital charge calculated by another method for the Specified Market Risk Charge.

Proposed capital charges for concentrated proprietary positions

149. Respondents generally supported our proposal to impose a concentration risk charge on concentrated proprietary positions to encourage the diversification of investment risks, with one respondent suggesting reducing the capital charge percentage by half if the instrument is not illiquid.
150. In the consultation paper, we have explained that it is not appropriate for the concentration risk charge percentage to be determined according to the quality of the concentrated investment because investment quality (including liquidity of the investment) has already been reflected in the market risk charge percentage for the investment. Accordingly, it is considered not necessary for the concentration risk charge percentage to be based on the liquidity of the concentrated investment.
151. In light of the support received, we will proceed to implement the proposed capital charge for concentrated proprietary positions.

Proposed treatment for opposite positions where the proceeds upon realization of one of the positions are subject to remittance control

152. In the consultation paper, we sought comments on our proposal to disallow the offsetting of opposite positions if the proceeds upon realization of one of the opposite positions are subject to remittance control because the proceeds would not be readily available for meeting the LC's liabilities or obligations under the other position. Under such circumstances, the market risk charge shall be calculated on one side of the matched positions.
153. One respondent supported the proposal, whereas three respondents disagreed with the proposal for different reasons –



- (a) the proceeds subject to remittance control are not illiquid because their value is not likely to depreciate and is easily realizable;
 - (b) the proposed capital charge is disproportional to the market risk of the matched positions; and
 - (c) net position in a non-freely floating foreign currency is already subject to the foreign exchange risk charge, which would result in double-counting with the proposed capital charge.
154. As explained in the consultation paper, the proposed treatment aims to address funding risk caused by remittance control. It is not intended for addressing foreign exchange risk of the positions concerned or the credit risk of the proceeds realizable from those positions, and therefore would not result in overlaps with the capital charges for foreign exchange risk and credit risk on the same transactions. While the proposed treatment would result in one side of the matched position being subject to the applicable market risk charge(s), as opposed to full exemption from such charge(s) if offsetting were allowed, those capital charges are necessary in order to protect the LC's liquidity from the funding gap that may be caused by the remittance control.
155. A respondent requested for an example of the application of the proposed treatment to positions in a non-freely floating foreign currency. Two examples are provided below to illustrate how the proposed treatment operates:
156. Example 1: Assuming a non-freely floating foreign currency X, which has an onshore market with the exchange rate against USD denoted as X_{onshore} , and a free offshore market with the exchange rate against USD denoted as X_{offshore} . If an LC is long in a X_{onshore} non-deliverable forward ("NDF") and short in a X_{offshore} forward of the same notional principal as the NDF, and both contracts are settled offshore and the proceeds realized under the contracts would not be subject to remittance control, the two positions in currency X can be offset in the calculation of foreign exchange risk charge subject to a 1.5% charge on one side of the matched positions.
157. Example 2: Same background as in Example 1 except that the X_{onshore} NDF is substituted by X_{onshore} forward, which is to be settled onshore and the proceeds realized under this contract would be subject to remittance control. In this case, the LC's two positions in currency X cannot be offset, and the foreign exchange risk charge will be calculated at 8% of one side of the matched positions.

Proposed BMRA

Proposed capital charges for OTCD

158. The consultation paper sought views on whether the proposed capital charges for OTCD transactions (i.e. Margin-based OTCD Market Risk Charge and Basic OTCD Market Risk Charge) are sufficient for addressing the market risk of OTCD for LCs which adopt BMRA.
159. Respondents were supportive of the proposed approach, though one respondent opined that the approach is basically treating all OTCD as non-standard instruments and as such, the capital requirements would be overly burdensome for smaller scale LCs.
160. BMRA is designed for use by LCs with no or limited OTCD activities. Conceivably, such LCs' risk management and infrastructure may not be robust enough to manage the risk of



OTCD positions. Therefore, a prudent market risk charge for non-cleared OTCD is necessary to ensure the risk of OTCD positions which are not cleared by a Regulated CCP is adequately capitalized. For OTCD that are cleared by a Regulated CCP, the Margin-based OTCD Market Risk Charge will use the initial margin requirements applicable to the product as the objective basis of charge.

Modified proposal – Introduction of market risk charge for non-standard instruments

161. As mentioned in paragraph 51 above, we have proposed to adopt the definition of “OTC derivative product” under the SFAO for the FRR in order to better align with the licensing regime. Following this alignment, a catch-all market risk charge is necessary to ensure the market risks of derivative products that fall outside the definition of “OTC derivative product” will be captured by the FRR and adequately capitalized for. We therefore propose to introduce into the BMRA the same concept of non-standard instruments as proposed under SMRA and apply similar capital charges.

Additional proposal – Treatment for trading loss sharing arrangement

162. In the OTC Derivatives Activities Survey 2016, a number of responding firms reported that they act as OTCD agency dealers inducing clients to enter into OTCD transactions with a group company (referred to as “client facing affiliate” (“**CFA**”)). The CFA may retain the market risks of the OTCD transactions so entered or offload the risk to another group company (referred to as “risk booking affiliate” (“**RBA**”)) by entering into back-to-back OTCD transactions with the RBA.
163. It is further noted that, in respect of the OTCD transactions introduced or handled by an OTCD dealer and booked in a CFA or RBA, there may be transfers of income and/or expenses between the OTCD dealer and the CFA/RBA. In addition, the OTCD dealer may periodically share all or part of the trading profit or loss caused by price movements on the transactions booked in the CFA/RBA (which may include the OTCD transactions introduced or handled for the CFA/RBA by the OTCD dealer and other transactions) (such arrangement is referred to as “**trading profit/loss sharing arrangement**”).
164. When a trading loss occurs on the transactions booked in the CFA/RBA, an OTCD dealer who has entered into a trading loss sharing arrangement ²⁹ and ³⁰ with the CFA/RBA would be obliged to share the loss. In other words, under a trading loss sharing arrangement, the OTCD dealer is, in effect, indemnifying the CFA/RBA’s trading losses wholly or partly.
165. When the loss is shared with and charged on the OTCD dealer (say by way of intercompany charges at the end of each month), it is possible that the OTCD dealer’s liquid capital would be reduced as a result of booking a liability for the amount of loss shared or payment to the CFA/RBA to settle the shared loss. It is therefore imperative to ensure the OTCD dealer maintains sufficient capital to absorb the market risks associated with the transactions booked in the CFA/RBA that are effectively indemnified by it.

²⁹ Include arrangements whereby trading profit of an affiliate previously shared by an LC is clawed back subsequently.

³⁰ Include arrangements whereby losses arising from OTCD and/or other products in an affiliate’s proprietary trading book is shared by an LC.



166. We understand that similar trading loss sharing arrangements may apply to non-OTCD transactions. Accordingly, we propose to require any LC which has entered into a trading loss sharing arrangement with a group company to provide capital for the market risks of proprietary transactions booked in the group company that are covered by the trading loss sharing arrangement (referred to as “**within-scope transactions**”) in a timely manner. The LC shall calculate the proposed market risk capital charges as if the within-scope transactions were booked in the LC adopting the same market risk capital charge calculation approach (i.e. SMRA or BMRA) that applies to it.
167. Where the LC is required to share only a portion of the trading losses of within-scope transactions or the maximum amount of loss shared is capped, it is proposed that the LC may similarly apportion or cap the total amount of market risk capital charges on the within-scope transactions subject to the SFC’s approval.
168. Moreover, in order to cater for the scenario where the shared loss is settled through an intercompany current account with the group company concerned, it is proposed to permit the LCs to reduce the market risk capital charges on the within-scope transactions up to the amount receivable from the group company concerned which has not been included in the LCs’ liquid assets.
169. In the case where the LC shares only trading profits of the within-scope transactions but any profits shared may be clawed back by the group company before finalization, the LC may opt for excluding any interim profit shared from its liquid assets in lieu of undertaking the proposed market risk capital charges subject to the SFC’s approval.

Question 3:

Do you agree that LCs which enter into a trading loss sharing arrangement should provide in a timely manner for a capital charge for the amounts of market risks of the proprietary transactions of their affiliates on which trading losses will be shared by the LCs?

Other regulatory concerns relating to CFA/RBA booking models

170. The use of CFA and RBA by an LC to deal with clients or book proprietary OTCD transactions gives rise to two additional regulatory concerns apart from the capital implications to the LC discussed above.
171. The first regulatory concern is regarding what duty an LC owes its clients and what conduct standard should apply when it introduces a client to enter into an OTCD transaction with a CFA (instead of itself). Given the bespoke nature of OTCD transactions and the ongoing contractual relationship between the counterparties created under the transactions, a concern that the interest of a client contracting with a CFA would be prejudiced would arise if the CFA is in a poor financial condition, fails to properly manage its risks or misconducts itself in its dealing with the client. The client would not receive the same protection that he would otherwise receive had the transaction been entered into with the LC instead of the CFA.
172. The second regulatory concern is regarding what risks (reputational or financial) a CFA or RBA of an LC would pose to the LC and/or the latter’s clients if the CFA or RBA fails to properly manage their risks, and what measures the LC should be required to take to mitigate such risks.



173. It is considered that these concerns should best be dealt with by imposing new conduct and control standards instead of regulatory capital requirement. Detailed proposals will be discussed and covered in a separate consultation exercise.

Proposed mechanism for opting out of SMRA

174. In the consultation paper, we proposed to permit LCs which are required to adopt SMRA (i.e. OTCD dealers and LCs licensed for the new Type 7 activity or Type 12 RA) and whose OTCD activity level does not exceed the OTCD de minimis thresholds to opt out of SMRA and use BMRA to calculate market risk capital requirements.
175. Respondents generally welcomed the flexibility, with a few respondents suggesting lowering the thresholds for qualifying LCs to opt out of SMRA. One respondent also asked for how long an LC's activity level should remain below the OTCD de minimis thresholds in order to be eligible to opt out of SMRA. Another respondent suggested central dealing desks be carved out of SMRA.
176. As discussed in the earlier part of this paper, we have changed the benchmark for OTCD de minimis thresholds to 50% of the transitional (instead of the final) US registration thresholds, which effectively raises the OTCD de minimis thresholds significantly. It is also intended to apply the same approach to comparing LC's OTCD activity level with OTCD de minimis thresholds as that adopted for applying the OTCD de minimis reduction to the opt out mechanism. For the purpose of such a comparison, all OTC derivative transactions entered into for the LC's own or its client account or cleared for another person, including those cleared through a Regulated CCP, must be aggregated and included in the calculation of the LC's aggregate gross notional amounts of OTCD transactions.
177. It has also been proposed in the earlier part of this paper to exclude OTCD central dealing desk dealers from the application of SMRA. Such dealers would adopt BMRA as their default market risk approach.

Proposed mechanism for opting into SMRA

178. We proposed in the consultation paper to permit LCs that do not engage in OTCD dealing/clearing/ATS activities to adopt SMRA to calculate market risk capital requirements provided that they can meet the same minimum capital requirements as an RA11 dealer.
179. Respondents were supportive of the proposal, though a respondent commented that there is no strong reason to deter an LC from using SMRA just because of its capital size if the LC considers SMRA is more beneficial.
180. We maintain our view that LCs adopting SMRA should maintain adequate backstop capital to cover any residual risk and enable it to establish sophisticated risk management to tightly monitor and control their market risks.

Other comments on the proposed market risk frameworks

Capital requirements for OTC cash products



181. One respondent opined that OTC cash products should not be subject to the capital requirements under the FRR or the capital requirements should be kept to a minimum in order to avoid discouraging market making business for such products.
182. We do not agree that a capital waiver or concession should be applied to market making of OTC cash products. It is important to apply our capital requirements consistently to the same risk, whether it arises from market making or other activities, to ensure a level playing field. Unlike listed cash products, OTC cash products generally have lower market liquidity and transparency. They may be exposed to a higher market risk than similar listed products, especially in times of stress. Moreover, the risk caused by their lower market liquidity must be addressed in a prudent way given the liquidity focus of the FRR regime.

Additional proposal – approval to use Basel latest standardized market risk approach

183. The Basel Committee completed the fundamental review of trading book treatments and issued a revised standardized market risk approach in January 2016, which is expected to be implemented in or after 2019 by national supervisors.
184. The revised approach is more sophisticated than the existing approach. In order to provide greater flexibility to LCs which are sophisticated enough to apply the latest Basel capital approach, it is proposed to allow LCs, subject to the SFC's approval, to apply the latest Basel standardized market risk approach that is in force to calculate capital charges for their market risks.

C. Capital treatments for counterparty credit risk arising from OTCD transactions

185. We proposed in the consultation paper to address counterparty credit risk arising from OTCD transactions by two approaches of different levels of complexity (namely, SOCCRA and BOCCRA). These approaches have combined the key features of the Basel CCR approach (mainly the CEM adopted in Basel II) and the SEC's "under-margined capital charge approach" and "capital charge in lieu of margin collateral approach". Given that unsecured receivables on OTCD transactions can be admitted as liquid assets under SOCCRA, which may undermine the objective of the FRR to ensure LCs have sufficient liquid assets to meet their liabilities, additional measures (including a concentration charge, a liquidity adjustment and specified liquidity risk management measures, all of which are benchmarked to the SEC's CCR approach) were also introduced as part of SOCCRA.

Proposed SOCCRA

Additional proposal – approval to use latest Basel standardized counterparty credit risk approach

186. Respondents generally supported our proposal to adopt the modified CEM to calculate counterparty credit risk exposures while monitoring the development of the new standardized approach for counterparty credit risk ("i.e. **SA-CCR**") introduced by the Basel Committee, with two respondents suggesting allowing LCs to freely choose between SOCCRA and BOCCRA, or between SOCCRA and SA-CCR. One respondent reminded that LCs may be disadvantaged compared to banks after SA-CCR is implemented in the banking sector and suggested putting in place a transitional arrangement if SA-CCR is adopted by the FRR in the future.



187. We do not find it appropriate to use BOCCRA as the alternative to SOCCRA or SA-CCR because BOCCRA may result in a higher capital requirement on LCs than SOCCRA or SA-CCR. Given that the SA-CCR is more sophisticated than the CEM approach and in order to provide greater flexibility to LCs which are sophisticated enough to apply the latest Basel capital approach, we propose to allow LCs, subject to the SFC's approval, to apply the latest Basel standardized approach for counterparty credit risk that is in force to calculate capital charges for their counterparty credit risk.
188. Respondents were also supportive of the proposed approach to supplement SOCCRA with a concentration charge, a liquidity adjustment and specified liquidity risk management measures.
189. In view of the support for the proposed approach to addressing counterparty credit risk, we will proceed with the proposals in the consultation paper subject to the fine-tunings as discussed below to address some concerns raised by the respondents.

Proposed CMS Charge on exposures to clearing clients

190. For the purpose of CMS Charge calculation, the applicable margin requirement for a transaction which is not cleared through a Regulated CCP equals the highest of the respective margin requirements imposed by the LC, CCP, any clearing intermediary involved in the clearing process, and the PFE of the transaction calculated by CEM. One respondent made the following comments:
- (a) the definition of margin requirement should be in line with future regulatory margin requirements for non-centrally-cleared OTCD;
 - (b) there should be exclusions or more favorable capital treatment for OTCD traded with affiliates; and
 - (c) the CMS Charge should be applied on a prospective basis i.e. applicable to swaps entered into after the effective date of the new FRR requirement.
191. Our responses to the above comments are as follows:
- (a) If the LC or clearing intermediary involved in the clearing of the transaction concerned is required to calculate margin requirement(s) according to any regulatory requirements that apply to them, such margin requirement(s) would be taken into account in the calculation of CMS Charge. By choosing the most prudent margin requirement imposed on the transaction among the margin requirements imposed by the various parties involved in the clearing of the transaction as the basis of CMS Charge calculation, it can ensure that the CMS Charge is prudent enough and address any funding gap that the LC would need to bridge if the margin requirement imposed by it on the client is lower than that imposed by the clearing intermediary or the CCP.
 - (b) We do not agree that transactions with affiliates should be given a more favorable capital treatment. By using the margin requirements imposed by the LC as one of the parameters for calculating CMS Charge, the charge has already reflected the credit standing of the client. Moreover, LCs dealing with affiliates would face interconnectedness risk. Allowing a more favorable capital treatment for transactions with affiliates would undermine the effectiveness of the capital requirement.



- (c) There is no plausible justification to exempt transactions entered into before the commencement of the new FRR requirements from the CMS Charge. LCs will continue to face the counterparty credit risk of pre-existing OTCD transactions, for which they should maintain sufficient regulatory capital.

Modified proposal on determination of PFE for a portfolio of OTCD transactions

192. In the consultation paper, we sought comments on whether, for the purposes of calculating CCR Charge under SOCCRA:
- (a) in respect of a portfolio of Regulated CCP-cleared OTCD transactions which are subject to net margining by a Regulated CCP, the initial margin requirements imposed by the Regulated CCP should be used as the PFE; and
 - (b) in respect of a portfolio of OTCD transactions which are not cleared through a Regulated CCP, the higher/highest of the PFE calculated by using the PFE add-on factors and the initial margin requirements imposed by a non-Regulated CCP, the parties to the transactions or clearing intermediary should be used as PFE.
193. We received support for the use of the initial margin requirements in the calculation of PFE, with one respondent suggesting the use of a margining model developed by an industry association.
194. We do not find it appropriate to specify any particular model to be used to determine the initial margin requirements on OTCD transactions for the purposes of the FRR. It is the responsibilities of the contracting parties, CCPs and clearing intermediaries to set appropriate margin requirements to cover the credit risks involved and to comply with applicable regulation on margin requirement. Our proposed approach already incorporated a built-in floor amount for PFE, namely the PFE calculated by using the PFE add-on factors to ensure the PFE is prudent enough.
195. In light of the support received, we propose to modify the original proposal to allow LCs to adopt the approaches described in paragraph 192 (a) and (b) in the determination of PFE of OTCD transactions on a portfolio basis.

Modified proposal on the determination of applicable risk weights

196. In relation to the determination of applicable risk weights for counterparties, we consulted on whether the lower risk weights that apply to a clearing member of a Regulated CCP can be equally applied to a clearing intermediary which is a client of a clearing member of a Regulated CCP if certain conditions³¹ under the Basel CCP Rules are met. We received unanimous support for the proposal and we will proceed with the said treatment.
197. In relation to the proposed conditions for applying a 2% risk weight to exposures to clearing members of Regulated CCP, which are set out in paragraph 38(a) & (b) in Appendix 8 of the consultation paper, following the revision by the Basel Committee of the corresponding conditions in the Basel CCP Rules, those conditions will be replaced by the following:

³¹ See the new paragraph 197 of Section XI of Annex 4 of the Basel II inserted under the Basel CCP Rules.



- (a) The offsetting transaction between the clearing member and the CCP is identified by the CCP as a client transaction and collateral to support it is held by the CCP and/or the clearing member, as applicable, under arrangements that prevent any losses to the client due to: (i) the default or insolvency of the clearing member; (ii) the default or insolvency of the clearing member's other clients; and (iii) the joint default or insolvency of the clearing member and any of its other clients. In other words, upon the insolvency of the clearing member, there is no legal impediment (other than the need to obtain a court order to which the client is entitled) to the transfer of the collateral belonging to clients of a defaulting clearing member to the CCP, to one or more other surviving clearing member or to the client or the client's nominee.

The LC must have conducted a sufficient legal review (and undertake such further review as necessary to ensure continuing enforceability) and have a well-founded basis to conclude that, in the event of a legal challenge, the relevant courts and administrative authorities would find that such arrangements mentioned above would be legal, valid, binding and enforceable under the relevant laws of the relevant jurisdiction(s).

- (b) The effect of relevant laws, regulations, rules, or contractual or administrative arrangements is that the offsetting transactions with the defaulted or insolvent clearing member are highly likely to continue to be indirectly transacted through the CCP, or by the CCP, if the clearing member defaults or becomes insolvent.³² In such circumstances, the LC's positions and collateral with the CCP will be transferred at market value unless the LC requests to close out the position at market value.

Modified proposal on exemption from CVA Charge

- 198. It was proposed in the consultation paper to require LCs to calculate and include in their ranking liabilities a CVA Charge in respect of their credit exposures to counterparties, CCP (other than a Regulated CCP) and clearing intermediaries. We consulted on whether only transactions with Regulated CCPs can be exempt from the proposed CVA Charge.
- 199. Respondents generally suggested expanding the scope of exemption to various extents, from QCCPs to all CCPs, and from clearing members to affiliated counterparties.
- 200. As noted in the consultation paper, there is no international consensus on the scope of exemption. Similarly, no consensual views can be derived from the submissions received. That said, it is considered appropriate to extend the exemption to exposures to clearing members of Regulated CCP provided that those exposures are qualified to enjoy the 2% risk weight in SOCCRA, as in such case it is highly likely that the exposures will be protected from the default of the clearing member in a similar way as a direct exposure to Regulated CCP.
- 201. We maintain our view that it would not be appropriate to apply the exemption to all CCPs indiscriminately. The definition of "Regulated CCP" already included the concept of

³² If there is a clear precedent for transactions being ported at a CCP and industry intent for this practice to continue, then these factors must be considered when assessing if trades are highly likely to be ported. The fact that CCP documentation does not prohibit client trades from being ported is not sufficient to say they are highly likely to be ported.



approved CCP to enable CCPs other than a recognized clearing house or authorized automated trading services provider to be treated as Regulated CCP if they meet certain criteria, including whether the CCP is regulated and supervised in a manner consistent with the PFMI issued by CPMI and IOSCO.

Modified proposal on Counterparty Concentration Charge calculation

202. In order to address the concentration risk of exposures to individual OTCD counterparties in respect of non-centrally-cleared OTCD transactions, we proposed in our consultation paper to introduce a Counterparty Concentration Charge on such exposures.
203. One respondent suggested allowing LCs to deduct from the aggregate uncollateralized current exposure from a counterparty the amount of CCR Charge already imposed on the exposure to the counterparty in the calculation of the Counterparty Concentration Charge in respect of that counterparty in order to avoid any double charge on the same exposure.
204. We agree that it would be fairer to allow an LC to deduct the amount of CCR Charge already imposed on the same exposure in the calculation of the related Counterparty Concentration Charge. It is therefore proposed to allow the deduction of the amount of CCR Charge in respect of the current exposures of non-centrally-cleared OTCD transactions from the corresponding aggregate uncollateralized current exposure in the Counterparty Concentration Charge calculation. Mathematically, the Counterparty Concentration Charge will be calculated as follows:

$$\text{Counterparty Concentration Charge} = \max[0, CCC_{CE} \times (1 - RW \times 8\%) - CCC_{threshold}] \times CCC_{percentage}$$

Where:

CCC_{CE} = aggregate uncollateralized current exposure as defined in paragraph 54 in Appendix 8 of the consultation paper

$CCC_{threshold}$ = Counterparty Concentration Threshold as defined in paragraph 52 in Appendix 8 in the consultation paper

RW = risk weight under SOCCRA applicable to the counterparty

$CCC_{percentage}$ = Counterparty Concentration Charge percentage as described in paragraph 55 in Appendix 8 of the consultation paper

205. We also fine-tuned the proposed three-tier sliding scale for determining the Counterparty Concentration Charge percentage by assigning a 20% charge to counterparties with a risk weight of 50% (instead of greater than 20% but less than 50% as originally proposed) and a 50% charge for counterparties with a risk weight higher than 50% (instead of 50% or more as originally proposed) because there is no risk weight that falls between 21% and 49% under SOCCRA.

Proposed Liquidity Adjustment and specified liquidity risk management measures

206. In order to address the impact on an LC's liquidity of admitting uncollateralized receivables on non-centrally-cleared OTCD transactions as liquid assets, we proposed in the consultation paper to introduce a capital charge known as Liquidity Adjustment and require LCs meeting certain criteria to apply specified liquidity risk management measures.



207. Respondents generally agreed that the proposed Liquidity Adjustment and specified liquidity risk management measures can serve the aforesaid purpose.

Modified proposal on Liquidity Adjustment calculation

208. A few respondents requested for relaxation of the calculation of Liquidity Adjustment, which include:

- (a) excluding uncollateralized receivables that have not been outstanding for more than three business days from the calculation of aggregate uncollateralized current exposure because it may take time for LCs to collect collateral from counterparties located in countries in different time zones;
- (b) allowing LCs to deduct the amount of CCR Charges already imposed on the exposures covered in the calculation of Liquidity Adjustment; and
- (c) allowing LCs to use term funding or long term debt as an alternative to Liquidity Adjustment to achieve the same objective.

209. Regarding the request to exempt uncollateralized receivables that have not been outstanding for more than three business days from Liquidity Adjustment, it is appreciated that there may be time lags between the time when a receivable becomes under-collateralized and when the LC successfully collects margin call from the counterparty. That said, it is not considered prudent to provide for such an exemption because the formula for calculating uncollateralized current exposure already allows LCs to take into account of both initial margin and variation margin received. A receivable would become uncollateralized only when it exceeds the aggregate of the initial margin and variation margin. It is considered that in such a situation, timely collection of margin call must be carried out, and it would not be appropriate to provide any capital relief in this connection.

210. We appreciate that it would be fairer to allow an LC to deduct the amount of CCR Charge(s) already imposed on the same exposure(s) in the calculation of the related Liquidity Adjustment. It is therefore proposed to allow the deduction of the amount of CCR Charges in respect of the current exposures of non-centrally-cleared OTCD transactions from the corresponding aggregate uncollateralized current exposure in the Liquidity Adjustment calculation. Mathematically, the Liquidity Adjustment will be calculated as follows:

$$\text{Liquidity Adjustment} = \max\left[0, \sum_i LA_{CEi} (1 - RW_i \times 8\%) - LA_{threshold}\right]$$

Where:

- LA_{CEi} = aggregate uncollateralized current exposure as defined in paragraph 54 in Appendix 8 of the consultation paper in respect of counterparty “i”
 $LA_{threshold}$ = Liquidity Adjustment Threshold as defined in paragraph 56 in Appendix 8 of the consultation paper
 RW_i = risk weight under SOCCRA applicable to the counterparty “i”

211. Regarding the suggestion of allowing LCs to use term funding or long term debt as an alternative to Liquidity Adjustment, it is noted that LCs are already allowed to use



approved subordinated loan to satisfy the minimum capital requirements under the FRR. If a term loan obtained by an LC is not subordinated in nature (i.e. the rights of the lender are not subordinated to those of other creditors of the LC in the event of the LC's insolvency), it would not provide the same capital-like protection as an approved subordinated loan and therefore cannot be excluded from the LC's ranking liabilities for the purpose of FRR calculation.

Proposed specified liquidity risk management measures

212. A respondent considered that the specified liquidity risk management measures are not necessary as the FRR regime is a "liquid capital" regime with a focus on liquidity in its design.
213. We disagree with this view. Receivables in respect of current exposures of non-centrally-cleared OTCD transactions are less liquid than other types of liquid asset typically accepted by the FRR, and as such, their admission as liquid assets under SOCCRA may affect the effectiveness of the FRR as a tool for ensuring that LCs maintain sufficient liquidity to meet their liabilities and obligations. Therefore, it is of utmost importance for LCs having a significant portion of liquid assets in the form of such receivables to be able to identify and address potential liquidity issues in a timely manner.
214. Other comments on the specified liquidity risk management measures were mainly focused on the implementation of such measures:
- (a) a respondent opined that conducting liquidity stress tests on a monthly basis is demanding; and
 - (b) a few respondents requested for further guidelines on the calculation of liquid reserve, the scope of non-cash assets acceptable for liquid reserve purpose, and the preparation of an emergency funding plan.
215. We stress that liquidity is critical to the survival of LCs, and liquidity risk may rise rapidly in a stressed market. Performing regular liquidity stress testing can serve as a health check enabling potential problems to be promptly identified. We maintain our view that making this a monthly requirement strikes a right balance between prudence and compliance cost.

Elaboration of the proposal relating to liquid reserve

216. In the consultation paper, we proposed that liquid reserve shall comprise cash or other liquid assets which are readily convertible into cash to ensure the LC can meet payment obligations as they fall due.
217. Given the purpose of liquid reserve to ensure that the LC's short term payment obligations can be met when they fall due, it would be necessary for the liquid reserve to be able to generate the cash needed for payment purpose on a timely basis, but its constituents need not be limited to cash only. On the other hand, illiquid assets, assets which are highly volatile in price or valuation (e.g. non-blue chips stocks, current exposures arising from OTCD transactions), and assets which are encumbered or subject to lien should not qualify for liquid reserve purpose. Moreover, appropriate haircuts (including a haircut for the currency mismatch between the LC's assets and liabilities) should be applied to the assets constituting liquid reserve to provide for the potential impact of price movements on the value of the assets before they can be realized into cash.



218. Given the above consideration, it is proposed that the LC may include in liquid reserve cash, marketable debt securities (after applying appropriate haircut) with an issue rating which maps to credit quality grade 1, 2 or 3 in our proposal, and other liquid assets approved by the SFC for this purpose, subject to the following qualifying conditions³³:
- (a) the asset must be monetizable;
 - (b) the asset must not be overdue or in default;
 - (c) the asset must be free from encumbrances and there must be no regulatory, legal, contractual or other restrictions that inhibit the LC from liquidating, selling, transferring or assigning the asset;
 - (d) the value of the asset must be readily identifiable and measurable;
 - (e) the asset must be freely transferable and available to the LC and must not be subject to any liquidity transfer restriction;
 - (f) the asset must not be a subordinated debt security;
 - (g) if the asset is a structured financial instrument, the structure of the instrument must be simple and standardized; and
 - (h) the asset must be denominated in Hong Kong dollars or in a currency freely convertible into Hong Kong dollars.

Additional proposals relating to implementation of specified liquidity risk management measures

219. The consultation paper invited suggestions on the amount of time an LC should be allowed to perform the specified liquidity risk management measures after the Counterparty Concentration Charge or Liquidity Adjustment has been triggered. Suggestions received ranged from allowing a grace period of three weeks or six months subject to extension, to determining the grace period on a case-by-case basis taking into account the magnitude of exposures, size and licence type of the LC etc.,.
220. We appreciate that the amount of time required to implement the specified liquidity risk management measures would depend on the circumstances of individual firms. That said, it is imperative for the LC to identify any potential liquidity shortfall at the soonest and act promptly to reduce that risk.
221. In the consultation paper, we proposed requiring LCs to perform liquidity stress testing as soon as possible after the Counterparty Concentration Charge or Liquidity Adjustment is triggered and submit the results of the liquidity stress test to the SFC together with the LC's monthly financial returns. The current submission deadline for monthly financial returns is three weeks after the end of each calendar month. It is considered that the proposal has allowed LCs sufficient time to complete the stress test. Therefore, we maintain our view to require liquidity stress test results to be submitted to the SFC by the same deadline as the submission of monthly financial returns under the FRR, i.e. within three weeks after the calendar month in which the requirement to perform liquidity stress testing was triggered.

³³ Reference has been made to the qualifying criteria for liquefiable assets as stated in Rule 49 of the Banking (Liquidity) Rules.



222. Moreover, in order to minimize the administrative burden of the LC, the stress test shall be based on the LC's positions and assets and liabilities as at the accounting cut-off date of the calendar month in which the requirement to perform liquidity stress testing was triggered. A 30-day time horizon should be applied in the stress test, which aligns with the length of the stress period assumption to be applied in the stress test.
223. Regarding the deadline for establishing a liquid reserve and an emergency funding plan, these measures can only be established after the liquidity stress test results are available to support the calculation of the amounts of liquid reserve and emergency funding required. In addition, time must be allowed for LCs to acquire additional liquid assets and/or secure emergency funding facilities.
224. While applying a uniform completion deadline across all LCs subject to the proposed requirements would ensure a level playing field, we agree that flexibility should be built into the framework to enable us to grant extension where this is considered appropriate. Accordingly, we propose to require LCs subject to specified liquidity risk management measures to establish liquid reserve and submit to the SFC their emergency funding plan within one month after the submission of their liquidity stress test results, subject to such extension as may be granted by the SFC.
225. In the consultation paper, it is proposed that the specified liquidity risk management measures, once triggered, can only be ceased with the SFC's consent. While maintaining this exit channel, we have fine-tuned this proposal to further allow LCs to cease carrying out such measures if it did not trigger either the Counterparty Concentration Charge or Liquidity Adjustment in the preceding three months. No expressed consent of the SFC would be required in this case, though the LC needs to file a notification within one business day of cessation of the specified liquidity risk management measures confirming the cessation and that both the Counterparty Concentration Charge and Liquidity Adjustment had not been triggered in the three months preceding the cessation.

Applying specified liquidity risk management measures to LCs with poor liquidity management

226. We consulted on whether the proposed specified liquidity risk management measures should be applied to other LCs which have poor liquidity management. One respondent agreed that such measures should apply to LCs which have poor liquidity management, whereas another respondent opined that they should be applied to all LCs as the measures are in line with the principle of sound liquidity risk management. Other respondents requested more information about the definition of "poor liquidity management".
227. We agree that all LCs should practice sound liquidity risk management. To this end, the existing regulations³⁴ already require LCs to properly monitor and manage liquidity risk. The specified liquidity risk management measures are additional to these existing requirements which aim to ensure the LC subject to such measures exercises greater discipline in liquidity risk management. As these requirements have significant resources implications for both the LC and the SFC, it is considered that they should only be applied on a "needs basis" on LCs with high liquidity risk.

³⁴ Such as the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission and Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the Securities and Futures Commission.



228. Whether an LC's liquidity risk is high should be judged with reference to the circumstances of the LC (such as its balance sheet structure, funding sources and liquidity needs) and contemporary market conditions, for example, the liquidity risk may be considered high if the LC's funding can barely meet its liquidity needs without sufficient contingency buffer, or its liquidity is highly susceptible to changes in market conditions. It would not be appropriate to attach to the term "poor liquidity management" a "one-size-fits all" definition, as otherwise it may unduly restrict the scope of application of the specified liquidity risk management measures.
229. In light of the foregoing, it is concluded that LCs not applying SOCCRA but are identified to be exhibiting high liquidity risk should be required to take out the specified liquidity risk management measures.

Treatment of exposures to affiliates

230. We consulted on whether uncollateralized receivables from affiliates in respect of current exposures of non-centrally-cleared OTCD transactions should be treated in the same way as third party exposures in the calculation of Counterparty Concentration Charge and Liquidity Adjustment and the determination of the triggering event for imposing the specified liquidity risk management measures.
231. The responses received are mixed, and the majority of the respondents suggested providing relief or exemption for exposures to affiliated entities. The reasons for relief/exemption they submitted include:
- (a) these capital charges and measures would adversely affect the risk management strategy available to LCs;
 - (b) affiliates of global financial institutions are well-capitalized, controlled and supervised and should be treated differently from less-capitalized counterparties or counterparties subject to inadequate regulatory supervision;
 - (c) LCs should be able to exert more influence/control on their affiliates financially and operationally than unrelated counterparties and, therefore, it is inappropriate to apply the same credit risk charges on the exposures to affiliates and unrelated counterparties;
 - (d) concentration risk has already been addressed by the proposed 25% cap on aggregate uncollateralized receivables from affiliated banks and brokers;
 - (e) the capital charges would defeat the purpose of the intra-group exemption for bilateral collateralization under the IOSCO margining rules;
 - (f) exposures to affiliates should be excluded from concentration charge to align with the Basel supervisory framework for measuring and controlling large exposures; and
 - (g) other credit risk mitigation techniques and bilateral agreement with affiliates should be considered.
232. We have considered the above suggestions and reasons and have the following responses:



- (a) It would create an unlevel playing field for LCs that carry out hedging directly with the market if a more favorable treatment is offered to those that carry out hedging transactions with affiliates. Moreover, since uncollateralized non-cleared transactions are the primary target of the proposed measures, transactions with affiliates, which are often uncollateralized and non-centrally-cleared, should rightly be captured by those measures. In addition, LCs would be subject to interconnectedness risk to their group companies when they transact with the latter. Therefore, it would not be appropriate to treat inter-company exposures differently from exposures to unrelated counterparties from a counterparty concentration risk or a liquidity risk perspective.
- (b) The credit quality and regulated status of counterparties have already been factored into the determination of risk weights and concentration charge percentage for the counterparty, with lower risk weights/charge percentages being applied to counterparties that are regulated or of higher credit quality.
- (c) The Counterparty Concentration Charge is intended to minimize the impact of counterparty default on the LC. Based on past experience, when a group company defaults, its liquidator or administrator would take over the control of the company from its existing management. There is no evidence to suggest that the defaulting company's affiliates would be placed in a more favorable position than its other creditors. On the other hand, the Liquidity Adjustment is intended to address the impact of illiquidity of OTCD. The counterparty's credit standing and group relationship with the LC are irrelevant in this regard.
- (d) The proposed 25% cap on aggregate uncollateralized receivables from affiliated banks and brokers, IOSCO margining rules, and Basel's large exposure regime all serve different regulatory objectives from the Counterparty Concentration Charge and Liquidity Adjustment. It would not be appropriate for the latter to adopt the same policy in regard to exposures to affiliates.
- (e) We do not consider receivables covered by credit risk mitigation techniques other than collateral (such as guarantee) can be exempt from Counterparty Concentration Charge and Liquidity Adjustment. Firstly, the effect of other credit risk mitigation techniques have already been taken into account in the calculation of CCR Charge. Secondly, from a liquidity perspective, collateral may stand a better chance to generate cash (such as through re-hypothecation or liquidation of the collateral) than other credit risk mitigation techniques. Accordingly, it is desirable to adopt a more prudent approach by excluding only collateralized receivable from the application of Counterparty Concentration Charge and Liquidity Adjustment.

233. In view of the absence of a strong justification for treating exposures to affiliates differently, no exemption will be available for such exposures in the calculation of Counterparty Concentration Charge and Liquidity Adjustment and the application of the specified liquidity risk management measures.

Application of Counterparty Concentration Charge, Liquidity Adjustment and specified liquidity risk management measures to collateral posted

234. We consulted on whether collateral posted for securing non-centrally-cleared OTCD transactions should be included in the calculation of Counterparty Concentration Charge



and Liquidity Adjustment and in the determination of the triggering event for specified liquidity risk management measures.

235. Mixed responses were received. Those who were not in favor of this treatment believed that this inclusion would discourage market participants from exchanging margins. Those who were in favor made various suggestions, such as excluding variation margin and posted collateral which is held in segregated and bankruptcy remote manner, allowing a set off between the initial margin posted and received, and including only excess collateral posted after taking into account the LC's payable to the counterparty.
236. Collateral is usually posted to secure the actual or contingent liability of the LC to its counterparty. As such, the net exposure of the LC to the counterparty could be much smaller than the gross value of the collateral posted. Moreover, collateral posted is subject to CCR Charge, which covers the credit risk of the LC's exposure to the counterparty. In view of the foregoing and the market's concern about the impact on LCs' motivation to exchange margins with counterparties on non-centrally-cleared OTCD transactions, we agree that the initial margin and variation margin should not be included in the application of Counterparty Concentration Charge, Liquidity Adjustment and specified liquidity risk management measures.
237. Regarding excess margins posted to counterparties, it is understood that they are unlikely to be subject to restriction on withdrawal by the posting party, and therefore would be more liquid than the initial margin or variation margin kept by the counterparty. If the credit status of the counterparty deteriorates, the LC should stand a better chance to withdraw excess margins than the initial margin or variation margin to reduce its exposure to the counterparty. Accordingly, there does not seem to be a need to include excess margins in the application of Counterparty Concentration Charge, Liquidity Adjustment and specified liquidity risk management measures.
238. Given the foregoing, it is concluded that collateral posted should not be included in the application of Counterparty Concentration Charge, Liquidity Adjustment and specified liquidity risk management measures.

New proposal – Adoption of Basel treatment for repurchase transactions and securities borrowing and lending

239. One respondent suggested aligning the existing FRR treatments for repo-style transactions with Basel standards.
240. We agree that it would be appropriate to allow LCs, which are already applying Basel-like treatments under SOCCRA to calculate capital charges for counterparty credit risk of OTCD positions, to adopt the Basel comprehensive approach to calculate the capital requirements for counterparty credit risk of repo-style transactions.
241. We propose to allow LCs using SOCCRA to adopt the Basel comprehensive approach³⁵ subject to certain modifications, instead of the methodology prescribed in sections 45 and

³⁵ See paragraphs 147 to 181 of the Basel II for details.



46 of the FRR³⁶, to calculate the capital requirements for repo-style transactions. Details of the proposed alternative treatment are as follows.

242. In respect of repo-style transactions not subject to netting agreements, the LC may calculate the capital charge by using the following:

$$K = 8\% \times RW \times \max\{0, [E \times (1+H_e) - C \times \max(0, (1 - H_c - H_{fx}))]\}$$

Where:

K = capital charge to be included in ranking liabilities

RW = risk weight prescribed in SOCCRA applicable to the counterparty

E = market value of the exposure

H_e = haircut percentage prescribed in SOCCRA³⁷ (or the market risk charge percentage under SMRA if the exposure would not qualify as an eligible collateral under SOCCRA) appropriate to the exposure³⁸

C = market value of the collateral received

H_c = haircut percentage prescribed in SOCCRA³⁷ appropriate to the collateral³⁸

H_{fx} = haircut percentage appropriate for currency mismatch between the collateral and exposure, i.e. 8%³⁸

243. In the case the LC is the lender of securities under an SBL agreement or seller in the first instance of securities in a repo transaction, exposure refers to the market value of the securities lent or sold in the first instance in relation to the repo transaction and “collateral received” refers to the cash and other collateral received from the borrower or the amount of consideration received by the LC on the repo transaction.
244. In the case where the LC is the borrower of securities under an SBL agreement or the purchaser in the first instance of securities in a repo transaction, exposure refers to the amount of cash deposited and market value of other collateral provided to the lender or amount of consideration paid by the LC on the repo transaction. “Collateral” received refers to the securities so borrowed or purchased.
245. LCs adopting the proposed alternative treatment are also required to follow the same minimum standards for legal documentation and eligibility requirements, and haircut percentages for collateral received as for SOCCRA. The haircut percentages under SOCCRA (or the market risk charge percentage under SMRA if the exposure is not qualified as an eligible collateral under SOCCRA) instead of the haircut percentages under the Basel Capital Accord will be applied to the exposures.
246. In respect of repo-style transactions subject to netting agreements³⁹, LCs should calculate the capital charge of each netting set using the formula below:

³⁶ Sections 45 and 46 of the FRR require the full amount of uncollateralized exposures in relation to repo-style transactions to be included in the LC's ranking liabilities as risk charge. Uncollateralized exposures are calculated after adjusting for the potential price movements of the securities involved in the repo-style transaction and collateral received or posted using a simple haircut approach.

³⁷ Refers to the haircut percentage prescribed in paragraph 10 in Appendix 11 in the consultation paper. The same haircut percentage will be applied to the same asset or security whether it is an exposure or a collateral.

³⁸ The haircut percentages for exposure, collateral and currency mismatch will be scaled up or down depending on the frequency of remargining using the formula stated in paragraph 13 in Appendix 11 of the consultation paper. Minimum holding period (in business days) for repo-style transactions is five.



$$K = 8\% \times RW \times \max\{0, [\sum(E) - \sum(C) + \sum(E_s \times H_s) + \sum(E_{fx} \times H_{fx})]\}$$

Where:

K = capital charge to be included in ranking liabilities

RW = risk weight prescribed in SOCCRA applicable to the counterparty

E = market value of the exposure

C = market value of the collateral received

E_s = absolute value of the net position in a given asset/security (both collateral received and exposures)

H_s = haircut percentage prescribed in SOCCRA³⁷ (or the market risk charge percentage under SMRA if the asset/security would not qualify as an eligible collateral under SOCCRA) appropriate to E_s³⁸

E_{fx} = absolute value of the net position in a currency different from the settlement currency

H_{fx} = haircut percentage appropriate for currency mismatch i.e. 8%³⁸

247. LCs may choose not to recognize the netting effects in calculating the capital charge. In that case, each transaction will be subject to a capital charge as if there was no netting agreement.
248. The Basel Committee proposed in December 2015⁴⁰ to revise the standardized approach for credit risk, including revising the formula under the comprehensive approach to address the concern about a lack of risk sensitivity in the existing formula. We have proposed to adopt the existing standards in order to allow more time to monitor the Basel development while keeping in view the latest development of the Basel consultation.

Question 4:

Do you agree that the above modified Basel comprehensive approach should be used to calculate the capital requirements for repo-style transactions by LCs using SOCCRA?

Proposed BOCCRA

249. We proposed in the consultation paper to introduce BOCCRA, which is a simpler approach than SOCCRA, as the default approach for LCs other than RA11 dealers, Non-RA11 OTCD dealers, LCs licensed for the new Type 7 activity and LCs licensed for Type 12 RA to treat counterparty credit risk arising from OTCD transactions.
250. Respondents were generally supportive of adopting BOCCRA as the default approach for LCs with fewer OTCD activities. Nevertheless, one respondent suggested lowering the haircut for exposures in respect of transactions which are centrally-cleared through non-Regulated CCP or non-centrally-cleared transactions.
251. It is envisaged that users of BOCCRA will mostly be less sophisticated and less capitalized firms, which may not have a strong risk management function and backstop

³⁹ The netting agreement must meet the conditions set out in paragraph 173 of the Basel II.

⁴⁰ See the consultative document "Revisions to the Standardized Approach for credit risk" issued by the Basel Committee in December 2015.



capital to absorb residual risks of non-standardized products trading. The 100% haircuts for exposures to non-Regulated CCP and exposures arising from non-centrally-cleared OTCD transactions are necessary to minimize the impact on the LC's liquid capital of the residual risks that the firm may not have properly managed.

Modified proposal on haircut for exposures to Regulated CCP clearing members

- 252. We consulted on whether we should apply a lower haircut on net uncollateralized exposure to clearing members of a Regulated CCP if certain conditions on portability and protection of open positions and collateral posted are complied with.
- 253. All respondents were in favor of such a treatment. Some respondents asked for clarification on the details of those conditions.
- 254. In light of the support, we propose to apply a haircut of 0.16% on exposures to clearing members of Regulated CCP which fulfill the same conditions as those set out in SOCCRA for applying a 2% risk weight to exposures to clearing members of Regulated CCP. Where the LC is not protected from losses in the case where the clearing member and another client of the clearing member jointly default or become jointly insolvent, but all other conditions are met, the LC may apply a 0.32% haircut on the exposures to clearing members of the Regulated CCP concerned.

Proposed mechanism for opting out of SOCCRA

- 255. We consulted on whether RA11 dealers, Non-RA11 OTCD dealers and LCs licensed for the new Type 7 activity or Type 12 RA should be permitted to adopt BOCCRA instead of SOCCRA if the level of their OTCD activities does not exceed the OTCD de minimis thresholds. Most respondents were supportive of the above proposal. We welcome the strong support and will adopt this "opt-out" mechanism in the FRR. For the avoidance of doubt, all OTC derivative transactions entered into for the LC's own or its client account or cleared for another person, including those cleared through a Regulated CCP, must be aggregated and included in the calculation of the LC's aggregate gross notional amounts of OTCD transactions for the purpose of comparing the LC's OTCD activities with the OTCD de minimis thresholds.

Proposed mechanism for opting into SOCCRA

- 256. We consulted on an "opt-in" mechanism of SOCCRA for other LCs. We received strong support for the proposal and will adopt the proposed "opt-in" mechanism in the FRR.

D. Introduction of internal models approach

- 257. Respondents supported the introduction of the internal models approach and their comments were mainly focused on the details of the approach. In light of the support, we will proceed to introduce the approach into the FRR subject to certain modifications to fine-tune the approach and to reflect the latest Basel standards.
- 258. A few respondents expressed concerns over the cost of complying with the standardized approach before model approval is granted and asked whether approval can be granted before the new FRR become effective.
- 259. LCs must apply the applicable non-model-based market risk and counterparty credit risk approaches provided in the FRR before approval to use the internal models approach is



granted. In addition, as approval would be granted on a business unit or desk basis, for those areas not covered by the approval, the LC must continue to apply the applicable non-model-based market risk and counterparty credit risk approaches. Furthermore, the latest international trend is to require model users to refer to the capital requirements calculated by the non-model-based method as the floor or fallback for model-based capital requirements. We have to adopt a similar standard. In other words, model approval applicants should ensure that they have the systems for calculating both model-based capital requirements and non-model-based capital requirements.

260. Regarding the time required for processing model approval applications, based on past experience, the approval process involves a lot of complex analyses of the risks being modelled and in-depth review of the business and risk management of the applicant, let alone the review of the technical details of the models used by the applicant. Applicants are advised to allow sufficient time for the approval process and ensure the required documentations are ready before submitting their application.
261. One respondent sought clarification on the following areas of the draft application guidelines for model approval:
- (a) the meaning of risk-theoretical profit and loss (“**P&L**”);
 - (b) whether the trade date P&L attribution requirement is additional to or substitute for the P&L attribution requirements set by the Basel Committee; and
 - (c) the meaning of “measurement of valuation uncertainty”.
262. Risk-theoretical P&L has the same meaning as the corresponding definition in the Basel Capital Accord and means the P&L that would be produced by the pricing models for the desk if they only included the risk factors used in the risk management model.
263. The trade date P&L attribution requirement is additional to the P&L attribution requirements set by the Basel Committee. The purpose of this additional requirement is to promote better risk management control to enable material residual unexplained P&L can be identified for further investigation in a timely manner.
264. Valuation uncertainty is one of the areas that should be considered in the model user’s valuation policy and methodology. The policy should ensure that appropriate valuation adjustments are made to cover uncertainty of the model valuation and the valuation of less liquid positions.

Proposed three-year FRR compliance record eligibility requirement

265. In the consultation paper, it was proposed as one of the eligibility requirements for application for approval to use the internal models approach that the applicant must have a clean record of compliance with the FRR in the previous three years. Mixed views on this proposed requirement were received. While some respondents supported the requirement, others generally opined that a clean record of FRR compliance should not be an eligibility requirement or be considered as an integral part of the applicant’s controls. Most respondents asked for a definition of “clean record” and suggested excluding minor or inadvertent breaches.
266. The three-year FRR compliance record requirement is proposed to ensure that the applicant is committed to, and capable of, maintaining compliance with the FRR. These



are important attributes that the applicant must possess because the monitoring of FRR compliance would be a highly complicated job after model approval is granted, including ensuring the correct calculation of the model-based capital as well as the capital floor using the non-model-based approach. Any mistake in these calculations can result in a significant impact on the capital adequacy of the firm.

267. A pragmatic approach will be adopted in considering the implication of past FRR breaches of the applicant, including but not limited to the nature and materiality of the breaches, the circumstances leading to the non-compliance and the rectification measures taken by the applicant to prevent further breaches.

Modified proposal on leverage ratio requirement

268. We consulted on the need to impose a leverage ratio requirement on LCs approved to use the internal models approach. The responses received were mixed, with the majority of the respondents expressing concerns about this requirement:

- (a) imposing a leverage ratio requirement will substantially lower the profitability of LCs;
- (b) the calculation of variable RLC already takes leverage into account; and
- (c) calibration on the 3% requirement relative to the risk-based capital requirement is suggested.

269. We stress that Basel's leverage ratio serves as a backstop to the risk-based capital measures, and is intended to constrain excessive leverage and provide an extra layer of protection against model risk and measurement error. In view of the possible overlap between variable RLC and leverage ratio in containing the leverage of the LC and that the exposure structures of banks and securities firms can be very different, we will consider the need to impose a leverage ratio requirement on model users on a case-by-case basis.

Modified proposal – updating the criteria for approval of use of internal models approach to reflect the latest Basel standards

270. The Basel Committee has recently published new standards for and a consultative document on the internal models approach for market risk⁴¹ and counterparty credit risk⁴² respectively, such as the use of expected shortfall as the measurement of market risk and requirement for approved model users to refer to the capital requirements calculated by the non-model-based method as the floor or fallback for model-based capital requirements.
271. It is desirable for the FRR to follow closely international standards on model approval. We will update the criteria for approval of use of the internal models approach and the related application guidelines to reflect the latest Basel standards for further consultation.

⁴¹ Please refer to the Basel Standards Document "Minimum capital requirements for market risk" (January 2016) for details.

⁴² Please refer to the Basel Consultative Document – "Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches" (March 2016) for details.



E. Measures to address operational risks of LCs engaging in certain regulated OTCD activities and LCs opting into the standardized approaches

272. We proposed in the consultation paper to require OTCD dealers, LCs licensed to carry on the new Type 7 activity or Type 12 RA, and LCs opting into SMRA or SOCCRA to annually conduct a self-assessment of their internal controls and risk management and submit the results to the SFC.
273. Respondents were generally supportive of the above proposal. One respondent further suggested extending the self-assessment requirement to all LCs regardless of whether they engage in OTCD activities or not, and requiring LCs to conduct self-assessment whenever there are significant changes in the firm's structure and external operating environment.
274. We maintain our view that only the above types of LCs should be required to conduct the proposed self-assessment due to the additional operational risks arising from conducting the specified OTCD business. Other LCs are also required to ensure that proper risk management and control system are in place at all times, and they are expected to regularly review their controls and risk management. Moreover, they are required to complete and submit a Business and Risk Management Questionnaire to the SFC each year. If at any time a need to review an LC's internal control or risk management arises, it is an established practice to invite the LC concerned to commission such a review, usually by an independent consultant. The scope of this review is usually tailor-made for the circumstances giving rise to the need for the review.
275. One respondent was concerned that the self-assessment might be treated as a high level "check the box activity" which cannot capture granular inherent risks and residual risk. There were also requests for more guidance on the SFC's expectation on specific control areas and related record keeping requirements. On the other hand, a respondent found part of the Self-Assessment Return over-prescriptive.
276. As stated in the draft Self-Assessment Return attached to the consultation paper, the return should not be treated as an exhaustive list of internal control and risk management practices to be applied by LCs. LCs should adopt policies and procedures commensurate with the nature and level of their activities, their resources and organizational structures. The Self-Assessment Return and the general record keeping requirement will set out the detailed requirements on LCs. However, given the wide range of areas covered in the Self-Assessment Return and the diversity in LCs' businesses and control practices, LCs are welcome to discuss their case with their designated case officers in the Intermediaries Supervision Department of the SFC. We may also issue an FAQ where necessary.
277. Other comments received concerned specific contents of the Self-Assessment Return which are summarized below together with our responses:
- (a) In respect of question 3 under Part V, one respondent opined that monitoring of concentration of funding sources by products, markets and counterparties is not appropriate for LCs in Hong Kong. We would like to clarify that the question is asking whether the LC has established and regularly monitors the measures of concentration of individual products, markets and counterparties instead of asking whether the LC is monitoring concentration of funding sources by products, markets and counterparties.



- (b) In respect of question 5 under Part V, one respondent considered that revenue is not relevant in designing and implementing liquidity risk management strategies given the volatility and the unrealized components of revenue could potentially distort the accuracy of the forecast liquidity requirement though he agreed that the adequacy of funding arrangements needs to be incorporated into the liquidity risk management strategy. We maintain our view that revenue is one of the components which can be taken into account in designing and implementing liquidity risk management measures. That said, LCs should take into account factors appropriate to their own case and decide whether revenue is a reliable liquidity source.
- (c) In respect of question 6 under Part V, one respondent sought clarification on whether it is only applicable to LCs licensed for Type 12 RA. We clarify that this question applies to all types of LCs that are required to conduct the self-assessment.

278. Please note that as the relevant regulations relating to OTCD activities have not been finalized, the Self-Assessment Return will be subject to further changes in order to align with those regulations.

F. Notification and other requirements

279. We proposed in the consultation paper a number of additional notification and reporting requirements for LCs engaging in OTCD or other derivative transactions and removal of the existing notification requirement under section 55(4) of the FRR.
280. Respondents were supportive of the proposal. Accordingly, we will proceed to implement the changes.

G. Miscellaneous technical changes

Revised proposal – replacing the proposed cap on aggregate uncollateralized receivables from affiliated banks and brokers with a proposed control requirement

281. In the consultation paper, we consulted on a proposed cap on aggregate uncollateralized receivables from affiliated banks and brokers ("**the Cap**", which equals 25% of the LC's shareholders' funds), which aims to address interconnectedness risk by reducing the risk of an LC suffering liquidity strain in case its affiliated bank or broker fails. We also consulted on whether margins held in a bankruptcy remote manner with affiliated banks or brokers should be excluded from the application of the Cap.
282. While some of the respondents acknowledged that interconnectedness risk might be a concern, all the respondents either considered the Cap unnecessary or suggested relaxing the proposal to such an extent that essentially defeats its purpose (such as excluding also exposures to overseas affiliated banks/brokers from the application of the Cap). Reasons for objection included (i) the Cap would affect the internal asset management of a group; (ii) overseas financial institutions, whether affiliated or unaffiliated with an LC, are subject to equivalent local regulation and prudential supervision; and (iii) the regime would become overly conservative when taken together with the Liquidity Adjustment requirement.



283. A respondent further explained that it would be difficult to ensure compliance in practice because the balances with affiliated banks/brokers may fluctuate due to factors outside the control of the LC (such as margin calls by affiliated banks/brokers and profits arising on client positions) and time zone differences between LCs and overseas affiliates. Other suggestions included allowing LCs to substitute a capital charge for the Cap, exempting segregated client money from the application of the Cap, etc.
284. Respondents generally supported excluding margins held in a bankruptcy remote manner with affiliated banks or brokers from the application of the Cap.
285. We acknowledge the concerns and practical difficulties as highlighted by the respondents. It remains our view that LCs should prudently manage their exposures to group companies to minimize the impact of interconnectedness risk. In order to balance between investor protection and the operational needs of LCs and raise their awareness of the importance of interconnectedness risk management, we plan to replace the proposed Cap with a proposed control requirement which requires LCs to properly manage their financial exposures to affiliates in the same manner as exposures to independent third parties undertaken by the LCs on an arm's length basis. We will continue to explore what prudential measures can be taken to protect LCs and their clients if the LCs are exposed to significant interconnectedness risk.

Proposal on reducing reliance on external credit ratings

286. As mentioned in the consultation paper, while we are monitoring the international development relating to reducing reliance on external credit ratings in regulatory requirements, an assessment criterion has been included in the Self-Assessment Return requiring an LC to supplement the consideration of external ratings with due diligence or other analysis by the LC in order to encourage it to conduct its own credit risk assessment. A respondent reminded that LCs should not be discriminated for using external credit ratings because small and medium sized LCs might not have adequate resources to maintain their own credit risk database and assessment, and external credit ratings are not inferior or less scientific.
287. We would like to clarify that LCs will not be discriminated for using external credit ratings. The proposed self-assessment criterion is intended to encourage LCs to supplement the consideration of external credit ratings with their own assessment and avoid mechanistic reliance on external credit ratings. By doing so, the LC should be able to form a better understanding of their credit risk exposures and build up credit assessment experience, which will benefit its credit risk management capability in the longer term.

Proposed treatment of currency subject to exchange control or assets the proceeds of which upon realization being subject to remittance control

288. We proposed in the consultation paper that an LC may disapply section 18(2) of the FRR to an amount of currency that is subject to exchange control and any asset the proceeds of which upon realization are subject to remittance control if such currency/asset can be freely applied to meet an existing liability or obligation of the LC which is settled in the same currency without needing to seek approval from the relevant authority.
289. The only respondent on this proposal expressed his support for the proposal.
290. We would like to take this opportunity to clarify that in disapplying section 18(2) as proposed, the asset concerned should be subject to the applicable haircut or other



deduction calculated on a standalone basis⁴³ if it is qualified to be included as liquid assets in the LC's liquid capital after section 18(2) is disapplied⁴⁴. In addition, if the aggregate amount of the assets concerned included in the LC's liquid assets exceeds the aggregate amount of liabilities that such assets may be freely applied to meet, an additional ranking liability amount (calculated on a currency-by-currency basis) will be required to eliminate the effect on liquid capital of the excess amount of the assets concerned which are not required for meeting the abovementioned liabilities.

Modified proposal on updating the list of specified exchanges

291. In the consultation paper, we proposed to add China Financial Futures Exchange to the list of specified exchanges in the FRR. The only respondent on this proposal expressed his support for the proposal. Accordingly, we shall proceed with the proposal.
292. In addition, we further propose to include the Mainland commodity futures markets into the list of specified exchanges. At the 13th Shanghai Derivatives Market Forum, the China Securities Regulatory Commission announced its plan to open up the Mainland futures market, including the introduction of overseas investors into the Mainland commodity futures market. In order to facilitate LCs' participation in the Mainland commodity futures markets, we propose to include the four Mainland commodity exchanges, namely Dalian Commodity Exchange, Shanghai Futures Exchange, Shanghai International Energy Exchange and Zhengzhou Commodity Exchange, into the list of specified exchanges in Schedule 3 to the FRR.

Proposals to update haircut percentages for certain types of securities and commodities

Modified proposal on approach to determining haircut percentage for equity/debt securities basket or index

293. It is proposed in the consultation paper that for a position in a basket of equities/debt securities or an index representing a basket of equities/debt securities, the highest of the applicable haircut percentages for the constituents of the basket or index should be chosen as the haircut percentage for the position.
294. A few respondents suggested to allow LCs to alternatively calculate the haircut percentage for the basket or index by treating the basket or index as a portfolio of the constituents or as the weighted average of the haircuts of the underlying constituents. One of them further suggested allowing special treatment if one single constituent of the index/basket has unfavorable haircut or becomes illiquid asset attracting a 100% haircut.
295. We appreciate that these alternative approaches may achieve a haircut which better reflects the risk of the basket or index. However, the complication of implementing such approaches renders them unsuitable for general application. We therefore modified the proposal to allow an LC to calculate the haircut percentage of the basket or index underlying equity-linked instruments or index funds tracking an equity or debt securities index on a weighted average basis after seeking the SFC's approval.

⁴³ Because it is impossible to determine the proportion of a haircut or risk charge calculated on a portfolio basis (i.e. the haircut or risk charge is calculated on an aggregate position or net position of a portfolio or assets, positions and/or liabilities) which is attributable to a single asset in the portfolio.

⁴⁴ An asset will continue to be excluded from liquid assets if it does not qualify as liquid assets despite section 18(2) has been disapplied.



Proposed haircut percentages for certain types of investment funds

296. In the consultation paper, we proposed to revise the haircut percentages for certain types of authorized investment funds and Recognized Jurisdiction Schemes. A respondent considered the 40% haircut proposed for structured funds and funds investing in financial derivative instrument too high.
297. Under the existing FRR, warrant funds and futures and options funds are already subject to a haircut of 40%. Given that structured funds and funds investing in financial derivative instrument may invest in OTCD, we maintain our view that the proposed 40% haircut is reasonable and in line with the existing policy. We shall also proceed with all the proposed changes to other investments funds as outlined in the consultation paper.

Modified proposal on haircut percentage for index tracking funds

298. It was proposed in the consultation paper that the haircut percentage for an index fund (including ETFs) that tracks an equity index will be the same as the haircut percentage for its underlying equity index. We believe that there is room to extend similar treatment to index funds (including ETFs) that track debt securities index. Such funds are subject to a 20% haircut under the existing FRR, which may be too high for funds tracking the performance of an index of high quality debt securities. Accordingly, we propose to define the haircut percentage of an index fund (including ETFs) that tracks a debt securities index to be equal to the haircut percentage for its underlying debt securities index.
299. We would like to clarify that for a fund which has the same nature as more than one type of the funds described in item 3 in Table 7 in Schedule 2 to the FRR, the highest applicable haircut percentage shall apply in order to reflect the associated higher risk level.

Proposed haircut percentages for unspecified securities and illiquid investments

300. There is generally no objection to our proposal to specify a 100% haircut for illiquid investments and securities not specified in Schedule 2 to the FRR. Accordingly, we will proceed to implement the change.
301. We would also like to clarify that investments not specified in Schedule 2 to the FRR (i.e. investments other than specified investments) shall also be subject to a 100% haircut. A new definition of “miscellaneous investments” is proposed to cover securities and investments which are not otherwise specified in the proposed Schedule 2 to the FRR. Please refer to Appendix 1 for the detailed definition.

Incidental changes

302. The following incidental changes to the FRR will be made to clarify the treatment of illiquid investments and miscellaneous investments:
- (a) the definitions of “marking to market”, “floating losses”, “floating profits” and “trade date” in section 2 of the FRR will be expanded to cover illiquid investments and miscellaneous investments;
 - (b) the definition of “haircut percentage” for listed shares will be amended to cease to apply to shares which are illiquid investments;



- (c) securities and investments which are illiquid investments will be excluded from the definitions of “qualifying debt securities”, “special debt securities”, “specified securities” and “specified investments”;
- (d) section 8 (Accounting for transactions on trade date basis) of the existing FRR will be expanded to cover transactions in illiquid investments and miscellaneous investments;
- (e) section 9 (Valuation of proprietary positions, etc.) of the existing FRR will be expanded to cover open positions in illiquid investments and miscellaneous investments;
- (f) the scope of section 43(1) of the existing FRR (i.e. short positions) will be expanded to cover short positions in illiquid investments and miscellaneous investments so that the market value of such short positions shall be included in ranking liabilities;
- (g) the scope of section 43(2) of the existing FRR will be expanded to cover short positions in illiquid investments and miscellaneous investments so that the haircut amount in relation to such short positions will also be included in ranking liabilities; and
- (h) section 43(3)(a) and (c) will be repealed following the expansion of the scopes of sections 43(1) and (2) as suggested above.

Modified proposal on treatment of financial instruments with leverage

- 303. No comment was received on our proposal to require the use of effective notional amount of a product, which takes into account the leverage feature of the product, instead of its stated notional amount in the calculation of market risk charges and counterparty credit risk charges.
- 304. It is clarified that the leverage factor may also be applied to the market value of a security or investment with leverage (such as a leveraged ETF) as its haircut amount, as defined in the existing FRR, is calculated based on its market value (instead of notional amount).
- 305. The definition of “haircut amount” will be amended to reflect the leverage (if any) embedded in a security or investment. For example, for a leveraged fund with a leverage factor of 2, the formula for the calculation of haircut amount will be [market value of the leveraged fund x 2 x haircut %].
- 306. In order to avoid the haircut amount on a long holding of a security or investment with leverage exceeding the market value of the security/investment where the maximum possible loss on the position is capped at the market value, it is proposed to introduce a cap for the haircut amount in such situation at 100% of the market value.

Proposed treatment of amounts receivable in respect of dealings in securities

- 307. In the consultation paper, we proposed to revise the wording in different sections of the FRR relating to amounts receivable in respect of dealings in securities with the aim of ensuring that the policy intent for those sections are clearly reflected. No comment was received on this proposal and we will proceed to apply the changes to those sections and make similar changes to section 30 of the FRR to address a similar concern.



308. In addition, in order to better facilitate third party clearing by LCs, it was proposed in the consultation paper to allow an LC to include in its liquid assets:
- (a) any amount receivable from a general clearing participant (“**GCP**”) of a recognized clearing house⁴⁵ in respect of securities sales cleared by the GCP on a cash-against-delivery basis, which is not yet due for settlement according to the settlement date of the transaction; and
 - (b) where the LC is a GCP of a recognized clearing house, any amount receivable from a clearing client (including non-clearing participants of the recognized clearing house) on securities purchase cleared for the client on a cash-against-delivery basis, which is not yet due for settlement according to the settlement date of the transaction.
309. We received support for the above proposals. In addition, some respondents suggested allowing an LC to set off receivables from and payables to a GCP or a GCP of a specific class (such as banks regulated by the Hong Kong Monetary Authority or GCPs posing low settlement risk) in FRR calculation.
310. As mentioned in the consultation paper, it is intended to allow an LC to set off its amounts receivable from and amounts payable to a GCP of a recognized clearing house under a netting arrangement only in exceptional situations where the settlement risk is considered to be low after considering the financial status and default risk control of the GCP. Default risk control requires strong financial capability and specific risk management measures to prevent settlement failure and contain the damage if settlement failure or delay occurs. It would not be appropriate to grant such approval just based on the regulated or financial status of the GCP.
311. One respondent sought clarification on whether the SFC will grandfather the modifications already granted to LCs in relation to the treatment of amounts receivable in respect of dealings in securities under a third party clearing arrangement.
312. In general, amendment of an existing rule would not have a direct effect on existing modifications granted in respect of the amended rule. However, existing modifications in respect of an amended rule may be subject to review to ensure consistency with the underlying policy of the amendment.

Clarification of treatment of clearing balances with clearing houses

313. Another respondent sought confirmation on whether amounts receivable from a Regulated CCP under a third party clearing arrangement can be included in liquid assets calculation. The respondent also suggested recognizing an amount receivable from a non-clearing member, who has a corresponding amount receivable from a clearing member of a Regulated CCP, as liquid assets.
314. It is clarified that under section 28(1) of the FRR, LCs are already required to include in liquid assets amounts receivable from a recognized clearing house. Section 28(2) of the FRR require LCs to include trade receivables from and cash deposited with Euroclear, Clearstream and Korea Securities Finance Corporation as liquid assets. In view of the

⁴⁵ The term “recognized clearing house” is defined in the SFO.



response received, we propose to amend the FRR to clarify that amounts receivable from and cash deposits with these clearing houses in respect of clearing transactions can be admitted as liquid assets. Similar amendment will be proposed for sections 28(3) and 29 of the FRR in respect of transactions cleared through future and option clearing houses and clearing participants and dealers.

315. Regarding the suggestion of admitting as liquid assets an LC's receivables from non-clearing member on securities transactions indirectly cleared by the latter for the LC through a clearing member, it is concerned that the LC would be exposed to higher risk in an indirect clearing relationship in the absence of a default protection mechanism to ensure the portability of the unsettled position and safety of any collateral or money posted by the LC in case the non-clearing member fails. Therefore, it is considered that such suggestion should not be accepted.

New proposal – Treatment of client money received for settlement of client transactions

316. Under the existing FRR, client money held by an LC must not be included in the LC's liquid assets because the money is not beneficially owned by the LC. One respondent advised that this treatment would result in hardship to the LC if the client money is held for settling a purchase of or subscription for stock. This is because the client's settlement money cannot be included in the LC's liquid assets, but the related amount payable to the clearing house on the purchase or subscription is required to be included in the LC's ranking liabilities. In addition, 5% of the amount payable to the clearing house will be included as part of the LC's variable RLC. The respondent considered that the LC's risk exposure in this situation is small as the cash has already been received from the client for settling the trade. He requested to allow offsetting of the client money received and the amount payable to the clearing house in the FRR calculation.
317. We agree that the settlement risk to the LC in such a situation is low as the client money has already been received by the LC for settling the outstanding transaction, but it is considered necessary to capitalize the operational risk arising from the transaction. As such, we propose to amend the FRR to allow LCs to include in liquid assets the client money held for settling outstanding securities transactions. On the other hand, the corresponding amount payable to the clearing house will continue to be included in the LC's ranking liabilities and variable RLC calculation.

New proposal – Treatment of underwriting fees receivable

318. Under section 35(a) of the existing FRR, fee accrual or receivable arising from regulated activities is admissible to liquid asset only if one of the following conditions is satisfied:
- (a) fee accrual - the fee has been accrued and will first be due for billing or repayment within the next three months; or
 - (b) fee receivable - the fee has been billed or fallen due for payment but outstanding for one month or less after the date on which it was billed or fell due.
319. One respondent commented that it will typically take more than three months for their clients to settle underwriting fees if the clients are Mainland-based companies due to exchange control and other regulatory requirements in China. As a result, the fees cannot qualify as liquid assets. Furthermore, if the LC is a global coordinator, there will be liabilities on the fees payable to the sub-underwriters, which will attract a 5% capital



charge through increasing its variable RLC. The respondent suggested allowing such underwriting fee receivable to be included in liquid assets.

320. The abovementioned conditions aim to minimize the risk of illiquid assets being treated as liquid assets while taking into account the market practice. In view of the observation made by the respondent, we propose to amend the FRR to allow underwriters to include in liquid assets any underwriting fee accrual or receivable not meeting the above conditions up to the amount of the corresponding accrued sub-underwriting fee liabilities or sub-underwriting fee payable by it the settlement of which is contingent upon collection of the underwriting fee by the LC.

New proposal – Treatment of tenancy agreements for business premises

321. We note that a tenant may be required to recognize its rights and obligations under certain tenancy agreements for business premises as on-balance sheet assets and liabilities due to a recent change in accounting standard. Such change in accounting treatment may result in additional capital burden on LCs which are tenants given the assets required to be recognized must be excluded from their liquid assets while the recognized liabilities must be included in the LC's ranking liabilities under the FRR. In addition, the recognized liabilities will also attract an additional 5% capital charge through increasing the LC's variable RLC.
322. Although an LC may be liable to pay any remaining rental if it terminates the tenancy agreement before the end of the non-cancellable period, such termination is not common among LCs and it does not appear to be necessary to impose additional capital charge on the tenancy agreement for business premises as a result of the change in accounting treatment.
323. In view of the above, we propose to amend the FRR to allow an LC to exclude the amount of recognized liabilities arising from a tenancy agreement entered into by it in respect of any premises used in carrying on the regulated activity for which it is licensed from its ranking liabilities up to the amount of recognized assets arising from the tenancy agreement which is not included in its liquid assets. It is also proposed to exclude the amount of recognized liabilities, which has been excluded from ranking liabilities, from the variable RLC calculation.

New proposal – Revision of the scopes of qualifying debt securities and special debt securities

Replacing listing status by marketability as a qualifying criterion

324. The definitions of “qualifying debt securities” and “special debt securities” in the FRR currently refer to the listing status on a recognized stock market as one of the qualifying criteria for such securities. However, debt securities, whether they are listed or not, are predominantly traded over-the-counter. As such, the above listing status is not a good indicator of the debt securities' market liquidity. Given that we have already introduced the concept of marketability as an indicator of the liquidity of debt securities, we propose to remove the above listing status as a qualifying criterion for qualifying debt securities and special debt securities.



Treatment of structured notes as special debt securities

325. Currently, it is not entirely clear in the FRR whether securities or instruments in note form that have part or all of their return determined by reference to an underlying index or asset would fall within the definition of “qualifying debt securities” or “special debt securities”.
326. Such instruments are generally classified as “structured product” under the SFO. They usually consist of embedded derivatives to enhance their return or replicate the return of the underlying index or assets. Given their nature, it would seem more appropriate to classify them as special debt securities, which currently include indexed bonds, convertible debt securities, bonds with non-detachable warrants, and non-interest bearing debt securities.
327. The term “indexed bonds” is not defined in the FRR. An indexed bond is subject to a haircut percentage which equals the haircut percentage that applies to its underlying asset. The term “indexed bond” has its origin in the repealed Financial Resources Rules made under the Securities and Futures Commission Ordinance (Cap 24) (“**pre-SFO FRR**”) which referred to it as a bond which has its return linked to the performance of listed stock index. The term “indexed bond” is seldom used nowadays in the financial market.
328. In light of the foregoing background and the evolvement of the bond market, it is proposed to amend the definition of “special debt securities” to replace the term “indexed bond” by “structured note”. It is further proposed that the haircut percentage for structured notes shall be the same haircut percentage as that applied to their permitted underlying. Only structured notes with simple structures are accepted in order to ensure that the risk of the structured notes can be covered by the haircut percentage.
329. It is also proposed to amend the definition of “qualifying debt securities” to exclude structured products (other than (a) bonds with coupon rate that has an inverse relationship to a money market or interbank reference interest rate that is widely quoted (generally known as “inverse floater”); or (b) inflation-linked bonds⁴⁶, as these are not highly complex products) to better reflect the policy intent.

Clarification of the treatments of different types of qualifying or special debt securities

330. Currently, Table 5 in Schedule 2 to the FRR specifies the haircut percentage for qualifying debt securities by reference to their remaining term to maturity. Column (I) of that Table prescribed haircut percentages for qualifying debt securities with a fixed or floating rate coupon whereas Column (II) of that Table prescribed haircut percentages for qualifying debt securities other than those specified in Column (I). Column (II) is intended to cover bonds which have a different method of determination of coupon rate from plain vanilla fixed coupon bonds and floating rate bonds⁴⁷ and bonds subject to different risk compared to plain vanilla bonds (for example, inverse floaters and perpetual bonds⁴⁸). The Table is also referred to in the determination of the applicable haircut percentage for certain types of special debt securities.

⁴⁶ e.g. iBond.

⁴⁷ Please refer to Table 2 in Part I of Schedule 2 to the Pre-SFO FRR.

⁴⁸ Based on A Consultation Paper on the Review of the Financial Resources Rules issued in March 1997.



331. In order to better reflect the policy intent of that Table and for greater clarity, we have proposed to define the terms “fixed rate coupon” and “floating rate coupon” in the FRR. Please refer to Appendix 1 for details of the definitions.
332. Moreover, we propose to categorize those debt securities that would qualify for the haircut percentages specified in Column (I) as “category 1 qualifying or special debt securities”, which shall cover qualifying or special debt securities with a fixed rate coupon or a floating rate coupon, except bonds with: (a) no maturity date (i.e. perpetual bonds); or (b) remaining term to maturity over 30 years (collectively referred to as “excluded bonds”). These excluded bonds and any other qualifying or special debt securities (such as inflation-linked bonds and inverse floater) will be categorized as “category 2 qualifying or special debt securities” and subject to the haircut percentages specified in Column (II).

New proposal – Haircut percentage for constituents of Hang Seng Composite LargeCap Index

333. A circular was issued by the SFC on 16 April 2010 informing LCs that following the cessation of compilation of the Hang Seng Hong Kong LargeCap Index (“**HSHKLCI**”) and Hang Seng Hong Kong MidCap Index (“**HSHKMCI**”), various provisions of the FRR⁴⁹ ceased to apply to constituent stocks of HSHKLCI and HSHKMCI. Prior to that, HSHKLCI constituents were subject to a 15% haircut whereas HSHKMCI constituents were subject to a 20% haircut under the FRR, and these stocks were exempted from being classified as illiquid collateral for the purpose of calculating the value of margin loan collateral in liquid assets calculation. At the time HSHKLCI and HSHKMCI were abolished, they had in aggregate 50 constituents, many of them were also Hang Seng Index constituents, which continued to be subject to a 15% haircut and enjoy the illiquid collateral exemption.
334. We have explored whether there is any other stock index which is made up of Hong Kong listed shares that may deserve a lower haircut percentage than the 30% haircut percentage for Hong Kong listed shares which are not Hang Seng Index constituents. We concluded that the Hang Seng Composite LargeCap Index, which comprises 100 constituents⁵⁰, may justify a haircut percentage of 20% and exemption from being classified as illiquid collateral, after considering the volatility, turnover and market capitalization of its constituents.
335. We have also reviewed the volatility, turnover and market capitalization of the constituents of Hang Seng Composite MidCap Index (“**HSMI**”). The review results suggested that their volatility, turnover and market capitalization vary greatly from stock to stock. In addition, the margin ratios assigned by market participants to a number of HSMI constituents also vary significantly, suggesting that there exists divergent views on the risks of these stocks. In view of the review findings, it is considered not appropriate to apply a lower haircut percentage to HSMI constituents.

⁴⁹ Items 1(a) & (b) of Table 1 in Schedule 2, items 1(a) & (b) of Table 1A in Schedule 2 and sections 22(4)(d)(ii) & (iii).

⁵⁰ As of 5th September 2016.



New proposal – Treatment of opposite onshore and offshore positions in non-freely floating foreign currency

336. Under section 52 of the existing FRR, an LC shall include in its ranking liabilities 5% of its net position in each foreign currency. Currently, it is not specified in the FRR whether onshore and offshore positions in a non-freely floating foreign currency are positions in the same currency and can be netted. It is observed that deviations between onshore and offshore exchange rates of a non-freely floating foreign currency (e.g. CNY and CNH) may arise from time to time. Therefore, it is proposed to apply a new capital charge in the form of ranking liabilities which equals 1.5% of one side of the matched onshore and offshore positions in a non-freely floating foreign currency that has been set off in the net position calculation to cover execution and basis risks.

New proposals – Sundry technical changes

337. We have identified some further technical changes to the FRR, which are not specific to OTCD activities, in light of market developments and in order to rationalize the drafting of the rules to better reflect the underlying policies. The key proposed changes are summarized below:
- (a) in order to better reflect our policy intent, it will be clarified in the definitions of “gross foreign currency position” and “net position” in a foreign currency in sections 2 and 52(3) of the FRR that all amounts of the foreign currency in respect of which the LC is exposed to the risk of a decline or rise in the value of the foreign currency under outstanding contracts shall be included in the calculation of these positions;
 - (b) the definition of “in-the-money amount” in section 2(1) of the FRR will be expanded to cover index options to provide greater clarity;
 - (c) the use of fair value determined in accordance with generally accepted accounting principles as the basis for valuation of securities, investments, derivative contracts etc. will be allowed if no published market price is available, and the valuation basis provided in section 9 of the FRR will be rationalized, including short positions in suspended listed securities and non-marketable debt securities will be valued at the higher of their fair value and last closing price before the suspension of trading/face value;
 - (d) in item 1(a) of Table 2 in Schedule 2 to the FRR, the Nikkei 500 Index will be replaced by the Nikkei Stock Average as the latter is the benchmark index of the Japan stock market and has greater popularity and liquidity in the futures and options markets in major jurisdictions;
 - (e) the amount required to be included in ranking liabilities under section 47(1)(a)(i) of the FRR in respect of underwriting transactions will be capped at the amount of net underwriting commitment which is the maximum possible loss under a securities underwriting transaction;
 - (f) the definition of “segregated account” in section 2(1) of the FRR will be revised to specify that the segregated account is established and maintained by the LC concerned;



- (g) section 37(a) of the FRR will be expanded to allow an LC to exclude from its ranking liabilities amount payable to any of its clients in respect of client money held by it in a segregated account maintained with a person approved by the SFC for the purposes of section 4(2) of the Securities and Futures (Client Money) Rules;
- (h) the definitions of "qualifying debt securities" and "special debt securities" in section 2(1) of the FRR, section 58(2)(b) and Table 4 of Schedule 2 to the FRR will be amended⁵¹ to recognize credit ratings issued by Fitch Ratings in order to align with the practices of peer regulators to provide a level playing field and more closely reflect the contemporary market practice;
- (i) the haircut percentage tables for shares will be combined and streamlined to better reflect the policy of allowing LCs to elect a lower applicable haircut percentage for shares which are listed on more than one exchange and reflect market developments; and
- (j) clarification of the applicability of various FRR provisions to listed options (such as listed warrants) and other options will be made in order to provide greater clarity of the underlying policies.

H. Transitional arrangements

- 338. We consulted on a proposal whereby pre-existing Non-RA11 OTCD dealers will be given a 6-month transitional period to comply with the proposed minimum capital requirements, SMRA and SOCCRA.
- 339. Respondents generally considered that a longer period is needed for the purposes of system enhancement, business re-organization, recapitalization, expertise training, etc. Most respondents suggested extending the transitional period to one year.
- 340. In view of these responses, it is proposed to extend the transitional period for full compliance with the new FRR requirements by pre-existing Non-RA11 OTCD dealers to one year ("**the FRR transitional period**") using a phase-in approach (please see below). In addition, similar transitional arrangement will be extended to LCs deemed to be licensed for the new Type 7 activity, Type 11 RA or Type 12 RA to ensure level playing with pre-existing Non-RA11 OTCD dealers.
- 341. For the avoidance of doubt, the transitional arrangements for compliance with minimum capital requirements will not apply to LCs approved to use the internal models approach. They will be subject to the applicable minimum capital requirements immediately upon the grant of the approval.
- 342. Details of the modified transitional arrangements are described below.

⁵¹ The proposed definition of "specified credit rating agency" under SMRA and SOCCRA will also be modified.



Phase-in transition approach for pre-existing Non-RA11 OTCD dealers

- 343. Same as the original proposal, during the first six months of the FRR transitional period, all pre-existing Non-RA11 OTCD dealers will continue to be subject to the existing paid-up share capital requirement and floor RLC that apply to their licensed regulated activity(ies).
- 344. During the last six months of the FRR transitional period, pre-existing Non-RA11 OTCD dealers, other than RCCP-cleared OTCD dealers and OTCD central dealing desk dealers, will be subject to half of the new minimum capital requirements applicable to them. In other words, firms with OTCD activity level not exceeding the OTCD de minimis thresholds will be subject to HK\$250 million tangible capital requirement and HK\$39 million floor RLC, whereas the others will be subject to HK\$500 million tangible capital requirement and HK\$78 million floor RLC. These transitional arrangements will end upon the expiry of the FRR transitional period, when these pre-existing Non-RA11 OTCD dealers will be subject to the full amounts of the new minimum capital requirements.
- 345. Pre-existing RCCP-cleared OTCD dealers and OTCD central dealing desk dealers will be required to comply with the new minimum capital requirements (i.e. HK\$30 million paid up share capital requirement and HK\$15 million floor RLC) upon the expiry of the first six months of the FRR transitional period.
- 346. Regarding the application of SMRA and SOCCRA, all pre-existing Non-RA11 OTCD dealers shall use BMRA and BOCCRA instead of SMRA and SOCCRA to calculate the capital requirements for market risk for proprietary positions and counterparty credit risk arising from OTCD transactions during the FRR transitional period. The option to early adopt SMRA and SOCCRA by LCs meeting the new minimum capital requirements as proposed in the consultation paper will remain.
- 347. These transitional arrangements will allow firms more time to transit to the new minimum capital requirements and the more sophisticated regulatory capital calculation approaches.

FRR transitional arrangement for LCs deemed to be licensed for the new Type 7 activity, Type 11 RA or Type 12 RA

- 348. Under the licensing regime, firms which have been engaging in any of the new Type 7 activity, new Type 9 activity, Type 11 RA or Type 12 RA within the two years before the commencement date of these regulated activities and applied to be licensed for the relevant regulated activity during the application period (as defined in the SFAO) will be deemed to be licensed for that regulated activity starting from the date immediately after the end of a 6-month transitional period. Under the original proposal, once their deemed licence takes effect, they will be required to comply with all applicable regulatory requirements, including the FRR.
- 349. As deemed licensees are in fact pre-existing OTCD intermediaries, they might encounter similar transitional issues as pre-existing Non-RA11 OTCD dealers in complying with the substantial minimum capital requirements and implementing the sophisticated regulatory capital calculation approaches. In order to maintain a level playing field between deemed licensees and pre-existing Non-RA11 OTCD dealers, who are given until the end of the FRR transitional period to comply with the new minimum capital requirements and implement SMRA and SOCCRA, similar concessionary treatments will be offered to firms deemed to be licensed for the new Type 7 activity, Type 11 RA (other than a deemed licensee whose business is limited to advising on OTC derivative products or resembles



that of an RCCP-cleared OTCD dealer or OTCD central dealing desk dealer (Note)) or Type 12 RA⁵², i.e. during the first six months after the effective date of their deemed status:

- (a) they will be subject to half of the new minimum capital requirements.
- (b) they should use BMRA and BOCCRA instead of SMRA and SOCCRA to calculate the capital requirements for market risk for proprietary positions and counterparty credit risk arising from OTCD transactions. They would also be given the option to early adopt SMRA and SOCCRA if they can meet the new minimum capital requirements.

(Note: such firms will be subject to the new minimum capital requirements once their deemed status takes effect.)

350. For the avoidance of doubt, after the end of the abovementioned 6-month period, the aforesaid firms are required to comply with all new FRR requirements.

351. The following table summarizes the revised transitional arrangements for the compliance of the new FRR requirements.

	FRR requirement	During the first 6 months beginning from the commencement date of the FRR amendments ("Commencement Date")	Between the 7 th month and 12 th month from the Commencement Date	After the end of the FRR transitional period
A pre-existing Non-RA11 OTCD dealer	Fixed-dollar baseline capital requirement and floor RLC	<ul style="list-style-type: none"> Subject to existing paid-up share capital requirement and floor RLC 	<ul style="list-style-type: none"> OTCD dealers (other than RCCP-cleared OTCD dealers and OTCD central dealing desk dealers): <ul style="list-style-type: none"> (i) if the level of OTCD activities does not exceed OTCD de minimis thresholds: HK\$250 million tangible capital requirement and HK\$39 million floor RLC (ii) in any other case: HK\$500 million tangible capital requirement and HK\$78 million floor RLC RCCP-cleared OTCD dealers and OTCD central dealing desk dealers: HK\$30 million paid-up share capital requirement and HK\$15 million floor RLC 	<ul style="list-style-type: none"> Subject to all new FRR requirements

⁵² Concessionary treatment is considered not necessary for deemed licensees for the new Type 9 RA as their minimum capital requirements are not substantial.



	FRR requirement	During the first 6 months beginning from the commencement date of the FRR amendments ("Commencement Date")	Between the 7th month and 12th month from the Commencement Date	After the end of the FRR transitional period
	Approaches to calculate capital for market risk and counterparty credit risk	<ul style="list-style-type: none"> • BMRA and BOCCRA • Option to adopt SMRA and SOCCRA if meeting the new minimum capital requirements as an LC licensed for Type 11 RA to carry on dealing in OTC derivative products 	<ul style="list-style-type: none"> • BMRA and BOCCRA • Option to adopt SMRA and SOCCRA if meeting the new minimum capital requirements as an LC licensed for Type 11 RA to carry on dealing in OTC derivative products 	
	Other FRR requirements	<ul style="list-style-type: none"> • Applicable 	<ul style="list-style-type: none"> • Applicable 	
LCs deemed to be licensed for the new Type 7 activity, Type 11 RA (dealing in OTC derivative products) or Type 12 RA	Fixed-dollar baseline capital requirement and floor RLC	<ul style="list-style-type: none"> • Not applicable if not licensed for any other RA (Note 1) 	<ul style="list-style-type: none"> • OTCD dealers (other than RCCP-cleared OTCD dealers and OTCD central dealing desk dealers): <ul style="list-style-type: none"> (i) if the level of OTCD activities does not exceed OTCD de minimis thresholds: HK\$250 million tangible capital requirement and HK\$39 million floor RLC (ii) in any other case: HK\$500 million tangible capital requirement and HK\$78 million floor RLC • RCCP-cleared OTCD dealers and OTCD central dealing desk dealers: HK\$30 million paid-up share capital requirement and HK\$15 million floor RLC • New Type 7 activity (trading): HK\$500 million tangible capital requirement and HK\$78 million floor RLC • New Type 7 activity (novation, clearing, settlement): HK\$1 billion tangible capital requirement and HK\$195 million floor RLC • Type 12 RA: HK\$1 billion tangible capital requirement and HK\$195 million floor RLC 	



	FRR requirement	During the first 6 months beginning from the commencement date of the FRR amendments (“Commencement Date”)	Between the 7 th month and 12 th month from the Commencement Date	After the end of the FRR transitional period
	Approaches to calculate capital for market risk and counterparty credit risk	<ul style="list-style-type: none">Not applicable if not licensed for any other RA (Note 1)	<ul style="list-style-type: none">BMRA and BOCCRAOption to adopt SMRA and SOCCRA if meeting the new minimum capital requirements	
	Other FRR requirements	<ul style="list-style-type: none">Not applicable if not licensed for any other RA (Note 1)	<ul style="list-style-type: none">Applicable	
LCs deemed to be licensed for the new Type 9 activity and Type 11 RA (advising on OTC derivative products)	Fixed-dollar baseline capital requirement and floor RLC	<ul style="list-style-type: none">Not applicable if not licensed for any other RA (Note 1)	<ul style="list-style-type: none">Applicable	
	Approaches to calculate capital for market risk and counterparty credit risk	<ul style="list-style-type: none">Not applicable if not licensed for any other RA (Note 1)	<ul style="list-style-type: none">BMRA and BOCCRAOption to adopt SMRA and SOCCRA if meeting the new minimum capital requirements as an LC licensed for Type 11 RA to carry on dealing in OTC derivative products	
	Other FRR requirements	<ul style="list-style-type: none">Not applicable if not licensed for any other RA (Note 1)	<ul style="list-style-type: none">Applicable	
All other LCs	<ul style="list-style-type: none">Subject to all applicable new FRR requirements on the Commencement Date			

Note 1: For the avoidance of doubt, firms licensed for one or more than one existing RAs shall continue to be subject to the capital requirements, including any new FRR requirements that apply to their existing RAs on the Commencement Date.

352. One respondent suggested a testing period of six months before the new FRR requirements take effect to enable technical implementation details to be identified for clarification and refinement and provide reference for gauging industry impact.
353. We welcome LCs and firms planning to apply for a licence for carrying out regulated OTCD activities to plan ahead for the implementation of the new FRR requirements and share with us any major implementation issues they envisaged or encountered during their testing. Meanwhile, the need for an industry-wide testing seems remote but we will keep an open mind to any suggestion in this regard.



III. Comments received in relation to the consultation paper issued in 2011

354. A consultation was conducted on 4 May 2011 ("**2011 consultation**") on a proposal to (i) add four futures exchanges, namely, HKMEx, Taiwan Futures Exchange Corporation, Thailand Futures Exchange Public Company Limited and Tokyo Commodity Exchange, Inc., to the list of specified exchanges in Schedule 3 to the FRR; (ii) to include participants of HKMEx in the definition of "exchange participant" in section 2(1) of the FRR; and (iii) to update the names of certain exchanges specified in the FRR that have changed their names. The consultation conclusion was put on hold following the cessation of business of HKMEx.
355. A total of five submissions were received from professional bodies, market participants and other interested parties. Respondents were generally supportive of the proposals. A respondent asked why some of the four newly-added exchanges are put under Part 1 of the list of specified exchanges and the others are put under Part 2 of the same list. The respondent also suggested the SFC to consider updating the names of the exchanges specified in the FRR once the names have changed.
356. The placing of a future exchange in Schedule 3 to the FRR, whether under Part 1 or Part 2 of that schedule, does not affect the application of the FRR provisions related to futures exchanges, which apply equally to all the futures exchanges specified in that Schedule. The proposed allocation of some of the newly-added futures exchanges to Part 2 of Schedule 3 aims to place the futures exchanges concerned in the same part of the list as the other exchanges operating in the same jurisdiction for ease of reference. This is consistent with the existing practice.
357. Regarding the frequency of updating the names of the exchanges specified in the FRR, we propose to include a new provision in the FRR to ensure that a reference to an exchange or a clearing house in the FRR will survive any subsequent name change of the exchange/clearing house or any succession of the exchange/clearing house by another exchange/clearing house (whether by reason of merger, amalgamation or otherwise).
358. Given that HKMEx's ATS authorization has been withdrawn, HKMEx will not be included in the list of specified exchange as originally proposed.
359. We have also updated the related proposed FRR amendments in the 2011 consultation, i.e. the Proposed Securities and Futures (Financial Resources) Amendment (No.2) Rules 2011, to reflect the subsequent changes of the names of some exchanges and market development, and included the updated amendments in Appendix 1 for further consultation.
360. The following comments and suggestions, which are outside the scope of the 2011 consultation, were also received:
- (a) A respondent noted that a firm selling its own collective investment schemes ("**CIS**") requires significantly more issued and liquid capital than a firm selling its own CIS but also exercising management of that CIS in Hong Kong. He suggested that the required liquid capital and issued capital requirements should be the same for both types of firms given the same prudential risk for them.



- (b) A respondent suggested that funds deposited with clearing brokers outside Hong Kong should be allowed to be included fully in an LC's liquid assets.
- (c) A respondent suggested that firms applying to be licensed should be allowed to apply for approval of a subordinated loan before the license is granted.
- (d) A respondent suggested that liability arising from a trade between the trade date and settlement date should not be included as liability for liquid capital calculation purpose if it is highly likely to be settled, and that only failed trades should be included as liability for liquid capital calculation purpose.
- (e) A respondent suggested that firms licensed for Type 9 RA should be exempt from completing any form of liquid capital calculation, and that such firms should only be required to complete an annual declaration of solvency without the requirement to monitor or report on any of the current requirements of the FRR.
- (f) A respondent suggested to allow netting between amounts receivable from and amounts payable to a GCP of the HKEX.

361. Our responses to the above comments/suggestions (using the same numbering) are as follows:

- (a) Dealing in CIS, which is Type 1 RA, must be distinguished from securities dealing carried out solely for the purposes of carrying on asset management activities (i.e. Type 9 RA), which is carved out from Type 1 RA. These two types of dealing activities have different nature and expose the intermediary to different types of risk and therefore should be subject to different capital requirements.
- (b) The FRR already allows an LC to include in liquid assets money (in the form of either a demand deposit or a time deposit maturing in six months or less) which it beneficially owns and holds in its name, or in a segregated account, with approved banks incorporated outside Hong Kong⁵³. Money held with clearing participants of futures or options clearing houses of overseas exchanges which are specified exchanges in respect of futures or options dealing or leveraged foreign exchange trading can also be included in liquid assets⁵⁴. It is considered that these FRR treatments have already struck a balance between the need to ensure liquid fund kept overseas is adequately protected and LCs' operational needs in conducting business in overseas markets.
- (c) Application for approval of subordinated loan can only be made by an LC pursuant to section 58(5) of the FRR, though we welcome licence applicants to discuss with us about their plan to apply for such approval after they are licensed and prepare their application in advance in order to expedite the application process.
- (d) According to the FRR, assets and liabilities are required to be accounted for in accordance with generally accepted accounting principles. Liability arising from a transaction is required to be recognized on a trade date basis and, therefore, must be included in the LC's ranking liabilities on the trade date. It would be

⁵³ Section 20 of the FRR.

⁵⁴ Section 29 of the FRR.



inconsistent with the FRR's objective to provide for potential future exposures (on top of realized losses) to allow booking to be based on the hindsight of settlement failure.

- (e) FRR provides a framework to ensure LCs maintain financial resources commensurate to the nature and risks of their activities. Firms subject to the FRR should monitor their compliance and report their financial positions to the SFC on a regular basis in order to enable the SFC to assess their compliance. As a majority of firms licensed for Type 9 RA are only required to submit FRR returns on a semi-annual basis, there is no compelling reason to exempt this class of LCs from the FRR's reporting requirements.
- (f) This suggestion has been considered in Section G of Part II above.



IV. Conclusion and further consultation

362. Subject to the results of the further consultation on the proposals set out in this paper, amendment rules for implementing the proposals will be drafted for consultation. As the proposals related to OTCD activities are voluminous and complex, the related rule drafting will take time to finish. On the other hand, the rule drafting for those proposals not specific to OTCD activities is more straight forward and less time-consuming. A respondent suggested giving priority to finalizing the latter in order that the industry can benefit from those changes earlier.
363. We welcome this suggestion and have prepared and attached in Appendix 1 the draft amendment rules on those proposals not specific to OTCD activities, incorporating the revised proposed amendments relating to the 2011 consultation, for consultation. These amendment rules will be implemented separately once finalized.
364. The draft amendment rules on those OTCD-related proposals will be published for consultation once available.
365. We take this opportunity to thank everyone who took the time and effort to comment on the proposals in our consultation paper. Your comments and suggestions have been most useful, and have helped us refine and finalize many key aspects of the changes to the FRR.



Appendix 1: Proposed amendments to the Securities and Futures (Financial Resources) Rules in relation to changes not specific to OTCD activities

DRAFT AMENDMENTS TO SECURITIES AND FUTURES (FINANCIAL RESOURCES) RULES

(Cap 571, sections 145 and 397)

Part 1 Preliminary

1 (Omitted as spent)

2 Interpretation

~~(1)~~—In these Rules, unless the context otherwise requires—

adjusted liabilities (經調整負債), for the purpose of calculating the variable required liquid capital in relation to a licensed corporation, means the sum of its on-balance sheet liabilities including provisions made for liabilities already incurred or for contingent liabilities, but excluding—

- (a) amounts payable to clients in respect of—
 - (i) client money held by it in a segregated account in accordance with the Securities and Futures (Client Money) Rules (Cap 571 sub. leg. I);
 - (ii) to the extent not covered in subparagraph (i), client money held by it in a segregated account with an authorized financial institution;
 - (iii) client money held by it in a segregated account with an approved bank incorporated outside Hong Kong;
 - (iv) client money held by it in a segregated account with a futures or options clearing house; or
 - (v) client money held by it with—
 - (A) a clearing house other than a futures or options clearing house;
 - (B) a clearing participant;
 - (C) a futures dealer; or
 - (D) a securities dealer,as margin in respect of outstanding futures contracts and outstanding unlisted options contracts held by it on behalf of its clients; ~~and~~
- (b) an approved subordinated loan provided to it; and



(c) any on-balance sheet liabilities arising from a tenancy agreement entered into by it in respect of any premises which it uses in carrying on the regulated activity for which it is licensed, which it has excluded from its ranking liabilities under section 53(2)(c):

aggregate gross foreign currency position (合計外幣總持倉量) means the aggregate of all the gross foreign currency positions held by a licensed corporation licensed for Type 3 regulated activity, excluding positions held with a recognized counterparty;

amount of margin required to be deposited (按規定須存放的保證金數額) means the amount of money required to be deposited as margin (whether the requirement is met by depositing the amount of money or by the provision of security instead of making such deposit)—

(a) upon opening a position; or

(b) for maintaining an existing position,

in a futures contract or an unlisted options contract, calculated as the highest of the prevailing margin amounts set by—

(c) the exchange on which the futures contract or options contract is traded;

(d) the clearing house who registers such trade;

(e) the agent who executes such trade for the licensed corporation;

(f) the counterparty who executes such trade with the licensed corporation; and

(g) the licensed corporation itself;

approved bank incorporated outside Hong Kong (核准的在香港以外成立為法團的銀行) means—

(a) a bank incorporated under the law or other authority of a prescribed country, and includes any of its branches or wholly owned subsidiaries which is a bank; or

(b) any other bank approved as such under section 58(1)(a), and includes any of its branches or wholly owned subsidiaries which is a bank;

approved credit rating agency (核准信貸評級機構) means a person approved as such under section 58(1)(b);

approved introducing agent (核准介紹代理人) means a licensed corporation approved as such under section 58(4);

approved redeemable shares (核准可贖回股份) means redeemable shares in the share capital of a licensed corporation approved as such under section 58(5)(a);

approved securities borrowing and lending counterparty (核准證券借貸對手方) means—

(a) a recognized clearing house; or

(b) a person approved as such under section 58(1)(c);

approved standby subordinated loan facility (核准備用後償貸款融通) means a standby subordinated loan facility obtained by a licensed corporation licensed for Type 1, Type 2, Type 3 or Type 8 regulated activity, which is approved as such under section 58(5)(c);

approved subordinated loan (核准後償貸款) means a subordinated loan obtained by a licensed corporation approved as such under section 58(5)(b);



authorized financial institution (認可財務機構) means—

- (a) a bank within the meaning of section 2(1) of the Banking Ordinance (Cap 155) and includes any of its branches;
- (b) any wholly owned subsidiary of a bank referred to in paragraph (a) which is a bank; or
- (c) the principal place of business in Hong Kong, and any local branch, of a restricted licence bank or a deposit-taking company, in each case within the meaning of section 2(1) of the Banking Ordinance (Cap 155);

authorized fund (認可基金) means a unit trust or mutual fund that is authorized by the Commission under section 104 of the Ordinance;

basic amount (基本數額), in relation to a licensed corporation, means 5% of the aggregate of—

- (a) its adjusted liabilities;
- (b) the aggregate of the initial margin requirements in respect of outstanding futures contracts and outstanding unlisted options contracts held by it on behalf of its clients; and
- (c) the aggregate of the amounts of margin required to be deposited in respect of outstanding futures contracts and outstanding unlisted options contracts held by it on behalf of its clients, to the extent that such contracts are not subject to payment of initial margin requirements;

clearing house (結算所) means a person—

- (a) whose activities or objects include the provision of services for the clearing and settlement of transactions in, or the day-to-day adjustment of the financial position of, futures contracts or unlisted options contracts effected on an exchange;
- (b) whose activities or objects include the provision of services for the clearing and settlement of transactions in securities effected on an exchange; or
- (c) who guarantees the settlement of any such transactions as are referred to in paragraph (a) or (b),

but does not include a corporation operated by or on behalf of the Government;

clearing participant (結算所參與者)—

- (a) in relation to a recognized clearing house, means a clearing participant within the meaning of section 1 of Part 1 of Schedule 1 to the Ordinance; or
- (b) in relation to a clearing house other than a recognized clearing house, means a person who, in accordance with the rules of the clearing house, may participate in one or more of the services provided by the clearing house in its capacity as a clearing house, and whose name is entered in a list, roll or register kept by the clearing house as a person who may participate in one or more of the services provided by the clearing house;

collateral (抵押品), in relation to a licensed corporation, means—

- (a) any listed shares;
- (b) any specified securities;
- (c) any qualifying debt securities; or



- (d) any special debt securities,
which—
- (e) are deposited as security by the licensed corporation with another person; or
- (f) are deposited as security with the licensed corporation by another person, and—
 - (i) are unencumbered in its possession and readily realizable by it;
 - (ii) are encumbered only by virtue of being lent, deposited or pledged by it in accordance with the requirements of the Securities and Futures (Client Securities) Rules (Cap 571 sub. leg. H); or
 - (iii) to which the Securities and Futures (Client Securities) Rules (Cap 571 sub. leg. H) do not apply, are encumbered only by virtue of being deposited or pledged by it with or to—
 - (A) an authorized financial institution or an approved bank incorporated outside Hong Kong;
 - (B) a person who is licensed, registered or authorized by an authority or regulatory organization outside Hong Kong, for an activity which, if carried on in Hong Kong, would constitute Type 1, Type 2, Type 3 or Type 8 regulated activity; or
 - (C) a clearing house of a specified exchange or any of its clearing participants to secure its obligation to meet its clearing obligations or liabilities;

collateralized warrants (有抵押權證) means derivative warrants listed on a recognized stock market in respect of which the issuer owns all of the underlying securities or other assets to which the warrants relate and grants a charge over those securities or assets in favour of an independent trustee who acts for the benefit of the warrant holders;

common client (共同客戶) means a client of a securities dealer who is also a client of a licensed corporation licensed for Type 8 regulated activity and whose dealings in securities by the securities dealer are settled on his behalf by the licensed corporation;

derivative contract (衍生工具合約) means an agreement the purpose or effect of which is to obtain a profit or avoid a loss by reference to the value or price of property of any description or an index or other factor designated for that purpose in the agreement, and includes a futures contract or an options contract;

equities (股本) means shares issued by a corporation (including shares in a mutual fund) and units in a unit trust;

equity-linked instruments (股票掛鉤票據) means securities within the description of such instruments under rules made under section 23 or 36 of the Ordinance governing the listing of securities and which are listed on a recognized stock market;

exchange participant (交易所參與者)—

- (a) in relation to a recognized exchange company, means an exchange participant within the meaning of section 1 of Part 1 of Schedule 1 to the Ordinance; or
- (b) in relation to an exchange outside Hong Kong, means a person who, in accordance with the rules of the exchange, may trade through that exchange, and whose name is entered in a list, roll or register kept by the exchange as a person who may trade through that exchange;



excluded liabilities (豁免負債), in relation to the on-balance sheet liabilities of a licensed corporation, means amounts payable to clients in respect of—

- (a) client money held by it in a segregated account in accordance with the Securities and Futures (Client Money) Rules (Cap 571 sub. leg. I);
- (b) client money held by it in a segregated account with an approved bank incorporated outside Hong Kong and, to the extent not covered in paragraph (a), in a segregated account with an authorized financial institution; and
- (c) client money held by it in a segregated account with a recognized clearing house;

floating losses (浮動虧損) means unrealized losses calculated by marking to market an open position in—

- (a) a futures contract;
- (b) any securities;
- (c) an options contract;
- (d) a derivative contract;
- (e) a leveraged foreign exchange contract;
- (f) a foreign exchange agreement;
- (g) an interest rate swap agreement; ~~or~~
- (h) a specified investment;
- (i) an illiquid investment; or
- (j) a miscellaneous investment;

floating profits (浮動利潤) means unrealized profits calculated by marking to market an open position in—

- (a) a futures contract;
- (b) any securities;
- (c) an options contract;
- (d) a derivative contract;
- (e) a leveraged foreign exchange contract;
- (f) a foreign exchange agreement;
- (g) an interest rate swap agreement; ~~or~~
- (h) a specified investment;
- (i) an illiquid investment; or
- (j) a miscellaneous investment;

foreign currency (外幣), in relation to a licensed corporation, means any currency other than—

- (a) its reporting currency; and
- (b) any currency which has an exchange rate which is linked to the reporting currency;



foreign exchange agreement (外匯協議) means an agreement other than a futures contract and an options contract, whereby the parties to the agreement agree to exchange different currencies at a future time;

free delivery basis (信用交付形式) means the basis on which a sale or purchase of securities is effected, under which—

- (a) delivery of the securities by the seller takes place irrespective of whether the seller has received payment in settlement of a liability arising from the sale of the securities; or
- (b) payment is made by the purchaser of the securities in settlement of a liability arising from the purchase of the securities, irrespective of whether the securities have been delivered;

futures contract (期貨合約) has the meaning assigned to it by section 1 of Part 1 of Schedule 1 to the Ordinance save that it does not include an options contract;

futures dealer (期貨交易商) means—

- (a) a licensed corporation licensed for Type 2 regulated activity; or
- (b) a person licensed, registered or authorized by an authority or regulatory organization outside Hong Kong for an activity which, if carried on in Hong Kong, would constitute Type 2 regulated activity;

futures non-clearing dealer (期貨非結算交易商) means a licensed corporation licensed for Type 2 regulated activity which is an exchange participant of a recognized futures market, but is not a clearing participant of a recognized clearing house;

futures or options clearing house (期貨或期權結算所) means—

- (a) a recognized clearing house other than a recognized clearing house whose activities or objects include the provision of services for the clearing and settlement of transactions in securities (other than unlisted options contracts); or
- (b) a person—
 - (i) whose activities or objects include the provision of services for—
 - (A) the clearing and settlement of transactions in futures contracts or unlisted options contracts; or
 - (B) the day-to-day adjustment of the financial position of futures contracts or unlisted options contracts,—effected on a specified exchange, or subject to the rules of a specified exchange; or
 - (ii) who guarantees the settlement of any such transactions as are referred to in subparagraph (i),

but does not include a corporation operated by or on behalf of the Government;

general clearing participant of HKSCC (香港結算公司全面結算參與者) means a clearing participant of HKSCC that is authorized in accordance with the rules of HKSCC to provide general clearing services to exchange participants of the Stock Exchange Company.

gross foreign currency position (外幣總持倉量), in relation to a licensed corporation's position in a foreign currency, means the total of—



- ~~(a) the aggregate of the value of assets, other than fixed assets, beneficially owned by a licensed corporation which are denominated in the foreign currency together with the amount of the foreign currency which it is obliged to purchase under any outstanding contract; and~~
- ~~(b) the aggregate of the amount of the on-balance sheet liabilities of the licensed corporation, other than excluded liabilities, which are denominated in such foreign currency together with the amount of that foreign currency which it is obliged to sell under any outstanding contract;~~
- ~~save that where the licensed corporation holds with a client (other than a client whose account with the licensed corporation is an omnibus account) 2 outstanding contracts and—~~
- ~~(c) under one of the contracts it is obliged to purchase an amount of a currency (**A**) and sell an amount (**X**) of another currency (**B**); and~~
- ~~(d) under the other contract it is obliged to purchase the same amount (**X**) of the other currency (**B**) and sell an amount of the first-mentioned currency (**A**);~~
- ~~it shall, in relation to the contracts described in paragraphs (c) and (d), include in the total—~~
- ~~(e) in relation to currency B, the amount X of currency B that it is obliged to sell under the contract referred to in paragraph (c); and~~
- ~~(f) in relation to currency A, the amount of currency A at the higher of—~~
- ~~(i) the amount of that currency which it is obliged to purchase under the contract referred to in paragraph (c); and~~
- ~~(ii) the amount of that currency which it is obliged to sell under the contract referred to in paragraph (d);~~(a) the aggregate of—
- ~~(i) the value of assets, other than fixed assets, beneficially owned by it which are denominated in the foreign currency; and~~
- ~~(ii) all of its on-balance sheet liabilities, other than excluded liabilities, which are denominated in the foreign currency;~~
- (b) subject to paragraph (c), the aggregate of—
- (i) the total amount of the foreign currency in respect of which it is exposed to the risk of a decline in the value of the foreign currency under outstanding contracts (including spot contracts); and
- (ii) the total amount of the foreign currency in respect of which it is exposed to the risk of a rise in the value of the foreign currency under outstanding contracts (including spot contracts);
- (c) it must include in paragraph (b) the amounts referred to in paragraph (d) in respect of a pair of outstanding contracts which it holds with a client (except a client whose account with it is an omnibus account) if—
- (i) under one of the contracts (**contract 1**) it is exposed to the risk of a decline in the value of an amount of a currency (**currency A**) and the risk of a rise in the value of an amount (**amount X**) of another currency (**currency B**); and



- (ii) under the other contract (**contract 2**) it is exposed to the risk of a decline in the value of amount X of currency B and to the risk of a rise in the value of an amount of currency A;
- (d) the amounts which it must include in paragraph (b) in respect of a pair of outstanding contracts referred to in paragraph (c) are—
 - (i) in relation to currency B, the amount X; and
 - (ii) in relation to currency A, the higher of the amounts in respect of which it is exposed to the risk of a decline in the value of currency A under contract 1 and to the risk of a rise in the value of currency A under contract 2;

haircut amount (扣減數額)—

- (a) in relation to any listed shares (except shares that are specified securities or illiquid investments)—
 - ~~(i) that are listed in Hong Kong, and specified in column 2 of Table 1 in Schedule 2;~~
 - ~~(ii) that are listed in Hong Kong, and specified in column 2 of Table 1A in Schedule 2;~~
 - ~~(iii) that are listed in the United Kingdom, the United States of America or Japan, and specified in column 2 of Table 2 in Schedule 2; or~~
 - ~~(iv) that are listed, and specified in column 2 of Table 3 in Schedule 2, _~~
- means an amount derived by multiplying the market value of the shares by the haircut percentage in relation to ~~such the~~ shares;
- (b) in relation to specified investments, means an amount derived by multiplying the market value of the specified investments by the haircut percentage in relation to such specified investments;
 - (c) in relation to specified securities, means an amount derived by multiplying the market value of the specified securities by the haircut percentage in relation to such specified securities;
 - (d) in relation to qualifying debt securities, means an amount derived by multiplying the market value of the qualifying debt securities by the haircut percentage in relation to such qualifying debt securities;
 - (e) in relation to special debt securities, means an amount derived by multiplying the market value of the special debt securities by the haircut percentage in relation to such special debt securities;
 - ~~(f) in relation to illiquid investments, means an amount derived by multiplying the market value of the illiquid investments by the haircut percentage in relation to the illiquid investments;~~
 - ~~(g) in relation to miscellaneous investments, means an amount derived by multiplying the market value of the miscellaneous investments by the haircut percentage in relation to the miscellaneous investments;~~
 - ~~(h) in relation to securities or investments referred to in paragraphs (a) to (g) that track the return on an index or reference asset and aim to deliver a daily return that is equivalent to a certain multiple (**the leverage factor**) of the daily return on the index or reference asset, means—~~
 - ~~(i) subject to subparagraph (ii), the amount derived in accordance with paragraphs (a) to (g) multiplied by the leverage factor;~~



(ii) the amount calculated in accordance with subparagraph (i) is not to exceed the market value of the securities or investments if—

(A) the relevant holding is not a short position; and

(B) the maximum loss that may be incurred is the market value;

haircut percentage (扣減百分率)—

(a) subject to paragraph (aa), in relation to any listed shares (except shares that are specified securities or illiquid investments)—

(i) that are listed in Hong Kong, and specified in column 2 of Table 1 in Schedule 2;

(ii) that are listed in Hong Kong, and specified in column 2 of Table 1A in Schedule 2;

(iii) that are listed in the United Kingdom, the United States of America or Japan, and specified in column 2 of Table 2 in Schedule 2; or

(iv) that are listed, and specified in column 2 of Table 3 in Schedule 2, _

means—

(v) subject to subparagraphs (vi), (vii), (viii) and (ix)(ii) and (iii), the percentage specified in column 3 of the Table 1 in Schedule 2 concerned opposite the applicable description set out in column 2 of that the Table;

(vi) where the shares fall within any of the descriptions in column 2 of Table 1A in Schedule 2 and within any of the descriptions in column 2 of Table 1, 2 or 3 in Schedule 2, subject to subparagraphs (vii) and (ix) and for the purpose of calculating the haircut amount under section 22(1)(b)(i), the percentage specified in column 3 of Table 1A in Schedule 2 opposite the applicable description set out in column 2 of that Table;

(vii) where the shares fall within 2 or more of the descriptions in column 2 of Table 1A in Schedule 2, subject to subparagraph (ix) and for the purpose of calculating the haircut amount under section 22(1)(b)(i), such percentage specified in column 3 of that Table opposite the applicable description set out in column 2 of that Table as may be elected by a licensed corporation;

(viii) where the shares fall within 2 or more than 1 of the descriptions set out in one or more of column 2 of the Table 1, 2 or 3 in Schedule 2, subject to subparagraph (vi), such, the percentage specified in column 3 of the Table concerned opposite any of the applicable descriptions set out in column 2 of that the Table, as may be elected by a licensed corporation; or

(iii) if elected by a licensed corporation, where the shares fall within a description set out in—

(A) item 1(a) or (b) in column 2 of the Table, the percentage specified in column 3 of the Table opposite the description set out in item 1(c) in column 2 of the Table;

(B) item 2(a)(i) in column 2 of the Table, the percentage specified in column 3 of the Table opposite the description set out in item 2(a)(ii) in column 2 of the Table;

(C) item 3(a)(i) in column 2 of the Table, the percentage specified in column 3 of the Table opposite the description set out in item 3(a)(ii) in column 2 of the Table;



- (D) item 4(a)(i) in column 2 of the Table, the percentage specified in column 3 of the Table opposite the description set out in item 4(a)(ii) in column 2 of the Table; or
 - (E) item 5(a) in column 2 of the Table, the percentage specified in column 3 of the Table opposite the description set out in item 5(b) in column 2 of the Table;
 - (aa) in relation to any shares (except shares that are specified securities or illiquid investments) that are listed on a recognized stock market and specified in column 2 of Table 1A in Schedule 2, means, for the purpose of calculating the haircut amount under section 22(1)(b)(i)—
 - (i) subject to subparagraphs (ii), (iii) and (iv) (and regardless of whether the shares also fall within any of the descriptions set out in column 2 of Table 1 in Schedule 2), the percentage specified in column 3 of the Table opposite the applicable description set out in column 2 of the Table;
 - (ii) where the shares fall within more than 1 of the descriptions set out in item 1(a), (b), (c) or (d) in column 2 of the Table, the percentage specified in column 3 of the Table opposite any of the applicable descriptions set out in column 2 of the Table, as elected by a licensed corporation;
 - (ixiii) where the shares described in item 1(a), (b), (c) or (d) in column 2 of ~~the Table 1A in Schedule 2~~—
 - (A) cease to be a constituent of the applicable index; and
 - (B) the cessation would result in the assignment to the shares of a higher percentage specified in ~~that the~~ Table,

in relation to the month in which the cessation occurs and for the period of the next 3 consecutive months ~~and for the purpose of calculating the haircut amount under section 22(1)(b)(i)~~, the percentage specified in column 3 of ~~the Table 1A in Schedule 2~~ which was applicable to the shares immediately prior to the cessation; or
 - (iv) if elected by a licensed corporation, where the shares fall within a description set out in item 1(a), (b), (c) or (d) in column 2 of the Table, the percentage specified in column 3 of the Table opposite the applicable description in item 1(e) in column 2 of the Table;
- (b) in relation to specified investments, means the percentage specified in column 3 of Table 8 in Schedule 2 opposite the applicable description set out in column 2 of the Table;
- (c) in relation to specified securities, means the percentage specified in column 3 of Table 7 in Schedule 2 opposite the applicable description set out in column 2 of the Table and, where the percentage is specified as being the same percentage applicable to—
 - (i) the underlying assets means, where the underlying assets are constituted by—
 - (A) a basket of equities, the highest of the haircut percentages which would apply to each of the equities, or the percentage calculated in accordance with an approval granted under section 58(5)(h); or
 - (B) a basket of debt securities, the highest of the haircut percentages which would apply to each of the debt securities, or the percentage



calculated in accordance with an approval granted under section 58(5)(h); or

(ii) the underlying index means, where the underlying index is calculated by reference to—

(A) a basket of equities, the highest of the haircut percentages which would apply to each of the equities, or the percentage calculated in accordance with an approval granted under section 58(5)(h); or

(B) a basket of debt securities, the highest of the haircut percentages which would apply to each of the debt securities, or the percentage calculated in accordance with an approval granted under section 58(5)(h);

(d) in relation to qualifying debt securities, means the aggregate of—

(i) the percentage specified in column 3 of Table 4 in Schedule 2 opposite the applicable description set out in column 2 of the Table; and

(ii) the percentage specified in column 2 or 3 (as the case may be) of Table 5 in Schedule 2 opposite the applicable description set out in column 1 of the Table;

(e) in relation to special debt securities ~~specified in column 2 of Table 6 in Schedule 2~~, means the percentage specified in column 3 of Table 6 in Schedule 2 opposite the applicable description set out in column 2 of the Table;

(f) in relation to illiquid investments or miscellaneous investments, means the percentage specified in column 3 of Table 9 in Schedule 2 opposite the applicable description set out in column 2 of the Table;

HKSCC (香港結算公司) means the recognized clearing house known as Hong Kong Securities Clearing Company Limited;

Hong Kong Exchange Fund (香港外匯基金) means the Exchange Fund established under the Exchange Fund Ordinance (Cap 66);

illiquid investments (低流通性投資項目) means—

(a) shares that are not listed, except shares in a mutual fund that do not fall within paragraph (b);

(b) units in a unit trust or shares in a mutual fund, where the unit trust or mutual fund—

(i) is not an authorized fund, a recognized jurisdiction fund or a specified exchange traded fund; or

(ii) is an authorized fund or a recognized jurisdiction fund, but—

(A) is not a specified exchange traded fund; and

(B) the units or shares are not redeemable within 30 days;

(c) debt securities that are not marketable debt securities;

(d) listed securities that have been suspended from trading for at least 3 trading days or ceased trading on any exchange on which the securities were listed, except where the securities can continue to be traded on any other exchange on which the securities are listed; or



(e) commodities that are not tradable commodities;

initial margin requirement (規定開倉保證金) means the amount of money required to be deposited (whether the requirement is met by depositing the amount of money or by the provision of security instead of making such deposit) upon opening a position in a futures contract or an unlisted options contract, calculated as the highest of the prevailing margin amounts set by—

- (a) the exchange on which the futures contract or options contract is traded;
- (b) the clearing house who registers such trade;
- (c) the agent who executes such trade for the licensed corporation;
- (d) the counterparty who executes such trade with the licensed corporation; and
- (e) the licensed corporation itself;

interest rate swap agreement (掉期息率協議) means an agreement whereby the parties to the agreement agree to exchange a series of interest payments over time;

in-the-money amount (價內值) means the amount calculated according to the following applicable formula—

- (a) in relation to a call options contract, $N \times (M - S)$;
- (b) in relation to a put options contract, $N \times (S - M)$; or
- (c) in relation to a call warrant on listed shares, $N \times (M - S)$,

where—

N represents—

- (i) where the asset underlying the options contract or warrant is shares, the number of such shares; ~~or~~
- (ii) where the asset underlying the options contract is an asset other than shares, the number of units of such asset; or

(iii) where an index underlies the options contract, the contract multiplier;

M represents ~~the market value of~~—

- (i) where the asset underlying the options contract or warrant is shares, the market value of one such share; ~~or~~
- (ii) where the asset underlying the options contract is an asset other than shares, the market value of one unit of such asset; or

(iii) where an index underlies the options contract, the current level of the index; and

S represents the strike price of the options contract or the exercise price of the warrant—

- (i) where the asset underlying the options contract or warrant is shares, for one such share; ~~or~~
- (ii) where the asset underlying the options contract is an asset other than shares, for one unit of such asset; or

(iii) where an index underlies the options contract, for the index;



liquid assets (速動資產), in relation to a licensed corporation, means the aggregate of the amounts required to be included in its liquid assets under the provisions of Division 3 of Part 4;

liquid capital (速動資金), in relation to a licensed corporation, means the amount by which its liquid assets exceeds its ranking liabilities;

listed (上市), in relation to securities, means ~~listed or traded on any exchange—~~

(a) subject to paragraph (b), the securities are—

(i) listed (within the meaning of the definition of **listed** in section 1 of Part 1 of Schedule 1 to the Ordinance) on a recognized stock market, and includes securities that are regulated in a jurisdiction outside Hong Kong which are admitted to trading on the recognized stock market; or

(ii) regarded as listed on an exchange outside Hong Kong under the laws or regulations of the jurisdiction in which the exchange is located and, in relation to a particular exchange—

(A) includes securities which are admitted to trading on the exchange if the securities are listed on another exchange in the same jurisdiction, or are regarded as listed on an exchange in another jurisdiction under the laws or regulations of the other jurisdiction; and

(B) for the purpose of this definition, securities continue to be regarded as listed during a period of suspension of dealings in the securities on the exchange; and

(b) despite paragraph (a), securities are not regarded as being listed on a particular exchange—

(i) merely because the exchange provides (directly or indirectly) facilities for—

(A) effecting transactions in the securities on another exchange; or

(B) transmitting or otherwise communicating by any means offers to effect transactions in the securities on another exchange; or

(ii) if the securities are options contracts—

(A) with standardised contractual terms and conditions specified by the exchange; and

(B) which are traded on the exchange;

margin client (保證金客戶)—

(a) in relation to a licensed corporation licensed for Type 1 regulated activity, means a client to whom the licensed corporation provides securities margin financing; or

(b) in relation to a licensed corporation licensed for Type 8 regulated activity, means any of its clients;

marketable debt securities (有價債務證券) means—

(a) certificates of deposit issued by an authorized financial institution or an approved bank incorporated outside Hong Kong; or



- (b) debt securities (other than certificates of deposit referred to in paragraph (a)) in respect of which—
- (i) there are genuine offers to buy and sell so that a price reasonably related to the last sales price or current bid and offer quotations can be determined within 1 day, and transactions can be settled at that determined price promptly in accordance with trading conventions; or
 - (ii) quotations are available within 1 day from any combination of 2 or more of the following persons who customarily deal in the debt securities —
 - (A) market makers;
 - (B) banks;
 - (C) securities dealers outside Hong Kong;
 - (D) licensed corporations;

marking to market (按照市值計算差額) means the method or procedure of adjusting the valuation of an open position in—

- (a) a futures contract;
- (b) any securities;
- (c) an options contract;
- (d) a derivative contract;
- (e) a leveraged foreign exchange contract;
- (f) a foreign exchange agreement;
- (g) an interest rate swap agreement; ~~or~~
- (h) a specified investment;
- (i) an illiquid investment; or
- (j) a miscellaneous investment,

to reflect its current market value;

miscellaneous investments (雜項投資項目) means—

- (a) subject to paragraph (b), any securities or an instrument held by a person for the purpose, or with the intention, of—
 - (i) resale;
 - (ii) securing a profit from fluctuations in the value of the securities or instrument;
 - (iii) locking in arbitrage profits; or
 - (iv) hedging any risks of any other securities or instrument held by the person which falls within sub-paragraph (i), (ii) or (iii); and
- (b) paragraph (a)—
 - (i) includes marketable debt securities that are not qualifying debt securities or special debt securities;
 - (ii) does not apply to the following securities or instruments—



- (A) securities that fall within any of the descriptions in Tables 1 to 7 of Schedule 2 or item 2 of Table 8 to the Schedule;
- (B) securities that are unlisted options contracts;
- (C) derivative contracts that are not securities;
- (D) specified investments;
- (E) illiquid investments;
- (F) foreign exchange agreements;
- (G) leveraged foreign exchange contracts;
- (H) fixed assets;
- (I) cash;
- (J) bank deposits;
- (K) loans, advances, credit facilities or other financial accommodation provided by the person to another person; or
- (L) amounts receivable by the person;

mutual fund (互惠基金) means any arrangement made for the purpose, or having the effect, of providing facilities for investment in shares in a corporation which is or holds itself out as being engaged primarily in the business of investing, reinvesting or trading in securities or any other property whatsoever and which is offering for sale or has outstanding any redeemable shares of which it is the issuer;

no sponsor work licensing condition (不任保薦人發牌條件), in relation to a licensed corporation licensed for Type 6 regulated activity, means a licensing condition that the licensed corporation shall not act as a sponsor in respect of an application for the listing on a recognized stock market of any securities;

non-collateralized warrants (非抵押權證) means derivative warrants listed on a recognized stock market other than collateralized warrants;

note issuance and revolving underwriting facility (票據的發行及循環式包銷融通) means an arrangement under which a borrower may draw down funds up to an agreed limit over an agreed period of time (the term to maturity of the facility) by making repeated note issues to the market, and where, should an issue prove unable to be placed in the market, the unplaced amount is to be taken up or funds made available by the underwriter of the facility;

off-exchange traded derivative contracts (場外買賣衍生工具合約) means derivative contracts which are traded other than on an exchange;

omnibus account (客戶匯集綜合帳戶) means an account opened with a licensed corporation by a client of the licensed corporation, and the client has notified it that the account is to be operated by him as agent for the benefit of 2 or more other persons;

options contract (期權合約) means a contract which gives the holder of the contract the option or right, exercisable at or before a time specified in the contract to—

- (a) buy or sell—
 - (i) at an agreed consideration an agreed quantity of a specified futures contract, share or other property; or



- (ii) an agreed value of a specified futures contract, share or other property; or
- (b) be paid an amount of money calculated by reference to the value of such futures contract, share or other property or by reference to the level of an index, as may be specified in the contract;

out-of-the-money amount (價外值) means the amount calculated according to the following applicable formula—

- (a) in relation to a call options contract, $N \times (S - M)$;
- (b) in relation to a put options contract, $N \times (M - S)$; or
- (c) in relation to a call warrant on listed shares, $N \times (S - M)$,

where—

N represents—

- (i) where the asset underlying the options contract or warrant is shares, the number of such shares; or
- (ii) where the asset underlying the options contract is an asset other than shares, the number of units of such asset;

M represents the market value of—

- (i) where the asset underlying the options contract or warrant is shares, one such share; or
- (ii) where the asset underlying the options contract is an asset other than shares, one unit of such asset; and

S represents the strike price of the options contract or the exercise price of the warrant—

- (i) where the asset underlying the options contract or warrant is shares, for one such share; or
- (ii) where the asset underlying the options contract is an asset other than shares, for one unit of such asset;

prescribed country (訂明國家) means—

- (a) a country belonging to the Organization for Economic Co-operation and Development; or
- (b) Singapore;

qualifying debt securities (合資格債務證券) means—

- (a) debenture stock, loan stock, debentures, bonds, notes and any securities or other instruments acknowledging, evidencing or creating indebtedness—
 - (i) which are issued or guaranteed by—
 - (A) the Central People's Government of the People's Republic of China or the People's Bank of China;
 - (B) the Government; or
 - (C) the Hong Kong Exchange Fund;
 - (ii) which are issued by the Hong Kong Mortgage Corporation;
 - ~~(iii) which are listed on a recognized stock market;~~



- (iv) the issuer of which has at least one issue currently rated by—
 - (A) Moody's Investors Service at either Baa or Prime-3 or above;
 - (B) Standard & Poor's Corporation at either BBB or A-3 or above;
 - (BA) Fitch Ratings at either BBB or F3 or above; or
 - (C) an approved credit rating agency at or above a grade specified by the Commission under section 58(2)(b); or
- (v) the guarantor of which has at least one issue currently rated by—
 - (A) Moody's Investors Service at either A or Prime-2 or above;
 - (B) Standard & Poor's Corporation at either A or A-2 or above;
 - (BA) Fitch Ratings at either A or F2 or above; or
 - (C) an approved credit rating agency at or above a grade specified by the Commission under section 58(2)(b),

but does not include—

- (vi) any special debt securities;
- (vii) any I-owe-you; ~~and~~
- (viii) any securities or any instrument acknowledging, evidencing or creating a subordinated loan or a debt due from a corporation within a group of companies of which the holder of the securities or instrument is a member; or
- (ix) any structured product other than a bond that—
 - (A) has a coupon rate that has an inverse relationship to a money market or interbank reference interest rate that is widely quoted; or
 - (B) has principal or coupon payments that are linked to an inflation rate; or
- (x) any illiquid investments; or
- (b) certificates of deposit issued by an authorized financial institution or an approved bank incorporated outside Hong Kong;

ranking liabilities (認可負債), in relation to a licensed corporation, means the aggregate of the amounts required to be included in its ranking liabilities under the provisions of Division 4 of Part 4;

recognized jurisdiction fund (認可司法管轄區基金) means a unit trust or mutual fund that—

- (a) is regulated in a jurisdiction outside Hong Kong, regardless of whether it is also an authorized fund; and
- (b) falls within all of the criteria (including as to the jurisdiction outside Hong Kong in which it is regulated, the applicable laws of that jurisdiction and the type of scheme that it constitutes under those laws) published on the Commission's website for the purposes of provisions of UT Code relating to recognition of certain overseas collective investment schemes;

redeemable shares (可贖回股份) means shares in the share capital of a corporation which are redeemable at the option of the holder of the shares or the corporation;



repledge (再質押), in relation to a licensed corporation, means an act by which the licensed corporation or an associated entity of such licensed corporation deposits securities collateral of the licensed corporation as collateral for financial accommodation provided to the licensed corporation;

reporting currency (申報貨幣), in relation to a licensed corporation, means the currency in which its financial statements, required under section 156 of the Ordinance to be submitted to the Commission, are denominated, or intended to be denominated;

repurchase transaction (回購交易) means a transaction under which there is a sale of securities and a further arrangement obliging the seller of the securities to repurchase from the purchaser, or obliging the purchaser to resell to the seller, securities of the same description as the securities first sold, at a pre-determined consideration and date;

required liquid capital (規定速動資金), in relation to a licensed corporation, means an amount equal to the higher of—

- (a) where it is—
 - (i) licensed for only one regulated activity specified in column 1 of Table 2 in Schedule 1, the amount specified in column 2 of the Table opposite the regulated activity or, where any further description is set out for the regulated activity in column 1 of the Table, opposite the applicable description; or
 - (ii) licensed for 2 or more regulated activities specified in column 1 of the Table, the amount which is the higher or highest upon comparing each amount specified in column 2 of the Table opposite any of such regulated activities or, where any further description is set out for any of such activities in column 1 of the Table, opposite any of such activities or any of the applicable descriptions; and
- (b) its variable required liquid capital;

required liquid capital deficit (規定速動資金短欠數額), in relation to a licensed corporation, means the amount by which its required liquid capital exceeds its liquid capital;

rules (規章)—

- (a) in relation to an exchange other than a recognized exchange company, includes its constitution and any rules, regulations, guidelines or directions, by whatever name they may be called and wherever contained, governing—
 - (i) its exchange participants;
 - (ii) the persons who may participate in any of the services it provides or trade on it;
 - (iii) the setting and levying of fees;
 - (iv) the listing of securities;
 - (v) the trading of securities, futures contracts, options contracts or leveraged foreign exchange contracts through or on it;
 - (vi) the provision of other services; or
 - (vii) generally, its management, operations or procedures; or



- (b) in relation to a clearing house other than a recognized clearing house, includes its constitution and any rules, regulations, guidelines or directions, by whatever name they may be called and wherever contained, governing—
- (i) its clearing participants;
 - (ii) the persons who may participate in any of the services it provides;
 - (iii) the setting and levying of fees;
 - (iv) the clearing and settlement of transactions, whether or not executed on an exchange, of which it is the clearing house;
 - (v) the imposition of margin requirements and matters pertaining to the deposit or collection of margin;
 - (vi) the manner of making and receiving payment of monies in respect of the provision by it of any service, including the setting-off of such amounts receivable and amounts payable to it;
 - (vii) the provision of other services; or
 - (viii) generally, its management, operations or procedures;

securities dealer (證券交易商) means—

- (a) a licensed corporation licensed for Type 1 regulated activity; or
- (b) a person licensed, registered or authorized by an authority or regulatory organization outside Hong Kong for an activity which, if carried on in Hong Kong, would constitute Type 1 regulated activity;

securities margin financing (證券保證金融資) has the meaning assigned to it by Part 2 of Schedule 5 to the Ordinance, save that notwithstanding paragraph (iii) of that definition, it includes the provision of financial accommodation by a licensed corporation licensed for Type 1 regulated activity to a client of the licensed corporation to facilitate—

- (a) the acquisition of securities listed on any stock market, whether a recognized stock market or any other stock market outside Hong Kong; or
- (b) (where applicable) the continued holding of those securities;

segregated account (獨立帳戶) in relation to a licensed corporation, means an account established and maintained by it, which —

- (a) is a segregated account within the meaning of section 2 of the Securities and Futures (Client Money) Rules (Cap 571 sub. leg. I); or
- (b) is an account for holding client money which is separate from ~~a licensed corporation's~~ own account;

settlement date (交收日期), in relation to any dealing in securities, means—

- (a) in the case of a transaction effected on an exchange, the date on which payment for the securities is first due in accordance with the rules or conventions of the exchange on which the securities are traded; or
- (b) in any other case, the date on which payment for the securities is first due as agreed between the parties to the transaction,

but in either case, the date not exceeding 20 business days after the trade date;

short selling (賣空) means a sale of securities where at the time of the sale—



- (a) the seller does not have a presently exercisable and unconditional right to vest the securities in the purchaser of them; or
- (b) the seller has a presently exercisable and unconditional right to vest the securities in the purchaser of them by virtue of having entered into a securities borrowing and lending agreement;

special debt securities (特別債務證券) means ~~indexed bonds~~ structured notes, convertible debt securities, bonds with non-detachable warrants and non-interest bearing debt securities—

- (a) which are issued or guaranteed by—
 - (i) the Central People's Government of the People's Republic of China or the People's Bank of China;
 - (ii) the Government; or
 - (iii) the Hong Kong Exchange Fund;
- (b) which are issued by the Hong Kong Mortgage Corporation;
- ~~(c) which are listed on a recognized stock market;~~
- (d) the issuer of which has at least one issue currently rated by—
 - (i) Moody's Investors Service at either Baa or Prime-3 or above;
 - (ii) Standard & Poor's Corporation at either BBB or A-3 or above;
 - (iia) Fitch Ratings at either BBB or F3 or above; or
 - (iii) an approved credit rating agency at or above a grade specified by the Commission under section 58(2)(b); or
- (e) the guarantor of which has at least one issue currently rated by—
 - (i) Moody's Investors Service at either A or Prime-2 or above;
 - (ii) Standard & Poor's Corporation at either A or A-2 or above;
 - (iia) Fitch Ratings at either A or F2 or above; or
 - (iii) an approved credit rating agency at or above a grade specified by the Commission under section 58(2)(b),

but does not include—

- (f) any I-owe-you; ~~and~~
- (g) any securities or any instrument acknowledging, evidencing or creating a subordinated loan or a debt due from a corporation within a group of companies of which the holder of the securities or instrument is a member; or
- (h) any illiquid investments;

specified exchange (指明交易所) means an exchange specified in Schedule 3;

specified exchange traded fund (指明交易所買賣基金) means a unit trust or mutual fund, the units or shares of which are listed on a specified exchange;

specified investments (指明投資項目) means the investments specified in column 2 of Table 8 in Schedule 2, but does not include illiquid investments;



specified licensing condition (指明發牌條件), in relation to a licensed corporation licensed for Type 4, Type 5, Type 6, Type 9 or Type 10 regulated activity, means a licensing condition that the licensed corporation shall not hold client assets;

specified securities (指明證券) means the securities specified in column 2 of Table 7 in Schedule 2, but does not include illiquid investments;

standby subordinated loan facility (備用後償貸款融通) means a loan facility provided to a licensed corporation licensed for Type 1, Type 2, Type 3 or Type 8 regulated activity under which the lender's claim in respect of any drawdown by the licensed corporation is subordinated to the prior payment, or provision for payment, in full of all claims of all other present and future creditors of the licensed corporation;

stock futures contract (股票期貨合約) means a contract traded on a specified exchange, the effect of which is that—

- (a) one party to the contract agrees to deliver to the other party to the contract at an agreed future time an agreed quantity of a specific listed share at an agreed consideration; or
- (b) the parties to the contract will make an adjustment between themselves at an agreed future time according to whether at that time an agreed quantity of a specific listed share is worth more or less than a value agreed at the time the contract is made;

stock options contract (股票期權合約) means a contract (except an options contract that is listed securities) traded on a specified exchange, the effect of which is that one party to the contract agrees to provide to the other party to the contract the right to sell or purchase at an agreed consideration an agreed quantity of a specific listed share at or before an agreed future time;

structured note (結構性票據) has the meaning given by section 2A;

subordinated loan (後償貸款) means a loan provided to a person under which the lender's claim in respect of the loan is subordinated to the prior payment, or provision for payment, in full of all claims of all other present and future creditors of the person;

tradable commodities (流通商品) means physical commodities of a quantity, quality and condition suitable for delivery under a tradable contract;

tradable contract (流通合約) means a futures contract or unlisted options contract that is traded on a specified exchange;

trade date (交易日期), in relation to a transaction in—

- (a) a futures contract;
- (b) any securities;
- (c) an options contract;
- (d) a derivative contract;
- (e) a leveraged foreign exchange contract;
- (f) a foreign exchange agreement;
- (g) an interest rate swap agreement; ~~or~~
- (h) a specified investment;



(ha) an illiquid investment; or

(hb) a miscellaneous investment,

means—

(i) in the case of a transaction on any exchange, the date on which the transaction is executed; or

(j) in any other case, the date on which the agreement between the parties is made;

trader (買賣商) means a licensed corporation licensed for Type 1 or Type 2 regulated activity which does not hold client assets or handle clients' orders and, in carrying on the regulated activity for which it is licensed, conducts no business other than effecting, or offering to effect, dealings in securities, futures contracts or options contracts for its own account;

trading day (交易日), in relation to listed securities, means a day on which the exchange on which the securities are listed is open for trading;

unit trust (單位信託) means any arrangement made for the purpose, or having the effect, of providing facilities for the participation by persons as beneficiaries under a trust, in profits or income arising from the acquisition, holding, management or disposal of securities or any other property whatsoever;

unlisted options contract (非上市期權合約) means an options contract that is not listed securities;

UT Code (《單位信託守則》) means the Code on Unit Trusts and Mutual Funds published by the Commission under section 399 of the Ordinance;

variable required liquid capital (可變動規定速動資金)—

(a) in relation to a licensed corporation licensed for Type 3 regulated activity (whether or not it is also licensed for any other regulated activity), means the sum of the basic amount and 1.5% of its aggregate gross foreign currency position; or

(b) in relation to a licensed corporation licensed for any regulated activity other than Type 3 regulated activity, means the basic amount.

2A Meaning of structured note

(1) In these Rules, **structured note** (結構性票據) means an instrument—

(a) that is in the form of a bond, debenture or note;

(b) that acknowledges, evidences or creates indebtedness, regardless of whether—

(i) the holder of the instrument has the right to receive the principal value upon or before maturity; or

(ii) the issuer of the instrument has the right to terminate the instrument before maturity;

(c) that is a structured product within the meaning of section 1A of Part 1 of Schedule 1 to the Ordinance (**the definition**), except a structured product that—

(i) falls within subsection (1)(a)(ii) or (iii) or subsection (1)(b) of the definition; or

(ii) is an OTC derivative product; and



(d) under which the holder is to receive a bullish note return or a bearish note return (whether or not subject to any deduction or payment of any expense or charge under the terms and conditions of the instrument) that is determined by comparing the strike price and the settlement price of—

(i) a permitted underlying type of asset; or

(ii) a permitted underlying type of rate or index.

(2) In this section—

bearish note return (看跌式票據回報), in relation to an instrument, means the holder of the instrument—

(a) is to receive—

(i) on or before maturity or termination, one or more coupon payments; and

(ii) on or after maturity or termination, an amount referred to in paragraph (b); or

(b) is to receive, on or after maturity or termination—

(i) if the settlement price is below the strike price, settlement amount 1;

(ii) if the settlement price exceeds the strike price, settlement amount 4; or

(iii) if the settlement price is equal to the strike price—

(A) settlement amount 1; or

(B) settlement amount 4;

bullish note return (看漲式票據回報), in relation to an instrument, means the holder of the instrument—

(a) is to receive—

(i) on or before maturity or termination, one or more coupon payments; and

(ii) on or after maturity or termination, an amount or quantity referred to in paragraph (b); or

(b) is to receive, on or after maturity or termination—

(i) if the settlement price exceeds the strike price, settlement amount 1;

(ii) if the settlement price is below the strike price and the instrument has a permitted underlying type of asset—

(A) the settlement quantity;

(B) settlement amount 2; or

(C) an amount and a number of units of the permitted underlying type of asset which together are equivalent in value to settlement amount 2;

(iii) if the settlement price is below the strike price and the instrument has a permitted underlying type of rate or index, settlement amount 3;

(iv) if the settlement price is equal to the strike price and the instrument has a permitted underlying type of asset, any of—

(A) the settlement quantity;



- (B) settlement amount 1;
- (C) settlement amount 2; or
- (D) an amount and a number of units of the permitted underlying type of asset which together are equivalent in value to settlement amount 2; or
- (v) if the settlement price is equal to the strike price and the instrument has a permitted underlying type of rate or index—
 - (A) settlement amount 1; or
 - (B) settlement amount 3;

coupon payment (票息付款), in relation to an instrument, means a payment of interest (or other periodic return of a similar nature) to the holder of the instrument during the tenor of the instrument, that is calculated by reference to the principal value in accordance with the terms and conditions of the instrument;

maturity (到期), in relation to an instrument, means the date on which the instrument is due to mature;

permitted interest rate (許可利率) means a money market or interbank reference interest rate that is widely quoted in a market that is domiciled in a jurisdiction which is rated by—

- (a) Moody's Investors Service at either Baa or Prime-3 or above;
- (b) Standard & Poor's Corporation at either BBB or A-3 or above; or
- (c) Fitch Ratings at either BBB or F3 or above;

permitted securities (許可證券) means securities other than—

- (a) special debt securities
- (b) an illiquid investment;
- (c) a miscellaneous investment;
- (d) a derivative contract; or
- (e) a structured product;

permitted underlying type of asset (屬許可類別的相關資產), in relation to an instrument, means a single type of—

- (a) permitted securities; or
- (b) tradable commodity;

permitted underlying type of rate or index (屬許可類別的相關比率或指數), in relation to an instrument, means a single type of —

- (a) permitted interest rate;
- (b) currency exchange rate;
- (c) tradable securities index;
- (d) tradable commodity index; or
- (e) tradable currency exchange rate index;



principal value (本金額), in relation to an instrument, means the nominal, face, par or similar value of the instrument;

settlement amount 1 (交收數額 1), in relation to an instrument, means the sum of the principal value and the outstanding coupon payments;

settlement amount 2 (交收數額 2), in relation to an instrument that has a permitted underlying type of asset, means the value of the settlement quantity calculated in accordance with—

(a) the following formula—

settlement quantity × *settlement price*; or

(b) a formula that achieves the same result as the formula referred to in paragraph (a);

settlement amount 3 (交收數額 3), in relation to an instrument that has a permitted underlying type of rate or index, means an amount calculated in accordance with—

(a) the following formula—

$\frac{\text{settlement amount 1}}{\text{strike price}} \times \text{settlement price}$; or

(b) a formula that achieves the same result as the formula referred to in paragraph (a);

settlement amount 4 (交收數額 4), in relation to an instrument, means—

(a) subject to paragraph (b), an amount calculated in accordance with—

(i) the following formula—

$\text{settlement amount 1} - \frac{\text{settlement amount 1}}{\text{strike price}} \times (\text{settlement price} - \text{strike price})$; or

(ii) a formula that achieves the same result as the formula referred to in subparagraph (i); and

(b) if the amount referred to in paragraph (a) is less than zero, a nil amount is to be substituted for that amount;

settlement price (交收價) means a price or value of 1 unit of a permitted underlying type of asset or a level of a permitted underlying type of rate or index that, for the purpose of determining the bearish note return or the bullish note return under an instrument, is—

(a) quoted in a market specified in the terms and conditions of the instrument at a time specified in, or to be determined in accordance with a method specified in, the terms and conditions of the instrument; or

(b) determined in accordance with a method specified in the terms and conditions of the instrument;

settlement quantity (交收數量), in relation to an instrument that has a permitted underlying type of asset, means the number of units of the asset calculated in accordance with —

(a) the following formula—

$\text{settlement amount 1} \div \text{strike price}$; or

(b) a formula that achieves the same result as the formula referred to in paragraph (a);



strike price (行使價) means a price or value of a permitted underlying type of asset or a level of a permitted underlying type of rate or index that is specified in the terms and conditions of an instrument for the purpose of determining the bearish note return or the bullish note return under the instrument;

termination (終止), in relation to an instrument, means a date before maturity on which the instrument terminates in accordance with the terms and conditions of the instrument or by agreement between the parties to the instrument;

tradable commodity index (流通商品指數) means a tradable index that is calculated by reference to changes in the price or value of a basket of tradable commodities;

tradable currency exchange rate index (流通貨幣匯率指數) means a tradable index that is calculated by reference to changes in the level of a combination of more than one type of currency exchange rate;

tradable index (流通指數) means an index that is traded under a tradable contract;

tradable securities index (流通證券指數) means a tradable index that is calculated by reference to changes in the price or value of a basket of permitted securities.

2B References to exchange or clearing house

~~(2)~~—In these Rules, a reference to ~~an exchange shall~~

(a) an exchange includes a reference to any market operated by that exchange; and

(b) an exchange or clearing house that is specified by name and, after the day on which it is specified—

(i) changes its name, is to be read as if it is a reference to the name by which the exchange or clearing house is presently known; or

(ii) is succeeded by another exchange or clearing house (whether by reason of merger, amalgamation or otherwise), is to be read as if it is a reference to the successor exchange or clearing house.

Part 2

Accounting treatment

3 Accounting treatment

(1) For the purposes of these Rules and subject to subsection (3), a licensed corporation shall account for all assets and liabilities—

(a) in accordance with generally accepted accounting principles, unless otherwise specified in these Rules; and

(b) in a way that recognizes the substance of a transaction, arrangement or position—~~including accounting for a structured bond as a derivative product and not as a debt security.~~

(2) Subject to subsection (3), a licensed corporation shall not without notifying the Commission under section 55(5), change any of its accounting principles, other than



those referred to in subsection (1)(a), in a way that may materially affect the liquid capital or paid-up share capital that it maintains or is required to maintain under Part 3.

- (3) A licensed corporation may, with the Commission's prior written approval under section 58(5)(d), adopt an accounting principle other than one of those referred to in subsection (1)(a).

Part 3

Financial resources requirements

4 Licensed corporations to maintain financial resources

A licensed corporation shall at all times maintain financial resources in the amount required of it under this Part.

5 Paid-up share capital requirement for licensed corporations

For the purposes of section 4, a licensed corporation other than one which carries on a regulated activity solely as one or more of the following—

- (a) an approved introducing agent who is not a licensed corporation licensed for Type 3 regulated activity;
- (b) a trader;
- (c) a futures non-clearing dealer;
- (d) a licensed corporation licensed for Type 4, Type 5, Type 9 or Type 10 regulated activity, which is subject to the specified licensing condition;
- (da) a licensed corporation licensed for Type 6 regulated activity, which is subject to both the specified licensing condition and the no sponsor work licensing condition,

shall at all times maintain paid-up share capital of not less than—

- (e) where it is licensed for only one regulated activity specified in column 1 of Table 1 in Schedule 1, the amount specified in column 2 of the Table opposite the regulated activity or, where any further description is set out for the regulated activity in column 1 of the Table, opposite the applicable description; or
- (f) where it is licensed for 2 or more regulated activities specified in column 1 of the Table, the amount which is the higher or highest upon comparing each amount specified in column 2 of the Table opposite any of such regulated activities or, where any further description is set out for any of such activities in column 1 of the Table, opposite any of such activities or any of the applicable descriptions.

6 Liquid capital requirement for licensed corporations

- (1) For the purposes of section 4, a licensed corporation shall at all times maintain liquid capital which is not less than its required liquid capital.
- (2) Subsections (3) and (4) apply in respect of a licensed corporation licensed for one or more of the following—



- (a) Type 1 regulated activity;
- (b) Type 2 regulated activity;
- (c) Type 3 regulated activity;
- (d) Type 8 regulated activity,

unless it is—

- (e) in the case of paragraph (a), an approved introducing agent or a trader;
- (f) in the case of paragraph (b), an approved introducing agent, a trader or a futures non-clearing dealer; or
- (g) in the case of paragraph (c), an approved introducing agent.

(3) Subject to subsection (4)—

- (a) on any particular business day on which a licensed corporation's required liquid capital rises above its liquid capital; and
- (b) where applicable, on any one or more consecutive business days immediately following the day referred to in paragraph (a) on which there continues to be a required liquid capital deficit,

the licensed corporation will be regarded as having complied with subsection (1) if—

- (c) it is entitled to draw down an amount not less than the required liquid capital deficit under an approved standby subordinated loan facility; and
- (d) its required liquid capital on the day that its required liquid capital rises above its liquid capital is at least 20% more than its required liquid capital at the close of business on the previous business day, as a result of—
 - (i) an increase in its adjusted liabilities which is attributable to an increase in its dealings in securities for its clients;
 - (ii) an increase in the aggregate of the initial margin requirements, or of the amounts of margin required to be deposited, in respect of outstanding futures contracts or outstanding unlisted options contracts held by it on behalf of its clients;
 - (iii) an increase in its aggregate gross foreign currency position;
 - (iv) an increase in its adjusted liabilities which is attributable to an increase in the aggregate of the amounts receivable from its margin clients; or
 - (v) where applicable, the aggregate of the increases described in 2 or more of subparagraph (i), (ii), (iii) or (iv).

(4) Subsection (3) only applies on a day referred to in subsection (3)(a) or (b) if, during the 60 days immediately preceding that day, the required liquid capital of the licensed corporation has exceeded its liquid capital on 4 or less business days.

Part 4

Liquid capital

Division 1—General



7 Calculation of liquid capital and required liquid capital

A licensed corporation, for the purposes of calculating its liquid capital and required liquid capital, shall account for all its assets, liabilities and transactions in accordance with this Part.

Division 2—Computation basis

8 Accounting for transactions on trade date basis

A licensed corporation, for the purposes of calculating its liquid capital and required liquid capital, ~~shall~~ must account on a trade date basis for all transactions effected by it, whether as principal or agent, in relation to any dealing or trading in or entering into—

- (a) ~~any dealing in~~—
 - ~~(i)~~ a futures contract;
 - ~~(ii)~~ any securities;
 - ~~(iii)~~ an options contract;
 - ~~(iv)~~ a derivative contract; ~~or~~
 - ~~(v)~~ a specified investment;
 - ~~(vi)~~ ~~trading in~~ a leveraged foreign exchange contract; ~~or~~
 - ~~(vii)~~ ~~entering into any~~—
 - ~~(i)~~ a foreign exchange agreement; ~~or~~
 - ~~(ii)~~ an interest rate swap agreement;
 - ~~(i)~~ an illiquid investment; or
 - ~~(j)~~ a miscellaneous investment.

9 ~~Valuations of proprietary positions, etc.~~

- (1) ~~A licensed corporation, for the purposes of calculating its liquid capital and required liquid capital, shall, subject to subsection (2), value any open position in~~ This section applies to the following instruments or assets—

- (a) a futures contract;
- (b) any securities;
- (c) an options contract;
- (d) a derivative contract;
- (e) a leveraged foreign exchange contract;
- (f) a foreign exchange agreement;
- (g) an interest rate swap agreement; ~~or~~
- (h) a specified investment;



- (i) an asset underlying a non-collateralized warrant that is issued by a licensed corporation;
 - (j) an illiquid investment;
 - (k) a miscellaneous investment;
- ~~entered into for its own account at market value.~~
- (2) Subject to subsection (4), any reference in these Rules to the market value of an instrument or asset referred to in subsection (1) is, if there is no published market price for the instrument or asset, to be construed as referring to the fair value (as determined in accordance with generally accepted accounting principles) of the instrument or asset.
- (3) Subject to subsection (4), a licensed corporation must, for the purposes of calculating its liquid capital and required liquid capital, value at market value any open position in an instrument or asset referred to in subsection (1).
- (24) Notwithstanding subsections ~~(1)(2) or (3)~~, for the purposes of calculating the liquid capital and required liquid capital of a licensed corporation, any reference in these Rules to the market value of the securities referred to in this subsection shall ~~(5), (6) or (7)~~ is to be construed as referring to the value (including any nil value) at which ~~they~~ the securities are required to be valued under this subsection, namely—(5), (6) or (7).
 - ~~(a) debt securities other than a certificate of deposit, in respect of which there is no published market price, shall be valued—~~
 - ~~(i) at the average value of quotations obtained in respect of those debt securities from—~~
 - ~~(A) at least 2 market makers; or~~
 - ~~(B) where in relation to any debt securities there are less than 2 market makers, at least 2 banks, securities dealers outside Hong Kong or licensed corporations, who customarily deal in such debt securities, or at least 2 of the persons referred to in this subparagraph; or~~
 - ~~(ii) if the quotations referred to in subparagraph (i) are not available—~~
 - ~~(A) in the case of long positions, at nil; or~~
 - ~~(B) in the case of short positions, at the face value of the debt securities;~~
 - ~~(b) listed securities which have been suspended from trading for at least 3 business days or ceased trading on any exchange on which the securities were listed, shall, unless the securities can continue to be traded on any other exchange on which the securities are listed, be valued—~~
 - ~~(i) in the case of long positions, at nil; or~~
 - ~~(ii) in the case of short positions, at the last closing price before the suspension or cessation of trading;~~
 - ~~(c) certificates of deposit issued by an authorized financial institution or an approved bank incorporated outside Hong Kong, in respect of which there is no published market price, shall be valued at the value quoted by the issuer.~~(5) Listed securities that have been suspended from trading for at least 3 trading days or ceased trading on any exchange on which the securities were listed, must, unless the securities can continue to be traded on any other exchange on which the securities are listed, be valued—



- (a) for long positions, at nil; or
 - (b) for short positions, at the higher of fair value and the last closing price before the suspension or cessation of trading.
- (6) Marketable debt securities, in respect of which there is no published market price, must be valued—
 - (a) for certificates of deposit, at the value quoted by the issuer; or
 - (b) for debt securities other than certificates of deposit—
 - (i) at the average value of quotations obtained from any combination of 2 or more of the following persons who customarily deal in the debt securities—
 - (A) market makers;
 - (B) banks;
 - (C) securities dealers outside Hong Kong;
 - (D) licensed corporations; or
 - (ii) if the quotations referred to in sub-paragraph (i) cannot be obtained, at fair value.
- (7) Debt securities that are not marketable debt securities must be valued—
 - (a) for long positions, at nil; or
 - (b) for short positions, at the higher of fair value and the face value of the debt securities.

10 Pairs of transactions

A licensed corporation which enters into a pair of transactions in which its respective roles are opposite, but which otherwise have identical or similar terms, shall account for the transactions as separate transactions.

11 No set-off

- (1) Subject to subsections (2), (3), (4), (5), ~~and~~ (6) and (7) and section 48(2), the assets and liabilities of a licensed corporation shall be treated separately on a gross basis and shall not be set-off against each other.
- (2) Subsection (1) does not apply in respect of any amounts receivable by a licensed corporation from, and any amounts payable by it to, a recognized clearing house, where the rules of the clearing house permit the setting-off of such amounts against each other for settlement purposes.
- (3) Subsection (1) does not apply in respect of any amounts receivable by a licensed corporation from a person, and any amounts payable by it to a ~~the~~ person, where—
 - (a) such amounts do not arise from the carrying on of any regulated activity for which it is licensed; and
 - (b) it has a legally enforceable right to set-off such amounts against each other.



- (4) Subsection (1) does not apply in respect of any amounts receivable by a licensed corporation from, and any amounts payable by it to, a client of the licensed corporation, where such amounts arise from—
- (a) the purchase and sale by the client of securities of the same description due to be settled on a cash-against-delivery basis and the client has authorized the licensed corporation to set-off such amounts;
 - (b) the purchase and sale by the client of securities in relation to which the licensed corporation has elected to set-off such amounts against each other under section 21(2); or
 - (c) the provision by it to the client of securities margin financing.
- (5) Subsection (1) does not apply in respect of any amounts receivable by a licensed corporation licensed for Type 8 regulated activity from, and any amounts payable by it to, each securities dealer with which it has common clients, where such amounts arise from dealings in securities by the securities dealer for those clients.
- (6) Subsection (1) does not apply in respect of any amounts receivable by a licensed corporation licensed for Type 1 regulated activity from, and any amounts payable by it to, each licensed corporation licensed for Type 8 regulated activity with which it has common clients, where such amounts arise from dealings in securities by it for those clients.
- (7) Subsection (1) does not apply in respect of amounts receivable by a licensed corporation from, and amounts payable by it to, a general clearing participant of HKSCC which arise from transactions in securities that are cleared by the participant with HKSCC for the licensed corporation or the licensed corporation's clients, if the licensed corporation has obtained an approval under section 58(5)(i).

12 Transactions in margined accounts

- (1) A licensed corporation shall not set-off amounts receivable by it from, and amounts payable by it to, a client of the licensed corporation arising from transactions in different margined accounts maintained with it by the client.
- (2) Where a licensed corporation has a client who—
- (a) maintains with it more than one margined account;
 - (b) has deposited with it security against his liabilities to it in the form of—
 - (i) cash;
 - (ii) collateral; or
 - (iii) a bank guarantee issued by an authorized financial institution or an approved bank incorporated outside Hong Kong; and
 - (c) has authorized it to apply such security to satisfy any liabilities to it arising from the execution by it of any transaction in relation to any of his margined accounts,
- the licensed corporation may, subject to subsections (3) and (4)—
- (d) for the purpose of calculating—
 - (i) a specified shortfall amount in relation to a margined account of the client; or
 - (ii) a margin shortfall amount under section 22(1)(b) in relation to the client,



- deem all or part of such security to be deposited by the client as security to the margined account in relation to which such shortfall amount is calculated; or
- (e) for the purpose of calculating any amount to be included in its ranking liabilities under section 45(1) or 46(1) in relation to a margined account of the client, reduce any such amount by—
- (i) where the client has deposited cash referred to in paragraph (b)(i), the amount of such cash;
 - (ii) where the client has deposited collateral referred to in paragraph (b)(ii), the amount of the market value of such collateral, less the haircut amount in relation to the collateral; or
 - (iii) where the client has deposited a bank guarantee referred to in paragraph (b)(iii), the amount that it can draw down under such bank guarantee.
- (3) A licensed corporation shall not—
- (a) under subsection (2)(d), deem—
 - (i) any amount of cash;
 - (ii) any collateral; or
 - (iii) any amount that it can draw down under a bank guarantee, to be security to the margined account concerned; or
 - (b) effect any reduction under subsection (2)(e) in respect of such security, if—
 - (c) such security has been deemed under subsection (2)(d) to be deposited as security to another margined account of the client; or
 - (d) in respect of such security a reduction under subsection (2)(e) has been effected in relation to another margined account of the client.
- (4) For the purposes of these Rules, a licensed corporation shall cease to treat—
- (a) any cash referred to in subsection (2)(b)(i);
 - (b) any collateral referred to in subsection (2)(b)(ii); or
 - (c) any bank guarantee referred to in subsection (2)(b)(iii),
- as security in relation to the margined account of the client into which it was deposited, to the extent that such security—
- (d) has been deemed under subsection (2)(d) to be deposited as security to another margined account of the client; or
 - (e) has been utilized to effect a reduction under subsection (2)(e).
- (5) For the purposes of subsection (2), **specified shortfall amount** (指明短欠數額) means an amount to be included in the licensed corporation's ranking liabilities under—
- (a) section 40(1);
 - (b) section 41(1);
 - (c) section 43(10);
 - (d) section 45(2); or



- (e) section 46(2).
- (6) In this section, ***margined account*** (以保證金形式操作的帳戶), in relation to a client of a licensed corporation, means—
 - (a) an account maintained with a licensed corporation licensed for Type 1 regulated activity by the client for the provision to him by the licensed corporation of securities margin financing; or
 - (b) an account maintained with the licensed corporation by the client for—
 - (i) short selling;
 - (ii) dealings in futures contracts;
 - (iii) dealings in unlisted options contracts;
 - (iv) securities borrowing and lending;
 - (v) trading in leveraged foreign exchange contracts; or
 - (vi) entering into repurchase transactions.

13 Treatment of exercised options contracts

A licensed corporation shall, immediately upon the exercise of an options contract purchased, written or cleared by it, treat the options contract as having ceased to exist and account for—

- (a) all its assets; and
- (b) all its liabilities,

arising from such exercise.

14 Assignments

- (1) A licensed corporation shall not include in its liquid assets any amount receivable by it from any of its clients if such amount has been assigned by it to another person.
- (2) A licensed corporation shall not treat any collateral or any other type of security deposited with it by any of its clients as so deposited where such collateral or other type of security has been assigned by it to another person.

15 Treatment of securities borrowing and lending agreements

- (1) A licensed corporation which, under a securities borrowing and lending agreement, is the borrower of any securities, is deemed for the purposes of these Rules—
 - (a) to remain the owner of any collateral beneficially owned by it and provided by it as security to the lender of the securities under the agreement;
 - (b) to have an amount receivable from that lender equal to the amount of cash provided by it as security to that lender; and
 - (c) not to own the securities borrowed under the agreement.
- (2) A licensed corporation which, under a securities borrowing and lending agreement, is the lender of any securities, is deemed for the purposes of these Rules—



- (a) where the securities lent under the agreement are beneficially owned by it, to remain the beneficial owner of the securities for the purposes of section 27;
- (b) not to own any collateral deposited with it as security by the borrower of the securities under the agreement; and
- (c) to have an amount payable to that borrower equal to the amount of cash deposited with it as security by that borrower, unless the cash—
 - (i) is not included in its liquid assets under section 20; and
 - (ii) is held in a segregated account.

16 Treatment of repurchase transactions

- (1) Where a licensed corporation is the purchaser in the first instance of any securities under a repurchase transaction, it is deemed for the purposes of these Rules—
 - (a) to have an amount receivable from the seller of the securities equal to the consideration for which it purchased the securities; and
 - (b) not to own the securities purchased and so shall not include them in its liquid assets under section 27.
- (2) Where a licensed corporation is the seller in the first instance of any securities beneficially owned by it under a repurchase transaction, it is deemed for the purposes of these Rules—
 - (a) to remain the owner of the securities sold by it; and
 - (b) to be liable to the purchaser of the securities for an amount equal to the consideration for which it sold the securities.

Division 3—Liquid assets

17 Computation basis

A licensed corporation shall, for the purpose of calculating its liquid assets under the provisions of this Division, apply the computation basis prescribed in Division 2.

18 Exclusions from liquid assets Exclusion of branch assets required to be maintained outside Hong Kong

~~(1)~~—A licensed corporation which operates a branch in a place outside Hong Kong shall not include in its liquid assets any asset which it is required by an authority or regulatory organization in, or under the law of, that place, to maintain in that place in order for the branch to obtain or maintain a licence, registration, membership or authorization to carry on an activity which, if carried on in Hong Kong, would constitute a regulated activity.

~~(2)~~—A licensed corporation shall not include in its liquid assets—

- ~~(a)~~—any asset that is an amount of a currency that is subject to exchange control; or
- ~~(b)~~—any assets the proceeds of which upon realization are not freely remittable to Hong Kong;



~~unless the licensed corporation reasonably believes that approval for the remittance of such currency or proceeds to Hong Kong can be obtained from the relevant authority within one week of application by it for such approval.~~

18A Exclusion of assets where remittance or exchange controls apply

- (1) Except in the circumstances referred to in subsections (2) and (3), a licensed corporation must not include a controlled asset in its liquid assets.
- (2) A licensed corporation must include a controlled asset in its liquid assets (in an amount calculated in accordance with the provisions of this Division, other than this section, which apply to the asset) if, in relation to the relevant prohibition applicable to the controlled asset or the proceeds of the controlled asset, it reasonably believes that it will be able to obtain the required approval from the relevant authority or regulatory organisation within 1 week after applying for approval.
- (3) Subject to subsection (4), a licensed corporation may elect to include in its liquid assets a controlled asset that it is able to freely apply to meet existing obligations or liabilities that are denominated in the same currency as the asset.
- (4) If a licensed corporation makes an election under subsection (3) in relation to a controlled asset—
- (a) the amounts to be included in liquid assets in respect of the controlled asset are to be calculated—
- (i) in accordance with the provisions of this Division (apart from this section) which apply to it in relation to the asset; and
- (ii) on the basis that the following provisions do not apply to it in relation to the controlled asset—
- (A) section 27(2), (3), (4), (6) and (7);
- (B) section 31(2) and (3);
- (b) the amounts to be included in ranking liabilities in respect of the controlled asset are to be calculated—
- (i) in accordance with Division 4; and
- (ii) on the basis that section 40(7), 40(8) and 43(6) do not apply to it in relation to the controlled asset; and
- (c) it must include in its ranking liabilities the amount referred to in section 52(d).
- (5) In this section—

controlled asset (受管制資產) means an asset —

- (a) that is an amount of a currency which, because a relevant prohibition applies to the currency, cannot (or cannot without approval from an authority or regulatory organization)—
- (i) be remitted to Hong Kong; or
- (ii) be exchanged into another currency which can be remitted to Hong Kong;
- or
- (b) the proceeds of which upon realization cannot (or cannot without approval from an authority or regulatory organization) be remitted to Hong Kong, because a relevant prohibition applies to the proceeds;



relevant prohibition (相關禁制), in relation to a controlled asset or the proceeds of a controlled asset, means a prohibition imposed under the laws of, or by an authority or regulatory organization in, a jurisdiction, and includes a prohibition that does not apply to a person in relation to the controlled asset or proceeds only if the person obtains approval from an authority or regulatory organization.

19 Assets provided to others as security

- (1) A licensed corporation, for the purpose of calculating its liquid capital, subject to subsection (2), is deemed not to own any asset which it beneficially owns and has provided to another person as security for any liabilities or obligations.
- (2) A licensed corporation is deemed to remain the owner of any asset which it beneficially owns and has provided as security—
 - (a) to—
 - (i) an authorized financial institution;
 - (ii) an approved bank incorporated outside Hong Kong; or
 - (iii) another licensed corporation,
for credit facilities provided to it by the institution, bank or corporation (as the case may be);
 - (b) under a securities borrowing and lending agreement under which it is the borrower of securities;
 - (c) in the form of margin deposited in respect of any short selling by it;
 - (d) in the form of margin deposited in respect of any dealing in futures contracts or unlisted options contracts by it;
 - (e) in the form of margin deposited in respect of any trading in leveraged foreign exchange contracts by it;
 - (f) to obtain a bank guarantee for the purpose of fulfilling its obligations under the rules of a recognized exchange company to furnish the exchange company with a guarantee as an alternative to participating in the Fidelity Fund established under the rules;
 - (g) to, or to obtain a bank guarantee in favour of, a recognized clearing house for the purpose of enabling it to fulfil its obligations under the rules of the clearing house (other than rules which relate to the Guarantee Fund or the Reserve Fund); or
 - (h) in relation to collateralized warrants of which it is the issuer, in the form of a charge over the underlying securities or other assets to which the warrants relate in favour of an independent trustee.

20 Cash in hand and at bank

A licensed corporation shall include in its liquid assets—

- (a) cash in hand which it beneficially owns;
- (b) money which it beneficially owns and holds in an account in its name, or in a segregated account, with an authorized financial institution or an approved bank incorporated outside Hong Kong in the form of—



- (i) a demand deposit; or
- (ii) a time deposit which will mature in 6 months or less; **and**
- (c) interest accrued on any deposit referred to in paragraph (b)(ii); **and**
- (d) money which it holds on behalf of a client in an account in its name, or in a segregated account, with an authorized financial institution or an approved bank incorporated outside Hong Kong, and which it has received from the client for the purpose of settling a purchase of, or subscription for, securities by it on behalf of the client.

21 Amounts receivable from clients in respect of purchase of and subscription for securities

- (1) Subject to subsections (3) and (7), a licensed corporation shall include in its liquid assets the following amount receivable from any of its clients arising from purchase by the client of securities on a cash-against-delivery basis—
 - (a) any such amount receivable which, when calculated on a transaction-by-transaction basis—
 - (i) is not yet due for settlement according to the settlement date; or
 - (ii) has been outstanding for 5 business days or less after the settlement date; and
 - (b) where any such amount receivable has been outstanding for more than 5 business days but less than one month after the settlement date, the amount which is the lower, when calculated on a transaction-by-transaction basis, of—
 - (i) such outstanding amount receivable less any specific provision for bad or doubtful debts made in respect of such outstanding amount; and
 - (ii) the market value of the securities to which such outstanding amount relates.
- (2) A licensed corporation may elect in respect of all its clients to set-off, on a client-by-client basis, any amount receivable from, and amount payable to, a client where such amounts arise from the purchase and sale of securities by the client on a cash-against-delivery basis, and the licensed corporation has obtained from the client a written authorization to—
 - (a) set-off such amounts against each other; and
 - (b) dispose of securities held for the client for the purpose of settling any of the amounts payable by the client to the licensed corporation.
- (3) Subject to subsection (7), where a licensed corporation makes an election under subsection (2), it shall include in its liquid assets in respect of the amount receivable by it from and the amount payable by it to a client which arise from the purchase and sale of securities by the client on a cash-against-delivery basis the amount which is the lower, when calculated on a client-by-client basis, of—
 - (a) any amount receivable that remains after the set-off referred to in subsection (2) less any specific provision for bad or doubtful debts made in respect of such amount receivable; and
 - (b) the market value of the securities held for the client, less the haircut amounts in relation to the securities.



- (4) Subject to subsection (7), a licensed corporation shall include in its liquid assets the following amount receivable from any of its clients in respect of the purchase of securities by the client on a free delivery basis—
- (a) in the case where the clearing system of the exchange on which the securities are traded effects settlement only on a free delivery basis, such amount receivable which, when calculated on a transaction-by-transaction basis—
 - (i) is not yet due for settlement according to the settlement date; or
 - (ii) has been outstanding for 2 weeks or less after the settlement date; or
 - (b) in any other case, such amount receivable which, when calculated on a transaction-by-transaction basis, is not yet due for settlement according to the settlement date.
- (5) Subject to subsection (7), a licensed corporation shall, in respect of securities subscribed for on behalf of any of its clients, include, prior to the commencement of trading of the securities on any exchange on which they are listed, in its liquid assets the amount which is the lower, when calculated on a transaction-by-transaction basis, of—
- (a) 90% of the total costs to the client of subscribing for the securities; and
 - (b) the amount receivable from the client for subscribing for the securities.
- (6) Subject to subsection (7), a licensed corporation shall, in respect of securities subscribed for on behalf of any of its clients, include, after the commencement of trading of the securities on any exchange on which they are listed, in its liquid assets the amount receivable from the client arising from subscribing for the securities in accordance with subsection (1) or (3) as if the securities had been purchased on a cash-against-delivery basis.
- (7) The aggregate of amounts that a licensed corporation includes in its liquid assets under subsections (1), (3), (4), (5) and (6) shall not exceed the aggregate of amounts receivable from its clients referred to in those subsections less the aggregate of amounts of specific and general provisions for bad or doubtful debts made in respect of such aggregate of amounts receivable.
- (8) In subsection (2), **written authorization** (書面授權) includes an agreement in writing within the meaning of the Securities and Futures (Client Securities) Rules (Cap 571 sub. leg. H).

22 Amounts receivable in respect of providing securities margin financing

- (1) Subject to subsections (2) and (3), a licensed corporation licensed for Type 1 or Type 8 regulated activity shall include in its liquid assets any net amount receivable from any of its margin clients, calculated as the amount by which the amount receivable from the margin client exceeds the amount payable by it to the margin client arising from the provision by it of securities margin financing, after deducting the higher of—
- (a) any specific provision for bad or doubtful debts made in respect of such net amount receivable; and
 - (b) the margin shortfall amount, calculated as the amount by which the net amount receivable exceeds the aggregate of—
 - (i) the market value of collateral, other than illiquid collateral, provided by the client, less the haircut amount in relation to such collateral;



- (ii) the market value of all illiquid collateral provided by the client, multiplied by—
 - (A) in the case of listed shares, 20%; and
 - (B) in the case of listed warrants, 0%;
 - (iii) the amount of cash deposited as security by the client; and
 - (iv) in the case of a licensed corporation licensed for Type 1 regulated activity, the maximum amount that it can draw under a bank guarantee provided to it by the client and issued by an authorized financial institution or an approved bank incorporated outside Hong Kong.
- (2) Notwithstanding section 8, a licensed corporation licensed for Type 1 or Type 8 regulated activity may, in calculating the margin shortfall amount referred to in subsection (1)(b) in relation to any of its margin clients, elect in respect of all its clients to exclude, on a client-by-client basis, from the calculation of the net amount receivable from the client, any—
 - (a) amount receivable from the client; and
 - (b) amount payable by it to the client,arising from dealings in securities which are not yet due for settlement according to the settlement date, whereupon subsection (1)(b) shall apply to it as if such dealings in securities—
 - (c) had not given rise to any amount receivable from, or any amount payable by it to, the client; and
 - (d) had not given rise to any change in the amount of collateral provided to it by the client.
- (3) The aggregate of amounts that a licensed corporation includes in its liquid assets under subsection (1) shall not exceed the aggregate of net amounts receivable from its margin clients referred to under that subsection less the aggregate of amounts of specific and general provisions for bad or doubtful debts made in respect of such aggregate of net amounts receivable.
- (4) In subsection (1)(b)(i) and (ii), **illiquid collateral** (非速動抵押品), in relation to any collateral provided to a licensed corporation licensed for Type 1 or Type 8 regulated activity by its margin clients, means any listed share or listed warrant which is of the same description as that identified as top 3 collateral provided by any top margin client of the licensed corporation, where—
 - (a) if it is a share, the aggregate market value of all shares of the same description as that share provided to the licensed corporation by its margin clients as collateral is equal to or greater than—
 - (i) the average monthly turnover of that share; or
 - (ii) 5% of the market capitalization of that share as at the end of the month immediately preceding the month prior to the month in which the calculation is made; or
 - (b) if it is a warrant, the aggregate market value of all warrants of the same description as that warrant provided to the licensed corporation by its margin clients as collateral is equal to or greater than—
 - (i) the average monthly turnover of that warrant; or



- (ii) 5% of the value of the relevant warrant issue as at the end of the month immediately preceding the month prior to the month in which the calculation is made,

but does not include—

- (c) any listed share or listed warrant which has been listed for less than 6 consecutive months (including any period during which the share or warrant is suspended from trading) immediately preceding the month prior to the month in which the calculation is made; and
- (d) any listed share which is a constituent stock of any of the following indices—
 - (i) Hang Seng Index;
 - (ii) Hang Seng ~~Hong Kong Composite~~ LargeCap Index;
 - ~~(iii) Hang Seng Hong Kong MidCap Index;~~
 - (iv) FTSE ~~-~~100 Index;
 - (v) Nikkei ~~Stock Average~~225 Index; or
 - (vi) ~~Standard & Poor's~~ 500 Index.

- (5) In subsection (4)—

average monthly turnover (平均每月成交額), in relation to a listed share or listed warrant, means one sixth of the aggregate value of transactions in that share or warrant on any exchange on which it is listed for a period of 6 consecutive months (including any period during which the share or warrant is suspended from trading) immediately preceding the month prior to the month in which the calculation is made;

calculation (有關計算) means a calculation made for the purposes of subsection (1);

market capitalization (市場資本值), in relation to a listed share, means the amount of the total number of shares of the same description as that share issued by the issuer of that share multiplied by their market price;

top 3 collateral (首 3 位抵押品), in relation to a top margin client of a licensed corporation licensed for Type 1 or Type 8 regulated activity, means any of the 3 highest listed shares or listed warrants in terms of market value among all listed shares and listed warrants provided by him to the licensed corporation as collateral;

top margin client (前列保證金客戶), in relation to a licensed corporation licensed for Type 1 or Type 8 regulated activity, means—

- (a) where it has less than 20 margin clients, all its margin clients with outstanding margin loan balance; or
- (b) where it has 20 or more margin clients, the 20 margin clients with the largest outstanding margin loan balance.

- (6) In the definition of **top 3 collateral** in subsection (5), **market value** (市值), in relation to a listed share or listed warrant provided by a margin client to the licensed corporation, means the market value of all such listed shares or listed warrants of the same description as that share or warrant (as the case may be) provided by the margin client to the licensed corporation.



23 Amounts receivable from ~~counterparties other dealers and clearing participants etc.~~ in respect of ~~dealings in~~ securities

(1) Subject to subsection (2), a licensed corporation ~~shall~~ must include in its liquid assets the following amounts receivable by the licensed corporation—

(a) an amount receivable from any securities dealer which arises from the sale of securities by the licensed corporation# to or through the securities dealer—

~~(a) — where the securities are sold —~~ on a cash-against-delivery basis, if — —

(i) ~~any such amount receivable which~~ the amount, when calculated on a transaction-by-transaction basis—

(A) is not yet due for settlement according to the settlement date; or

(B) has been outstanding for 2 weeks or less after the settlement date; and/or

(ii) ~~where any such amount receivable~~ the amount, when calculated on a transaction-by-transaction basis, has been outstanding for more than 2 weeks but less than one month after the settlement date, in which case the amount to be included which is the lower, when calculated on a transaction-by-transaction basis, of—

(A) ~~such the~~ outstanding amount receivable less any specific provision for bad or doubtful debts made in respect of ~~such the~~ outstanding amount; and

(B) the market value of the securities to which ~~such the~~ outstanding amount relates;

(b) an amount receivable from any securities dealer which arises from the sale of securities by the licensed corporation to or through the securities dealer where the securities are sold on a free delivery basis, such if the amount receivable, when calculated on a transaction-by-transaction basis, which —

(i) in the case where the clearing system of the exchange on which the securities are traded effects settlement only on a free delivery basis—

(A) is not yet due for settlement according to the settlement date; or

(B) —has been outstanding for 2 weeks or less after the settlement date; or

(ii) in any other case, is not yet due for settlement according to the settlement date;—

(c) an amount receivable from a general clearing participant of HKSCC which arises from a transaction in securities that is cleared for the licensed corporation by the participant with HKSCC and is to be settled on a cash-against-delivery basis, if the amount, when calculated on a transaction-by-transaction basis, is not yet due for settlement according to the settlement date;

(d) if the licensed corporation is a general clearing participant of HKSCC, an amount receivable from another person which arises from a transaction in securities that is cleared for the person by the licensed corporation with HKSCC and is to be settled on a cash-against-delivery basis, if the amount, when calculated on a transaction-by-transaction basis, is not yet due for settlement according to the settlement date.



- (2) The aggregate of amounts that a licensed corporation includes in its liquid assets under subsection (1) ~~shall~~ must not exceed the aggregate of amounts receivable from ~~securities dealer~~ the persons referred to in that subsection less the aggregate of amounts of specific and general provisions for bad or doubtful debts made in respect of such aggregate of amounts receivable.

24 Amounts receivable in respect of dealings in securities by common clients

- (1) A licensed corporation licensed for Type 8 regulated activity shall include in its liquid assets the net amount receivable from each securities dealer with which it has common clients, calculated as the amount by which the amount receivable from such securities dealer exceeds the amount payable by it to the securities dealer, where such amounts arise from any dealing in securities by such securities dealer for those clients, to the extent that such amount does not exceed the total amount receivable from such securities dealer arising from any such dealing in securities which is not yet due for settlement according to the settlement date.
- (2) A licensed corporation licensed for Type 1 regulated activity shall include in its liquid assets the net amount receivable from each licensed corporation licensed for Type 8 regulated activity with which it has common clients, calculated as the amount by which the amount receivable from such second-mentioned licensed corporation exceeds the amount payable by it to such second-mentioned licensed corporation, where such amounts arise from any dealing in securities by it for those clients, to the extent that such amount does not exceed the total amount receivable from such second-mentioned licensed corporation arising from any such dealing in securities which is not yet due for settlement according to the settlement date.

25 Amounts receivable from licensed corporations licensed for Type 8

- (1) Subject to subsection (2), a licensed corporation licensed for Type 1 regulated activity shall include in its liquid assets the aggregate of any amount receivable from each licensed corporation licensed for Type 8 regulated activity and any net amount receivable from such second-mentioned licensed corporation referred to in section 24(2) that has not been included in its liquid assets under that section, in the amount which, in relation to each such second-mentioned licensed corporation, is the lower of—
- (a) such aggregate amount less any specific provision for bad or doubtful debts made in respect of each such aggregate amount; and
 - (b) the sum of—
 - (i) the amount of cash deposited with it as security by such second-mentioned licensed corporation;
 - (ii) the market value of collateral deposited with it by such second-mentioned licensed corporation, less the haircut amount in relation to such collateral; and
 - (iii) the maximum amount that it can draw under a bank guarantee provided to it by such second-mentioned licensed corporation and issued by an authorized financial institution or an approved bank incorporated outside Hong Kong.
- (2) The aggregate of amounts that a licensed corporation includes in its liquid assets under subsection (1) shall not exceed the aggregate of amounts receivable from other licensed



corporations referred to in that subsection less the aggregate of amounts of specific and general provisions for bad or doubtful debts made in respect of such aggregate of amounts receivable.

26 Cash provided as security for short selling

A licensed corporation shall include in its liquid assets an amount receivable in the amount of any cash (including interest accrued on it) provided by it as security to the counterparty in respect of a short selling by it of securities where it has not yet delivered the securities to the counterparty for settlement, where the counterparty is—

- (a) a securities dealer;
- (b) a specified exchange;
- (c) a clearing house of a specified exchange; or
- (d) a clearing participant of a clearing house referred to in paragraph (c).

27 Proprietary positions of licensed corporations

(1) A licensed corporation shall include in its liquid assets any of the following assets that it beneficially owns—

- (a) subject to subsections (2), (3), (4), (6) and (7), listed shares;
- (b) qualifying debt securities;
- (c) special debt securities;
- (d) specified securities;
- (e) specified investments,

at market value, less the haircut amounts in relation to the securities or specified investments concerned.

(2) Subject to subsection (5), where a licensed corporation beneficially owns any listed shares and writes a call stock options contract on such shares, to the extent that the number of shares underlying the options contract is equal to the number of such shares, subsection (1)(a) does not apply in respect of such shares and section 40(3) and (4) does not apply in respect of the options contract and it shall include in its liquid assets such shares in the amount which is the lower of—

- (a) the market value of such shares, less the haircut amount in relation to such shares; and
- (b) the number of such shares multiplied by the strike price of such options contract.

(3) Subject to subsection (5), where a licensed corporation beneficially owns any listed shares and holds a short position in a stock futures contract in respect of such shares, to the extent that the number of shares underlying the futures contract is equal to the number of such shares, subsection (1)(a) does not apply in respect of such shares and section 40(4) does not apply in respect of the futures contract and it shall include in its liquid assets such shares at market value.

(4) Subject to subsection (5), where a licensed corporation beneficially owns any listed shares and holds a put stock options contract, which is not subject to any margin requirement, in respect of such shares, to the extent that the number of shares



underlying the options contract is equal to the number of such shares, it may elect not to apply subsection (1)(a) in respect of such shares and section 31(1)(b) in respect of the options contract whereupon it shall include in its liquid assets such shares in the amount which is the higher of—

- (a) the market value of such shares, less the haircut amount in relation to such shares; and
 - (b) the number of such shares multiplied by the strike price of such options contract.
- (5) Subsections (2), (3) and (4) do not apply in respect of a stock futures contract or a stock options contract which has been grouped with other positions for the purpose of calculating a net amount of margin required to be deposited by the licensed corporation.
- (6) Where a licensed corporation beneficially owns any listed shares and issues any call non-collateralized warrants on such shares, to the extent that the number of shares underlying the warrants which are outstanding is equal to the number of such shares, subsection (1)(a) does not apply in respect of such shares and section 43(1), (2)(d) and (3) does not apply in respect of such warrants and it shall include in its liquid assets such shares in the amount which is the lower of—
- (a) the market value of such shares, less the haircut amount in relation to such shares; and
 - (b) the number of such shares multiplied by the exercise price of such warrants.
- (7) Where a licensed corporation beneficially owns any listed shares which are charged for the purpose of issuing any call collateralized warrants on such shares, subsection (1)(a) does not apply in respect of such shares and section 43(1), (2)(d) and (3) does not apply in respect of such warrants and it shall include in its liquid assets such shares in the amount which is the lower of—
- (a) the market value of such shares, less the haircut amount in relation to such shares; and
 - (b) the number of such shares multiplied by the exercise price of such warrants.

28 Amounts receivable from clearing houses, etc.

- (1) A licensed corporation ~~shall~~must include in its liquid assets—
- (a) amounts receivable from a recognized clearing house; and
 - (b) cash deposited with such clearing house,
other than—
 - (c) admission fees it has paid to such clearing house;
 - (d) contributions it has made to the Guarantee Fund or Reserve Fund of such clearing house; and
 - (e) client money held in a segregated account ~~maintained~~ with such clearing house.
- (2) A licensed corporation ~~shall~~must include in its liquid assets amounts receivable from, and cash deposited with, a prescribed clearing house (except admission fees it has paid to the prescribed clearing house, and cash it has deposited with the prescribed clearing house as security against its general obligations), in respect of—
- (a) any dealing by it in its dealing or trading in, or entering into—



- (i) a futures contract;
- (ii) any securities;
- (iii) an options contract;
- (iv) a derivative contract; ~~or~~
- (v) a specified investment;
- ~~(bvi) any trading by it in~~ a leveraged foreign exchange contract; ~~or~~

~~(c) — its entering into any —~~

- ~~(vii) a~~ foreign exchange agreement; ~~or~~
- ~~(viii) an~~ interest rate swap agreement; ~~or~~

~~include in its liquid assets —~~

~~(d) — amounts receivable from Euroclear Bank S.A./N.V., Euroclear France S.A., Clearstream Banking S.A., Clearstream Banking AG or Korea Securities Finance Corporation; and~~

~~(e) — cash deposited with Euroclear Bank S.A./N.V., Euroclear France S.A., Clearstream Banking S.A., Clearstream Banking AG or Korea Securities Finance Corporation;~~

~~other than —~~

~~(f) — admission fees it has paid to Euroclear Bank S.A./N.V., Euroclear France S.A., Clearstream Banking S.A., Clearstream Banking AG or Korea Securities Finance Corporation; and~~

~~(g) — cash it has deposited with Euroclear Bank S.A./N.V., Euroclear France S.A., Clearstream Banking S.A., Clearstream Banking AG or Korea Securities Finance Corporation as security against its general obligations.~~

(b) any clearing by it with the prescribed clearing house (whether for its own account or on behalf of its clients) of a transaction in any contract, securities, investment or agreement referred to in paragraph (a).

- (3) A licensed corporation ~~shall~~must include in its liquid assets amounts receivable from, and cash deposited with, a futures or options clearing house other than a recognized clearing house (except admission fees it has paid to the futures or options clearing house, and cash it has deposited with the futures or options clearing house as security against its general obligations), in respect of —

(a) — any dealing by it in futures contracts or unlisted options contracts;

(b) — ~~or~~ any trading by it in leveraged foreign exchange contracts; or

(c) any clearing by it with the futures or options clearing house (whether for its own account or on behalf of its clients) of a transaction in a futures contract, unlisted options contract or leveraged foreign exchange contract —

~~(a) — amounts receivable from a futures or options clearing house other than a recognized clearing house; and~~

~~(b) — cash deposited with such clearing house;~~

~~other than —~~

~~(c) — admission fees it has paid to such clearing house; and~~



(d) ~~cash it has deposited with such clearing house as security against its general obligations.~~

(4) ~~In this section—~~

prescribed clearing house (訂明結算所) means—

(a) Euroclear Bank S.A./N.V.;

(b) Euroclear France S.A.;

(c) Clearstream Banking S.A.;

(d) Clearstream Banking AG; or

(e) Korea Securities Finance Corporation.

29 Amounts receivable from other dealers and clearing participants in respect of dealings in futures contracts, and options contracts and leveraged foreign exchange contracts

(1) Subject to subsection (2), a licensed corporation ~~shall~~ must include in its liquid assets amounts receivable from, and cash deposited with, a licensed corporation licensed for Type 1 or Type 2 regulated activity (**the dealer**) or a clearing participant of a futures or options clearing house (**the participant**), in respect of—

~~any dealing by it in futures contracts or options contracts or any trading by it in leveraged foreign exchange contracts—~~

(a) ~~amounts receivable from a licensed corporation licensed for Type 1 or Type 2 regulated activity or a clearing participant of a futures or options clearing house; and~~

(b) ~~cash deposited with that licensed corporation or that clearing participant,~~

~~other than—~~

(c) ~~admission fees it has paid to such licensed corporation or clearing participant; and~~

(d) ~~cash it has deposited with such licensed corporation or clearing participant as security against its general obligations.~~ (a) any dealing by it in futures contracts or unlisted options contracts;

(b) any trading by it in leveraged foreign exchange contracts; or

(c) any clearing by the dealer or the participant for it (whether for its own account or on behalf of its clients) of a transaction in a futures contract, unlisted options contract or leveraged foreign exchange contract.

(2) Subsection (1) does not apply to—

(a) admission fees the licensed corporation has paid to the dealer or the participant; and

(b) cash the licensed corporation has deposited with the dealer or the participant as security against its general obligations.

30 Amounts receivable from clients in respect of purchase of exchange-traded unlisted options contracts



A licensed corporation ~~shall~~must include in its liquid assets any amount receivable from any of its clients, calculated on a transaction-by-transaction basis, where such amount receivable arises from the purchase of any unlisted options contract traded on a specified exchange and—

(a) is not yet due for settlement according to the settlement date; or

(b) —has been outstanding for 5 business days or less after the settlement date.

31 Exchange-traded unlisted options contracts trading for own account

(1) Where a licensed corporation purchases for its own account any unlisted options contract traded on a specified exchange, it shall include in its liquid assets—

(a) in the case where the options contract has been grouped with any other position held by the licensed corporation in—

(i) a futures contract; or

(ii) any other unlisted options contract,

for the purpose of calculating a net amount of margin required to be deposited by it in respect of such positions, any amount receivable by it (other than any such amount receivable which has already been included in its liquid assets under section 28(1), (2) or (3) or 29) from—

(iii) a licensed corporation licensed for Type 1 or Type 2 regulated activity;

(iv) a futures or options clearing house; or

(v) a clearing participant of a futures or options clearing house,
arising from such calculation; or

(b) in any other case, subject to subsections (2) and (3) and sections 27(4), 40(7) and (8) and 43(6), an amount which equals 60% of the market value of such options contract.

(2) Subject to subsection (4) and without prejudice to section 40(7), where a licensed corporation holds a long position in a stock futures contract and holds a put stock options contract, which is not subject to any margin requirement, in respect of the same underlying listed shares, to the extent that the number of shares underlying the futures contract is equal to the number of shares underlying the options contract, subsection (1)(b) does not apply in respect of the options contract and section 40(4) does not apply in respect of the futures contract and it shall include in its liquid assets the options contract at market value.

(3) Subject to subsection (4) and without prejudice to section 40(8), where a licensed corporation holds a short position in a stock futures contract and holds a call stock options contract, which is not subject to any margin requirement, in respect of the same underlying listed shares, to the extent that the number of shares underlying the futures contract is equal to the number of shares underlying the options contract, subsection (1)(b) does not apply in respect of the options contract and section 40(4) does not apply in respect of the futures contract and it shall include in its liquid assets the options contract at market value.

(4) Subsections (2) and (3) do not apply in respect of a stock futures contract or a stock options contract which has been grouped with other positions for the purpose of calculating a net amount of margin required to be deposited by the licensed corporation.



32 Amounts receivable under securities borrowing and lending agreements

A licensed corporation which is the borrower of securities under a securities borrowing and lending agreement shall include in its liquid assets any amount receivable from the lender of the securities that it is deemed under section 15(1)(b) to have in respect of any cash provided by it as security to the lender.

33 Amounts receivable under repurchase transactions

A licensed corporation which is the purchaser in the first instance of any securities under a repurchase transaction shall include in its liquid assets any amount receivable from the seller of the securities that it is deemed under section 16(1)(a) to have in respect of the consideration for which it purchased the securities.

34 Amounts receivable in respect of leveraged foreign exchange trading

- (1) A licensed corporation licensed for Type 3 regulated activity shall include in its liquid assets, in respect of any trading by it in leveraged foreign exchange contracts—
 - (a) any amount receivable from a recognized counterparty; and
 - (b) the amount of any cash deposited by it with the recognized counterparty.
- (2) A licensed corporation licensed for Type 3 regulated activity shall include in its liquid assets the amount of any floating profits in respect of outstanding foreign exchange agreements and leveraged foreign exchange contracts to which it is a party.

35 Miscellaneous assets

A licensed corporation ~~shall~~must include in its liquid assets any of the following assets—

- (a) the amount of any fees, commissions, commission rebates and interest charges to which it is beneficially entitled which arise from the carrying on by it of any regulated activity for which it is licensed and—
 - (i) which have accrued and will first be due for billing or payment within the next 3 months; or
 - (ii) which have been billed or fallen due for payment and remain outstanding for one month or less after the date on which they were billed or fell due;
- (aa) if fees receivable by it in respect of its underwriting of an issue or a sale of securities (**underwriting fees**) do not fall within subparagraph (a)(i) or (ii) and, in respect of the issue or sale it has entered into one or more sub-underwriting agreements under which it is obliged to pay fees to the sub-underwriters, the amount of the underwriting fees—
 - (i) but only up to the total amount of the fees which it is obliged to pay to the sub-underwriters; and
 - (ii) only if the fees which it is obliged to pay to the sub-underwriters will not fall due for payment until on or after the day on which it receives the underwriting fees;



- (b) deposits which it beneficially owns and maintained with, and in accordance with the rules or requirements of, a recognized exchange company as security for its obligations or liabilities owed to the recognized exchange company for stamp duty chargeable under the Stamp Duty Ordinance (Cap 117) on contract notes specified in an agreement under section 5A of that Ordinance;
- (c) prepaid operating expenses which will be incurred within the next 3 months;
- (d) tax reserve certificates issued by the Commissioner of Inland Revenue in accordance with the Tax Reserve Certificates Ordinance (Cap 289) which it beneficially owns;
- (e) interest accrued to it under an interest rate swap agreement to which it is a party, other than interest which remains outstanding after it is first due for payment;
- (f) amounts paid by it for its own account for subscribing for—
 - (i) listed shares or shares pending their being listed;
 - (ii) qualifying debt securities;
 - (iii) special debt securities;
 - (iv) specified securities,less an amount equal to such amounts as multiplied by 50% of the haircut percentages in relation to such shares or securities;
- (g) dividends receivable on shares listed on a recognized stock market or on a specified exchange that are traded on an ex-dividend basis and which it beneficially owns;
- (h) interest accrued on qualifying debt securities or special debt securities that are traded on an ex-interest basis and which it beneficially owns.

Division 4—Ranking liabilities

36 Computation basis

A licensed corporation shall, for the purpose of calculating its ranking liabilities under the provisions of this Division, apply the computation basis prescribed in Division 2.

37 Amounts payable to clients, etc.

A licensed corporation ~~shall~~must include in its ranking liabilities any amount payable to any of its clients or any counterparty or clearing house which arises from the carrying on of any regulated activity for which it is licensed, other than—

- (a) an amount payable to any of its clients in respect of client money held by it—
 - (i) in a segregated account ~~maintained~~ with an authorized financial institution, an approved bank incorporated outside Hong Kong or a recognized clearing house; ~~or~~
 - (ii) in a segregated account—
 - (A) that is referred to in paragraph (a) of the definition of **segregated account** in section 2; and



(B) with a person approved by the Commission under section 4(2) of Securities and Futures (Client Money) Rules (Cap 571 sub. leg. I) for the purposes of those Rules; and

- (b) an amount payable to any of its clients which is set-off against an amount receivable from the client under section 21(3).

38 Amounts payable in respect of dealing in securities

A licensed corporation shall include in its ranking liabilities, in respect of a sale of securities—

- (a) by it for a client who is in default of his obligation to deliver the securities for—
- (i) more than 2 weeks after the settlement date; or
 - (ii) (A) more than 5 business days but not more than 2 weeks after the settlement date; and
 - (B) the market value of the securities is more than 200% of the consideration for which they were sold; and
- (b) which it has not settled with securities purchased at its own expense,

the amount by which the market value of the securities exceeds the consideration for which they were sold.

39 Amounts payable in respect of dealing in securities by common clients

- (1) A licensed corporation licensed for Type 1 regulated activity shall include in its ranking liabilities the net amount payable to each licensed corporation licensed for Type 8 regulated activity with which it has common clients, calculated as the amount by which the amount payable to each such second-mentioned licensed corporation exceeds the amount receivable by it from such second-mentioned licensed corporation, where such amounts arise from any dealing in securities by it for any of those clients.
- (2) A licensed corporation licensed for Type 8 regulated activity shall include in its ranking liabilities the net amount payable to each securities dealer with which it has common clients, calculated as the amount by which the amount payable to each such securities dealer exceeds the amount receivable by it from such securities dealer, where such amounts arise from any dealing in securities by such securities dealer for any of those clients.

40 Futures contracts and options contracts dealing, etc.

- (1) Subject to subsection (2), a licensed corporation shall include in its ranking liabilities, in respect of—
- (a) any dealing by it in any futures contract;
 - (b) any unlisted options contract written by it; or
 - (c) any futures contract or unlisted options contract cleared by it,

for another person, the amount, when calculated on an account-by-account basis, by which the aggregate of the amount of margin required to be deposited with it by the person and the amount of any floating losses incurred by the person on the contract less



the amount of any floating profits made by the person on the contract exceeds the aggregate of—

- (d) the amount of cash deposited with it as security by the person;
 - (e) the market value of collateral deposited with it by the person, less the haircut amounts in relation to such collateral;
 - (f) the market value of specified investments deposited with it as security by the person, less the haircut amounts in relation to such investments; and
 - (g) the maximum amount that it can draw under a bank guarantee provided to it as security by the person and issued by an authorized financial institution or an approved bank incorporated outside Hong Kong.
- (2) Subsection (1) does not apply to a licensed corporation on the day or days on which it is allowed, under the rules or conventions of the exchange on which the futures contract or options contract is traded, not to collect from the other person the margin required to be deposited by the other person in respect of the futures contract or options contract.
- (3) Subject to subsections (5), (6) and (9) and sections 27(2) and 43(5), a licensed corporation shall include in its ranking liabilities the market value of any unlisted options contract written by it for its own account and traded on a specified exchange, to the extent that the market value of the options contract exceeds the amount of margin required to be deposited by it in respect of the options contract.
- (4) Subject to subsections (5), (6), (7), (8) and (9) and sections 27(2) and (3), 31(2) and (3) and 43(4) and (5), a licensed corporation shall include in its ranking liabilities the amount of margin required to be deposited by it in respect of—
- (a) any futures contract which is traded by it for its own account; and
 - (b) any unlisted options contract which is purchased or written by it for its own account and traded on a specified exchange.
- (5) Subject to subsection (10), where a licensed corporation borrows any listed shares under a securities borrowing and lending agreement for the purpose of depositing them to cover a call stock options contract written by it, to the extent that the number of shares underlying the options contract is equal to the number of such shares, it may elect not to apply subsections (3) and (4) in respect of the options contract and not to apply section 45(1) in respect of the securities borrowing and lending agreement, whereupon it shall include in its ranking liabilities an amount in the aggregate of the in-the-money amount of the options contract and the higher of—
- (a) the haircut amount in relation to such shares; and
 - (b) the amount that would, but for this subsection, be required to be included in its ranking liabilities under section 45(1).
- (6) Subject to subsection (10), where a licensed corporation holds a long position in a stock futures contract and writes a call stock options contract in respect of the same underlying listed shares, to the extent that the number of shares underlying the futures contract is equal to the number of shares underlying the options contract, subsections (3) and (4) do not apply in respect of the futures contract and the options contract and it shall include in its ranking liabilities an amount which is the higher of—
- (a) the amount of margin required to be deposited by it in respect of the futures contract; and
 - (b) the in-the-money amount of the options contract.



- (7) Subject to subsection (10) and without prejudice to section 31(2), where a licensed corporation holds a long position in a stock futures contract and holds a put stock options contract, which is not subject to any margin requirement, in respect of the same underlying listed shares, to the extent that the number of shares underlying the futures contract is equal to the number of shares underlying the options contract, subsection (4) does not apply in respect of the futures contract and section 31(1)(b) does not apply in respect of the options contract and, if the options contract is out-of-the-money, it shall include in its ranking liabilities the lower of—
- (a) the amount of margin required to be deposited by it in respect of the futures contract; and
 - (b) the out-of-the-money amount of the options contract.
- (8) Subject to subsection (10) and without prejudice to section 31(3), where a licensed corporation holds a short position in a stock futures contract and holds a call stock options contract, which is not subject to any margin requirement, in respect of the same underlying listed shares, to the extent that the number of shares underlying the futures contract is equal to the number of shares underlying the options contract, subsection (4) does not apply in respect of the futures contract and section 31(1)(b) does not apply in respect of the options contract and, if the options contract is out-of-the-money, it shall include in its ranking liabilities the lower of—
- (a) the amount of margin required to be deposited by it in respect of the futures contract; and
 - (b) the out-of-the-money amount of the options contract.
- (9) Subject to subsection (10), where a licensed corporation holds a short position in a stock futures contract and writes a put stock options contract in respect of the same underlying listed shares, to the extent that the number of shares underlying the futures contract is equal to the number of shares underlying the options contract, subsections (3) and (4) do not apply in respect of the futures contract and the options contract and it shall include in its ranking liabilities an amount which is the higher of—
- (a) the amount of margin required to be deposited by it in respect of the futures contract; and
 - (b) the in-the-money amount of the options contract.
- (10) Subsections (5), (6), (7), (8) and (9) do not apply in respect of a stock futures contract or a stock options contract which has been grouped with other positions for the purpose of calculating a net amount of margin required to be deposited by the licensed corporation.
- (11) A licensed corporation shall include in its ranking liabilities, in respect of any unlisted options contract (other than a put unlisted options contract) which is written by it for its own account and traded other than on a specified exchange or not exchange traded, an amount which is the highest of—
- (a) 200% of the market value of the options contract;
 - (b) 200% of the in-the-money amount of the options contract; and
 - (c) 200% of the amount of margin required to be deposited by it.
- (12) A licensed corporation shall include in its ranking liabilities, in respect of any put unlisted options contract which is written by it for its own account and traded other than on a specified exchange or not exchange traded, an amount, not exceeding the value of the assets underlying the options contract stated at the strike price of the options contract, which is the highest of—



- (a) 200% of the market value of the options contract;
- (b) 200% of the in-the-money amount of the options contract; and
- (c) 200% of the amount of margin required to be deposited by it.

41 Leveraged foreign exchange trading

- (1) A licensed corporation licensed for Type 3 regulated activity shall include in its ranking liabilities—
 - (a) in respect of all outstanding leveraged foreign exchange contracts which it has with any of its clients, the excess, when calculated on a client-by-client basis, of the amount by which the aggregate of—
 - (i) 3% of the aggregate of the amount of the gross principal values of the contracts;
 - (ii) the amount of any floating losses incurred by, and due from, the client on the contracts; and
 - (iii) the amount of any accrued interest, fees and commissions receivable from the client in respect of any such contracts, exceeds the aggregate of—
 - (iv) 100% of the amount of cash in the Hong Kong currency (or any currency linked to the Hong Kong currency) deposited with it as security by the client;
 - (v) 95% of the amount of cash in such foreign currency as may be approved under section 58(5)(f) deposited with it as security by the client;
 - (vi) 95% of the amount of any time deposit in the Hong Kong currency (or currency linked to the Hong Kong currency) which—
 - (A) is placed with a local branch or the principal place of business in Hong Kong of an authorized financial institution;
 - (B) will become payable within 6 months; and
 - (C) has been assigned to it by the client;
 - (vii) the market value of collateral deposited with it by the client, less the haircut amounts in relation to such collateral;
 - (viii) the amount of any floating profits made by, and due to, the client on the contracts;
 - (ix) 90% of the maximum amount that it can draw under a letter of credit issued in favour of it as security by an authorized financial institution or an approved bank incorporated outside Hong Kong; and
 - (x) the amount of any accrued interest payable to the client in respect of any such contracts; and
 - (b) the amount of any floating losses incurred by it on any outstanding foreign exchange agreements and outstanding leveraged foreign exchange contracts to which it is a party.
 - (2) Where a licensed corporation holds with any of its clients (other than a client whose account with the licensed corporation is an omnibus account) any outstanding leveraged



foreign exchange contracts, for the purpose of calculating the aggregate of the amount of the gross principal values of the outstanding contracts, it may elect not to include in such aggregate the gross principal values of any 2 outstanding contracts where—

- (a) under one of the contracts it is obliged to purchase an amount of a currency (**A**) and sell an amount (**X**) of another currency (**B**); and
- (b) under the other contract it is obliged to purchase the same amount (**X**) of the other currency (**B**) and sell an amount of the first-mentioned currency (**A**),

whereupon it shall include in the aggregate the highest of the equivalent amount of its reporting currency of—

- (c) the amount X of currency B;
- (d) the amount of currency A which it is obliged to purchase under the contract referred to in paragraph (a); and
- (e) the amount of currency A which it is obliged to sell under the contract referred to in paragraph (b).

- (3) In this section, **gross principal value** (本金總額), in relation to an outstanding leveraged foreign exchange contract, means the higher of the equivalent amounts in the reporting currency of the licensed corporation of the 2 amounts of currencies that the contract is intended to exchange.

42 Provision of securities margin financing

- (1) A licensed corporation licensed for Type 1 or Type 8 regulated activity shall include in its ranking liabilities the amount, when calculated on a client-by-client basis, by which—
 - (a) any amount receivable from any of its margin clients; or
 - (b) in the case of a group of related margin clients, the aggregate of amounts receivable from the group,

included in its liquid assets under section 22(1), exceeds 10% of the aggregate of amounts receivable from its margin clients included in its liquid assets in accordance with that section.

- (2) Where a licensed corporation licensed for Type 1 or Type 8 regulated activity obtains any financial accommodation wholly or partly secured by collateral provided by any of its margin clients, it shall include in its ranking liabilities the amount by which such financial accommodation exceeds 80% of the aggregate of amounts receivable from its margin clients arising from the provision of securities margin financing.

- (3) In subsection (1), **group of related margin clients** (一組關連保證金客戶) means any 2 or more margin clients of a licensed corporation licensed for Type 1 or Type 8 regulated activity and—

- (a) where it is a group of 2 margin clients, one is the spouse of the other;
- (b) where one or more of the margin clients are corporations, one is in control, either alone or with his spouse, of 35% or more of the voting rights of that other margin client or each of the other margin clients (as the case may be); or
- (c) where the margin clients are corporations, they are members of the same group of companies.



43 Short positions in securities (other than unlisted options contracts) and ~~specified~~ investments

- (1) Subject to subsections (2), (3), (6), (8) and (9) and section 27(6) and (7), a licensed corporation which holds for its own account a short position in securities (other than unlisted options contracts) ~~or~~ specified investments, illiquid investments or miscellaneous investments, whether by short selling or otherwise, ~~shall~~ must include in its ranking liabilities the market value of those securities or ~~specified~~ investments.
- (2) Subject to subsection (3), a licensed corporation which holds for its own account a short position, whether by short selling or otherwise, in—
- (a) subject to subsections (4), (5) and (6) and section 45(5), listed shares;
 - (b) qualifying debt securities;
 - (c) special debt securities;
 - (d) subject to subsections (8) and (9) and section 27(6) and (7), specified securities;
~~or~~
 - (e) specified investments;
 - (f) illiquid investments; or
 - (g) miscellaneous investments,
- ~~shall~~ must increase the amount required to be included in its ranking liabilities under subsection (1) by the haircut amounts in relation thereto.
- (3) Subject to subsections (4), (5), (6), (8) and (9) and sections 27(6) and (7) and 45(5), a licensed corporation which holds for its own account a short position in securities, whether by short selling or otherwise, which ~~—~~
- ~~(a) — are not of a type specified in Schedule 2;~~
 - ~~(b) — constitute more than 5% by market value of all securities of the same description issued by a particular corporation; or~~
 - ~~(c) — are listed shares or listed warrants which have been suspended from trading for at least 3 business days or ceased trading on any exchange on which the securities were listed, unless the securities can continue to be traded on any other exchange on which the securities are listed, —~~
- ~~shall~~ must increase the amount required to be included in its ranking liabilities under subsection (1) by the market value of ~~such the~~ securities.
- (4) Subject to subsection (7), where a licensed corporation short sells any listed shares and holds a long position in a stock futures contract in respect of such shares, to the extent that the number of shares underlying the futures contract is equal to the number of shares short sold by it, subsections (2) and (3) do not apply in respect of the shares short sold and section 40(4) does not apply in respect of the futures contract.
- (5) Subject to subsection (7), where a licensed corporation short sells any listed shares and writes a put stock options contract in respect of such shares, to the extent that the number of shares underlying the options contract is equal to the number of shares short sold by it, subsections (2) and (3) do not apply in respect of the shares short sold and section 40(3) and (4) does not apply in respect of the options contract and it shall include in its ranking liabilities the higher of—
- (a) the increased amount that would, but for this subsection, arise under subsection (2) or (3); and



- (b) the in-the-money amount of the options contract.
- (6) Subject to subsection (7), where a licensed corporation short sells any listed shares and holds a call stock options contract, which is not subject to any margin requirement, in respect of such shares, to the extent that the number of shares underlying the options contract is equal to the number of shares short sold by it, it may elect not to apply subsections (1), (2) and (3) in respect of the shares short sold and not to apply section 31(1)(b) in respect of the options contract, whereupon it shall include in its ranking liabilities the lower of—
 - (a) the aggregate of the market value of such shares sold short and the increased amount that would, but for this subsection, arise under subsection (2) or (3); and
 - (b) the number of shares short sold multiplied by the strike price of the options contract.
- (7) Subsections (4), (5) and (6) do not apply in respect of a stock futures contract or a stock options contract which has been grouped with other positions for the purpose of calculating a net amount of margin required to be deposited by the licensed corporation.
- (8) A licensed corporation which is the issuer of any call non-collateralized warrants issued on listed shares shall increase the amount included in its ranking liabilities under subsection (1) in respect of any outstanding call non-collateralized warrants so issued which it does not cover by holding the underlying shares, by the amount by which the haircut amount in relation to the underlying shares which are not so held exceeds the aggregate of the out-of-the-money amounts of the warrants.
- (9) A licensed corporation shall increase the amount included in its ranking liabilities under subsection (1) in respect of any outstanding non-collateralized warrants issued by it on any assets other than shares, by 30% of the market value of the assets underlying such warrants.
- (10) A licensed corporation shall include in its ranking liabilities, in respect of the short selling of securities for any of its clients, save where such securities have been delivered to it by the client or are not yet due for settlement according to the settlement date, the amount by which the aggregate of—
 - (a) the market value of such securities; and
 - (b) the haircut amount in relation to such securities,exceeds the aggregate of—
 - (c) the amount of cash deposited with it by the client and the amount of proceeds of sale of such securities withheld by it as security for delivery of securities by the client to the licensed corporation;
 - (d) the maximum amount that it can draw under a bank guarantee provided to it as security by the client and issued by an authorized financial institution or an approved bank incorporated outside Hong Kong; and
 - (e) the market value of collateral deposited with it by the client, less the haircut amount in relation to such collateral.

44 Concentrated proprietary positions

- (1) Where a licensed corporation holds for its own account—
 - (a) listed shares;



- (b) qualifying debt securities;
- (c) special debt securities;
- (d) specified securities; or
- (e) specified investments,

and the net market value of any such securities or specified investments (as the case may be) which are of the same description equals 25% or more of its required liquid capital, it shall include in its ranking liabilities—

- (f) where the net market value is 25% or more but less than 51% of its required liquid capital, 5% of such net market value; or
- (g) where the net market value is 51% or more of its required liquid capital, 10% of such net market value.

- (2) In subsection (1), **net market value** (淨市值), in relation to any securities and any specified investments referred to in that subsection, means the market value that remains after netting each long and short position in securities and specified investments (as the case may be) of the same description.

45 Securities borrowing and lending agreements

- (1) Subject to subsections (5) and (6) and section 40(5), a licensed corporation which is the borrower of securities under a securities borrowing and lending agreement shall include in its ranking liabilities the amount by which the aggregate of—
- (a) the amount of cash deposited by it with the lender under the agreement as security; and
 - (b) the market value of collateral provided by it to the lender, less the haircut amount in relation to such collateral,
- exceeds—
- (c) in the case where the securities are—
 - (i) shares listed on a specified exchange;
 - (ii) qualifying debt securities; or
 - (iii) special debt securities,110% of their market value; or
 - (d) in any other case, 50% of the market value of the securities.
- (2) Subject to subsection (6), a licensed corporation which, under a securities borrowing and lending agreement, is the lender of securities which are included in its liquid assets under section 27, shall include in its ranking liabilities the amount by which the market value of the securities, less the haircut amount in relation to such securities, exceeds the aggregate of—
- (a) the maximum amount that it can draw under a bank guarantee provided to it as security by the borrower under the agreement and issued by an authorized financial institution or an approved bank incorporated outside Hong Kong;
 - (b) the amount of cash deposited with it as security by the borrower;
 - (c) the market value of—



- (i) any shares listed on a specified exchange;
 - (ii) any qualifying debt securities; and
 - (iii) any special debt securities,
deposited with it by the borrower as collateral, less the haircut amount in relation to such collateral; and
 - (d) 50% of the market value of any collateral, other than collateral referred to in paragraph (c), deposited with it by the borrower.
- (3) Subject to subsection (6), a licensed corporation which, under a securities borrowing and lending agreement, is the lender of any securities as agent for another person, or where the securities are borrowed by it under another securities borrowing and lending agreement, shall include in its ranking liabilities the amount by which the market value of the securities exceeds the aggregate of—
- (a) the maximum amount that it can draw under a bank guarantee provided to it as security by the borrower under the agreement and issued by an authorized financial institution or an approved bank incorporated outside Hong Kong;
 - (b) the amount of cash deposited with it as security by the borrower;
 - (c) the market value of—
 - (i) any shares listed on a specified exchange;
 - (ii) any qualifying debt securities; and
 - (iii) any special debt securities,
deposited with it by the borrower as collateral, less the haircut amount in relation to such collateral; and
 - (d) 50% of the market value of any collateral, other than collateral referred to in paragraph (c), deposited with it by the borrower.
- (4) A licensed corporation which is the lender of securities under a securities borrowing and lending agreement shall include in its ranking liabilities the amount payable to the borrower under the agreement in respect of any cash deposited with it as security by the borrower, save where the cash—
- (a) is held in a segregated account; and
 - (b) is not included in its liquid assets under section 20.
- (5) Where a licensed corporation borrows listed shares under a securities borrowing and lending agreement for the purpose of short selling for its own account, to the extent that the number of shares borrowed is equal to the number of shares short sold by it, subsection (1) does not apply in respect of the agreement and section 43(2) and (3) does not apply in respect of the shares short sold and it shall include in its ranking liabilities the amount which is the higher of—
- (a) the amount that would arise under subsection (1); and
 - (b) the increased amount that would arise under section 43(2) or (3),
but for this subsection.
- (6) Subsections (1), (2) and (3) do not apply in respect of a securities borrowing and lending agreement to which a licensed corporation is a party, where the other party to the agreement is an approved securities borrowing and lending counterparty.



46 Repurchase transactions

- (1) A licensed corporation which is the purchaser in the first instance of any securities in a repurchase transaction shall include in its ranking liabilities the amount by which the amount included in its liquid assets under section 33 exceeds—
 - (a) in the case where the securities are—
 - (i) shares listed on a specified exchange;
 - (ii) qualifying debt securities; or
 - (iii) special debt securities,
110% of their market value; or
 - (b) in any other case, 50% of the market value of the securities.
- (2) A licensed corporation which is the seller in the first instance of any securities in a repurchase transaction shall include in its ranking liabilities the amount by which the market value of the securities, less the haircut amount in relation to such securities, exceeds the aggregate of—
 - (a) the maximum amount that it can draw under a bank guarantee provided to it as security by the purchaser of the securities and issued by an authorized financial institution or an approved bank incorporated outside Hong Kong;
 - (b) the amount of proceeds of sale of such securities received by it from the purchaser;
 - (c) the market value of—
 - (i) any shares listed on a specified exchange;
 - (ii) any qualifying debt securities; and
 - (iii) any special debt securities,deposited with it by the purchaser as collateral, less the haircut amount in relation to such collateral; and
 - (d) 50% of the market value of any collateral, other than collateral referred to in paragraph (c), deposited with it by the purchaser.
- (3) A licensed corporation which is the seller in the first instance of any securities in a repurchase transaction shall include in its ranking liabilities the amount of the consideration for which it sold the securities.

47 Net underwriting commitments

- (1) Subject to subsection (2), a licensed corporation which underwrites or sub-underwrites an issue or a sale of securities ~~shall~~must include in its ranking liabilities—
 - (a) ~~in the case of~~ a rights issue where the market price of the securities is less than or equal to their subscription price, the lower of—
 - (i) ~~where the market price of the securities is less than or equal to their subscription price,~~ the aggregate of—
 - (A) 50% of the haircut percentage in relation to the securities multiplied by the net underwriting commitment; and



(B) the amount by which the net underwriting commitment exceeds the market value of the securities; ~~or~~ and

(ii) the net underwriting commitment:

(~~ii~~aa) for a rights issue where the market price of the securities is greater than their subscription price, 5% of the haircut percentage in relation to the securities multiplied by the net underwriting commitment; or

(b) in any other case, 50% of the haircut percentage in relation to the securities multiplied by the net underwriting commitment.

(2) This section does not apply to a licensed corporation on the day on which it acquires an underwriting or a sub-underwriting commitment in respect of an issue or a sale of securities and the business day following that day.

(3) For the purposes of subsection (2), a licensed corporation acquires an underwriting or a sub-underwriting commitment in respect of an issue or a sale of securities at the later of—

(a) the time when it commits itself to underwrite or sub-underwrite the securities; and

(b) the time when the lead underwriter or co-lead underwriter signs the underwriting agreement with the issuer or the seller (as the case may be) of the securities.

(4) In subsection (1), **net underwriting commitment** (包銷承擔淨額) means the total costs of subscribing for or purchasing securities underwritten or sub-underwritten by a licensed corporation other than—

(a) securities which are sub-underwritten; and

(b) securities which are the subject of a legally binding contract for the subscription for or purchase of such securities,

through or from that licensed corporation by another person.

48 Off-exchange traded derivative contracts

(1) Subject to subsection (2), a licensed corporation shall include in its ranking liabilities the amount of any floating losses incurred by it in respect of any position in any off-exchange traded derivative contract.

(2) Where a licensed corporation has entered into a bilateral netting agreement in respect of 2 or more off-exchange traded derivative contracts with the counterparty with whom it maintains the positions, it shall include in its ranking liabilities the amount by which the amount of any floating losses incurred by it exceeds the amount of any floating profits made by it in respect of the contracts.

(3) In subsection (2), **bilateral netting agreement** (雙邊淨額結算協議) means an agreement between the licensed corporation and the counterparty with whom it maintains positions in off-exchange traded derivative contracts under which each party has a single obligation to the other in respect of all such contracts covered by the agreement and which provides that, in the event that the counterparty fails to comply with its obligation under the agreement, the licensed corporation will have—

(a) a single claim to receive only the net amount of the aggregate positive mark-to-market value of any contract covered by the agreement, calculated by deducting from the aggregate positive mark-to-market value of any contract covered by the



agreement the aggregate negative mark-to-market value of any other contract covered by the agreement; or

- (b) a single obligation to pay only the net amount of the aggregate negative mark-to-market value of any contract covered by the agreement, calculated by deducting from the aggregate negative mark-to-market value of any contract covered by the agreement the aggregate positive mark-to-market value of any other contract covered by the agreement.

49 Interest rate swap agreements

- (1) A licensed corporation which is a party to an interest rate swap agreement shall include in its ranking liabilities the notional principal amount multiplied by the percentage specified in column 3 of Table 1 in Schedule 4 opposite the description of the remaining term to maturity in column 2 of the Table which is applicable to the agreement.
- (2) In subsection (1), **notional principal amount** (名義本金額) means the theoretical amount agreed upon by the parties to an interest rate swap agreement on the basis of which any interest payment to be made under the agreement is calculated.

50 Foreign exchange agreements

A licensed corporation which is a party to a foreign exchange agreement shall include in its ranking liabilities the amount of currency to be delivered by it under the agreement multiplied by the percentage specified in column 3 of Table 2 in Schedule 4 opposite the description of the counterparty and the remaining term to maturity in column 2 of the Table which is applicable to the agreement.

51 Introduction of transactions

- (1) Subject to subsection (2), where a licensed corporation introduces transactions which involve—
 - (a) a dealing in any securities;
 - (b) a dealing in a futures contract or an unlisted options contract; or
 - (c) a trading in a leveraged foreign exchange contract,to another person for execution or clearing on behalf of any of its clients and—
 - (d) it does not include the amount receivable by it or payable to it in respect of any such transaction in the calculation of its liquid capital under this Part; and
 - (e) there is neither express agreement nor a clear market practice that exempts it from any liability to the client or the other person in relation to such transaction,it shall include in its ranking liabilities the amount by which its required liquid capital would have been increased had one or more of the following amounts been included in the calculation of its variable required liquid capital (as if the transaction had been executed or cleared by it)—
 - (f) (where the transaction introduced is a dealing in securities and the transaction has not been fully settled by the client or the other person (as the case may be)) the total value of the transaction entered into as a result of the introduction;



- (g) (where the transaction introduced is a dealing in a futures contract or an unlisted options contract) the total amount of margin required to be deposited in respect of the futures contract or the options contract entered into as a result of the introduction which remains outstanding;
 - (h) (where the transaction introduced is a trading in a leveraged foreign exchange contract) the aggregate gross foreign currency position arising from the leveraged foreign exchange contract entered into as a result of the introduction which remains outstanding.
- (2) Subsection (1) does not apply where—
- (a) the person to whom the transaction is introduced is a member of a group of companies of which the licensed corporation is a member;
 - (b) the person to whom the transaction is introduced has entered into an agreement with the client for providing the execution or clearing service to the client and is contractually liable to the client for any default in the execution or clearing of the transaction; and
 - (c) the licensed corporation is not liable to the client for execution or clearing of such transactions or default by the person to whom the transaction is introduced.

51A Foreign currency positions

- (1) Subject to subsections (2) and (3), a licensed corporation must include in its ranking liabilities 5% of its net position in each foreign currency.
- (2) In calculating the net position in a foreign currency, a licensed corporation may elect to exclude from the calculation the value of any asset which is denominated in that foreign currency and not included in its liquid assets under any provision in Division 3.
- (3) If, in relation to a non-freely floating foreign currency, a licensed corporation has positions in the currency which are attributable to both the onshore and offshore markets in the currency, the licensed corporation must include in its ranking liabilities—
 - (a) if its onshore net position in the currency and its offshore net position in the currency are both long positions or are both short positions, 5% of the aggregate of the onshore net position and the offshore net position; or
 - (b) if paragraph (a) does not apply to it in relation to the currency—
 - (i) 1.5% of the lower of its onshore net position in the currency and its offshore net position in the currency; and
 - (ii) 5% of the difference between its onshore net position in the currency and its offshore net position in the currency.
- (4) In this section—

net position (淨持倉量), in relation to a licensed corporation's position in a foreign currency, means the difference between—

 - (a) the aggregate of—
 - (i) the value of assets, other than fixed assets, beneficially owned by it which are denominated in the foreign currency; and



(ii) the total amount of the foreign currency in respect of which it is exposed to the risk of a decline in the value of the foreign currency under outstanding contracts (including spot contracts); and

(b) the aggregate of—

(i) all of its on-balance sheet liabilities, other than excluded liabilities, which are denominated in the foreign currency; and

(ii) the total amount of the foreign currency in respect of which it is exposed to the risk of a rise in the value of the foreign currency under outstanding contracts (including spot contracts);

non-freely floating foreign currency (非自由浮動外幣) means a foreign currency in respect of which an authority of the jurisdiction of which the currency is the lawful currency specifies, in respect of one or more foreign exchange markets specified by the authority—

(a) the rate at which the currency is permitted by the authority to be converted into one or more other currencies; or

(b) a range of rates within which the currency is permitted by the authority to be converted into one or more other currencies;

offshore net position (境外淨持倉量), in relation to a licensed corporation's net position in a non-freely floating foreign currency, means its net position in the currency which is attributable to the offshore market in the currency;

onshore net position (境內淨持倉量), in relation to a licensed corporation's net position in a non-freely floating foreign currency, means its net position in the currency which is attributable to the onshore market in the currency.

52 Miscellaneous

~~(1)~~—A licensed corporation ~~shall~~must include in its ranking liabilities—

(a) 10% of the amount of any guarantee, indemnity or other similar financial commitment provided by it, directly or indirectly (including the pledging of assets for the purpose of obtaining a bank guarantee), other than a guarantee, an indemnity and other financial commitment provided by it in respect of its own liabilities and obligations;

(b) the amount by which the liabilities of any subsidiary of it (excluding any amounts due to it from the subsidiary) exceed the assets of the subsidiary;

(c) the consideration it is obliged to pay for the redemption of redeemable shares, other than approved redeemable shares, which have not yet been redeemed;

(d) ~~subject to subsection (2), 5% of its net position in each foreign currency where it has made one or more elections under section 18A(3) in respect of one or more controlled assets (as defined in section 18A(5)) denominated in a particular currency, the amount;—~~ (if it exceeds zero) calculated in accordance with the following formula—

$$A - L$$

Where—



A is the aggregate of the amounts that it is required to include in its liquid assets in respect of the controlled assets denominated in the currency; and

L is the aggregate of the amounts of existing obligations or liabilities denominated in the currency (which the controlled assets may be freely applied to meet) that it is required (apart from by this paragraph) to include in its ranking liabilities; and

- (e) where it is the underwriter of a note issuance and revolving underwriting facility, the maximum amount that can be drawn down by the issuer under the facility by issuing notes less the amount that has been drawn down by the issuer by issuing and placing notes multiplied by the percentage specified in column 3 of Schedule 5 opposite the description of the remaining term to maturity in column 2 of the Schedule which is applicable to the facility.

~~(2) In calculating the net position in a foreign currency for the purposes of subsection (1)(d), a licensed corporation may elect to exclude from the calculation the value of any asset which is denominated in that foreign currency and not included in its liquid assets under any provision in Division 3.~~

~~(3) In this section, **net position** (淨持倉量), in relation to a foreign currency, means the difference between—~~

~~(a) the aggregate of the value of assets, other than fixed assets, beneficially owned by a licensed corporation which are denominated in the foreign currency together with the amount of the foreign currency which it is obliged to purchase under any outstanding contract; and~~

~~(b) the aggregate of the amount of the on-balance sheet liabilities of the licensed corporation, other than excluded liabilities, which are denominated in such foreign currency together with the amount of such foreign currency which it is obliged to sell under any outstanding contract.~~

53 Other liabilities

- (1) Subject to subsection (2), a licensed corporation ~~shall~~must include in its ranking liabilities all its liabilities not otherwise required to be included in its ranking liabilities under any other provision of this Division, including—
- (a) any amount payable by it in relation to any overdraft obtained by it;
 - (b) any amount payable by it in relation to any loan obtained by it;
 - (c) any accrued interest payable by it to any other person;
 - (d) any accrued expenses incurred by it;
 - (e) any tax payable by it, less any tax prepaid by it, to the extent that the tax payable and the tax prepaid are of the same description and levied by the same taxation authority;
 - (f) any provision made by it for contingent liabilities;
 - (g) any provision made by it for floating losses in respect of open positions held for its own account; and
 - (h) any other liabilities provided for in accordance with generally accepted accounting principles.



- (2) A licensed corporation ~~shall~~must not include in its ranking liabilities—
- (a) any approved subordinated loan provided to it; ~~or~~
 - (b) any liability that it is not required to settle within the next 12 months and is secured by a first legal charge on immovable property beneficially owned by it and used in carrying on the regulated activity for which it is licensed, to the extent that the net realizable value of that property equals such liability; or
 - (c) any on-balance sheet liabilities arising from a tenancy agreement entered into by it in respect of any premises which it uses in carrying on the regulated activity for which it is licensed, but only up to the value of any assets in respect of the tenancy agreement which are not included in its liquid assets under any provision in Division 3.

Part 5

Miscellaneous

54 Licensed corporations to notify Commission of failure to comply with these Rules

- (1) Where a licensed corporation notifies the Commission—
- (a) under section 146(1) of the Ordinance that it is unable to maintain, or to ascertain whether it maintains, financial resources in accordance with the specified amount requirements that apply to it; or
 - (b) under section 146(3) of the Ordinance that it is unable to comply with, or to ascertain whether it complies with, all or any of the requirements of these Rules, other than the specified amount requirements,
- it shall include in the notice—
- (c) full details of the matter and the reason therefor; and
 - (d) full details of any steps it is taking, has taken or proposes to take to redress the inability.
- (2) The Commission may, where a licensed corporation gives notice to the Commission under section 146(1) and (3) of the Ordinance, request the licensed corporation to provide, in such form and within such time as the Commission may specify, such additional information and document as the Commission may require in connection with the matter, whereupon the licensed corporation shall comply with the request accordingly.
- (3) For the purposes of this section and section 144 of the Ordinance, ***specified amount requirements*** (指明-數額規定), in relation to a licensed corporation, means the applicable requirements specified in section 4 and—
- (a) the requirement to maintain paid-up share capital in the amount required under section 5; and
 - (b) the requirement to maintain liquid capital not less than its required liquid capital under section 6.



55 Licensed corporations to notify Commission of circumstances relating to financial resources and trading activities and to submit returns in certain cases

- (1) A licensed corporation shall notify the Commission in writing as soon as reasonably practicable and in any event within one business day of becoming aware of any of the following matters—
- (a) its liquid capital falls below 120% of its required liquid capital;
 - (b) a required liquid capital deficit occurs, but the licensed corporation is regarded as having complied with section 6(1) by virtue of section 6(3);
 - (c) its liquid capital falls below 50% of the liquid capital stated in its last return submitted to the Commission under section 56(1) or (3);
 - (d) any information contained in any of its previous returns submitted to the Commission pursuant to these Rules has become false or misleading in a material particular;
 - (e) the aggregate of the amounts it has drawn down on any loan, advance, credit facility or other financial accommodation provided to it by banks exceeds the aggregate of the credit limits thereof;
 - (f) it has been or will be unable, for 3 consecutive business days, to meet in whole or in part any calls or demands for payment or repayment (as the case may be), from any of its lenders, credit providers or financial accommodation providers;
 - (g) any of its lenders or any person who has provided credit or financial accommodation to it has exercised, or has informed it that he will exercise, the right to liquidate security provided by it to him in order to reduce its liability or indebtedness to him under any outstanding loan, advance, credit facility balance or other financial accommodation provided to it by him;
 - (h) (Repealed)
 - (i) the aggregate of the maximum amounts that can be drawn down against it under any guarantee, indemnity or any other similar financial commitment provided by it—
 - (i) exceeds \$5000000; or
 - (ii) would, if deducted from its liquid capital, cause its liquid capital to fall below 120% of its required liquid capital;
 - (j) the aggregate of amounts of any outstanding claim made in writing by it or against it (whether disputed or not) exceeds or is likely to exceed \$5000000;
 - (k) the aggregate of amounts of any outstanding claim made in writing by it or against it (whether disputed or not) would, if deducted from its liquid capital, cause its liquid capital to fall below 120% of its required liquid capital;
 - (l) any claim is made by it under any professional indemnity or other insurance policy that it is required to maintain under any rules made under section 116(5) of the Ordinance or the rules or conventions of any exchange or clearing house;
 - (m) any financial commitment, including a guarantee, is provided for it in favour of an exchange or a clearing house, by a corporation which is a member of a group of companies of which it is a member.
- (2) Where a licensed corporation notifies the Commission of any matter under subsection (1), it shall—



- (a) include in the notice full details of the matter and the reason therefor; and
 - (b) in the case of a notification under subsection (1)(a), (b), (c), (e), (f) or (g), include in the notice full details of any steps it is taking, has taken or proposes to take to prevent its liquid capital from falling below its required liquid capital or to improve its liquidity.
- (3) Where a licensed corporation has, prior to the commencement of these Rules, entered into any position in an off-exchange traded derivative contract other than—
 - (a) an options contract written by it on its own account;
 - (b) an interest rate swap agreement; and
 - (c) a foreign exchange agreement,of which it has not notified the Commission prior to the commencement of these Rules, it shall within one business day of the commencement of these Rules notify the Commission in writing of the details of such position.
- (4) Where a licensed corporation intends to enter into any position in an off-exchange traded derivative contract other than—
 - (a) an options contract written by it on its own account;
 - (b) an interest rate swap agreement; and
 - (c) a foreign exchange agreement,it shall notify the Commission in writing of the details of the position it intends to enter into at least 10 business days before entering into the position.
- (5) Where a licensed corporation intends to change any of its accounting principles in a way that may materially affect the liquid capital or paid-up share capital that it maintains or is required to maintain under Part 3, for the purposes of section 3(2), it shall notify the Commission in writing of the details of, and the reasons for, the intended change not less than 5 business days prior to effecting the change.

56 Licensed corporations to submit returns to Commission

- (1) Subject to subsection (4), a licensed corporation licensed for one or more of the following—
 - (a) Type 1 regulated activity;
 - (b) Type 2 regulated activity;
 - (c) Type 3 regulated activity;
 - (d) Type 4 regulated activity, and it is not subject to the specified licensing condition;
 - (e) Type 5 regulated activity, and it is not subject to the specified licensing condition;
 - (f) Type 6 regulated activity, and it is not subject to the specified licensing condition;
 - (g) Type 7 regulated activity;
 - (h) Type 8 regulated activity;
 - (i) Type 9 regulated activity, and it is not subject to the specified licensing condition;
 - (ia) Type 10 regulated activity, and it is not subject to the specified licensing condition,



shall, in respect of each month at the end of which it remains licensed, submit to the Commission, in the manner specified in subsection (5) and no later than 3 weeks after the end of the month concerned, a return which is in the form specified by the Commission under section 402 of the Ordinance and signed in the manner specified in subsection (6), and includes—

- (j) its liquid capital computation, as at the end of the month;
- (k) its required liquid capital computation, as at the end of the month;
- (l) a summary of bank loans, advances, credit facilities and other financial accommodation available to it, as at the end of the month;
- (m) an analysis of its margin clients, as at the end of the month;
- (n) an analysis of collateral received from its margin clients, as at the end of the month;
- (o) an analysis of its rolling balance cash clients, as at the end of the month;
- (p) an analysis of its profit and loss account;
- (q) an analysis of its client assets, as at the end of the month; and
- (r) where it is licensed for Type 3 regulated activity, an analysis of its foreign currency positions, as at the end of the month.

- (2) Subject to subsection (4), a licensed corporation to which subsection (1) applies shall, in respect of each period of 3 months at the end of which it remains licensed, being such period in a year ending at the end of the month of March, June, September or December, respectively, submit to the Commission, in the manner specified in subsection (5) and no later than 3 weeks after the end of the period concerned, a return which is in the form specified by the Commission under section 402 of the Ordinance and signed in the manner specified in subsection (6), and includes—

- (a) an analysis of its clientele, as at the end of the 3 month period;
- (b) an analysis of its proprietary derivative positions, as at the end of the 3 month period;
- (c) where it is licensed for Type 3 regulated activity, an analysis of its recognized counterparties, as at the end of the 3 month period; and
- (d) where it is licensed for Type 9 regulated activity, an analysis of the assets under its management, as at the end of the 3 month period.

- (3) Subject to subsection (4), a licensed corporation which is licensed solely for one or more of the following—

- (a) Type 4 regulated activity;
- (b) Type 5 regulated activity;
- (c) Type 6 regulated activity;
- (d) Type 9 regulated activity;
- (da) Type 10 regulated activity,

and subject to the specified licensing condition, shall, in respect of each period of 6 months at the end of which it remains licensed, being such period in a year ending at the end of the month of June or December, respectively, submit to the Commission, in the manner specified in subsection (5) and no later than 3 weeks after the end of the period



concerned, a return which is in the form specified by the Commission under section 402 of the Ordinance and signed in the manner specified in subsection (6), and includes—

- (e) its liquid capital computation, as at the end of the 6 month period;
- (f) its required liquid capital computation, as at the end of the 6 month period;
- (g) an analysis of its profit and loss account;
- (h) an analysis of its clientele, as at the end of the 6 month period; and
- (i) where it is licensed for Type 9 regulated activity, an analysis of the assets under its management, as at the end of the 6 month period.

(4) A licensed corporation may elect to submit the return required under—

- (a) subsection (1), in respect of periods of not less than 28 days but not more than 35 days, each ending not more than 7 days before or after the end of a month;
- (b) subsection (2), in respect of periods of 3 months each ending not more than 7 days before or after the end of March, June, September or December in a year;
- (c) subsection (3), in respect of periods of 6 months each ending not more than 7 days before or after the end of June or December in a year,

determined by it on a basis according to which the ending date of each period so determined is predictable, and where it so elects and submits the return concerned, it shall be deemed to have submitted the return concerned in respect of the period required under subsection (1), (2) or (3) (as the case may be).

(5) For the purposes of this section, a licensed corporation shall submit a return referred to in this section to the Commission electronically by means of an online communication system approved by the Commission under section 58(7) for the purposes of this subsection.

(6) For the purposes of this section—

- (a) a return referred to in this section shall be signed on behalf of the licensed corporation concerned by a responsible officer of the licensed corporation or another officer of the licensed corporation approved by the Commission under section 58(5)(e) for the purposes of this section, by way of attachment to the return of the digital signature or electronic signature of the responsible officer or other officer; and
- (b) the signature referred to in paragraph (a) shall—
 - (i) in the case of a digital signature, be supported by a recognized certificate, generated within the validity of that certificate and used in accordance with the terms of that certificate; or
 - (ii) in the case of an electronic signature, be authenticated in accordance with such directions and instructions for the use of the online communication system concerned as are published by the Commission under section 58(8).

(6A) For the purposes of subsection (6)(b)(i), a digital signature is taken to be supported by a recognized certificate if it is taken to be supported by that certificate under section 2(2) of the Electronic Transactions Ordinance (Cap 553).

(7) In this section—



digital signature (數碼簽署) has the meaning assigned to it by section 2(1) of the Electronic Transactions Ordinance (Cap 553);

electronic signature (電子簽署) has the meaning assigned to it by section 2(1) of the Electronic Transactions Ordinance (Cap 553);

recognized certificate (認可證書) has the meaning assigned to it by section 2(1) of the Electronic Transactions Ordinance (Cap 553);

rolling balance cash client (滾存結餘現金客戶) means a client of a licensed corporation in respect of whom the amounts receivable from, and amounts payable to, him by the licensed corporation arising from the purchase and sale of securities on a cash-against-delivery basis by the licensed corporation for him may be set-off by the licensed corporation under section 21(3);

within the validity of that certificate (在該證書的有效期內) has the meaning assigned to it by section 6(2) of the Electronic Transactions Ordinance (Cap 553).

57 Licensed corporations to provide information

The Commission may at any time, by notice in writing, request a licensed corporation to provide it within the time and in the manner specified in the notice with such information, including any record or document, as it may specify in the notice relating to the financial resources or trading activities of the licensed corporation, whereupon the licensed corporation shall comply with the request accordingly.

58 Approvals

- (1) For the purposes of these Rules, the Commission may, whether or not on application in writing and payment of the fee prescribed in the Securities and Futures (Fees) Rules (Cap 571 sub. leg. AF), approve a person as—
 - (a) an approved bank incorporated outside Hong Kong, where the person is a bank which is incorporated under the law or other authority of any jurisdiction outside Hong Kong;
 - (b) an approved credit rating agency; or
 - (c) an approved securities borrowing and lending counterparty.
- (2) Where the Commission approves a person under subsection (1), it shall as soon as reasonably practicable—
 - (a) publish in such manner as it considers appropriate the name of the person approved; and
 - (b) in the case of a person approved under subsection (1)(b), specify the ratings issued by the person as being equivalent to a specified rating issued by Moody's Investors Service ~~or~~, Standard & Poor's Corporation or Fitch Ratings.
- (3) A person approved under subsection (1)(c) shall be a person whose activities or objects include the provision of services for interposing himself in a securities borrowing and lending agreement as the counterparty to both the borrower and the lender, including administering any security deposited with him in connection with the agreement and registration and settlement of the agreement.



- (4) The Commission may, on application in writing and payment of the fee prescribed in the Securities and Futures (Fees) Rules (Cap 571 sub. leg. AF), approve a licensed corporation for the purposes of these Rules as an approved introducing agent where the licensed corporation satisfies the Commission that—
- (a) where—
- (i) it is licensed solely for Type 1 regulated activity, it conducts no business other than—
 - (A) communicating offers to effect dealings in securities to an exchange participant of a recognized exchange company or a specified exchange, in the names of the persons from whom those offers are received; and
 - (B) introducing persons to an exchange participant of a recognized exchange company or a specified exchange, in order that they may—
 - (I) effect dealings in securities; or
 - (II) make offers to deal in securities;
 - (ii) it is licensed solely for Type 2 regulated activity, it conducts no business other than—
 - (A) communicating offers to effect dealings in futures contracts or options contracts to an exchange participant of a recognized exchange company or a specified exchange, in the names of the persons from whom those offers are received; and
 - (B) introducing persons to an exchange participant of a recognized exchange company or a specified exchange, in order that they may—
 - (I) effect dealings in futures contracts or options contracts; or
 - (II) make offers to deal in futures contracts or options contracts;
 - (iii) it is licensed solely for Type 3 regulated activity, it conducts no business other than—
 - (A) communicating offers to effect leveraged foreign exchange trading to a recognized counterparty in the names of the persons from whom those offers are received; and
 - (B) introducing persons to a recognized counterparty in order that they may—
 - (I) effect trading in leveraged foreign exchange contracts; or
 - (II) make offers to trade in leveraged foreign exchange contracts; or
 - (iv) it is—
 - (A) licensed for one or more of the following-
 - (I) Type 1 regulated activity;
 - (II) Type 2 regulated activity;



- (III) Type 3 regulated activity; or
- (B) licensed for one or more of the regulated activities referred to in sub-subparagraph (A) and one or more of the following—
 - (I) Type 4 regulated activity, and it is subject to the specified licensing condition;
 - (II) Type 5 regulated activity, and it is subject to the specified licensing condition;
 - (III) Type 6 regulated activity, and it is subject to the specified licensing condition,

and not licensed for any regulated activity other than as described in sub-subparagraphs (A) and (B), and in relation to any one or more of the regulated activities referred to in sub-subparagraph (A) for which it is licensed, it conducts no business other than that described in subparagraph (i), (ii) or (iii);

- (b) in connection with the offers communicated or the persons so introduced, it will not incur any liability to any person except for its own negligence, wilful default or fraud; and
- (c) it does not hold client assets.

(5) The Commission may, on application in writing by a licensed corporation and payment of the fee prescribed in the Securities and Futures (Fees) Rules (Cap 571 sub. leg. AF), approve—

- (a) as approved redeemable shares, any redeemable shares issued by the licensed corporation;
- (b) as an approved subordinated loan, any subordinated loan obtained by the licensed corporation;
- (c) as an approved standby subordinated loan facility, any standby subordinated loan facility obtained by the licensed corporation;
- (d) for the purposes of section 3(3), the adoption by the licensed corporation of an accounting principle other than one of those referred to in section 3(1)(a);
- (e) for the purposes of section 56(6), an officer of the licensed corporation to sign a return;
- (f) for the purposes of section 41(1)(a)(v), a foreign currency; **and**
- (g) the withdrawal of an election made by the licensed corporation under any provision of these Rules;

(h) the calculation of the haircut percentage on a weighted average basis for specified securities that fall within the description in item 2 or 3(a)(vii) of Table 7 in Schedule 2 where—

- (i) the underlying assets are constituted by a basket of equities or a basket of debt securities; or
- (ii) the underlying index is calculated by reference to a basket of equities or a basket of debt securities; and

(i) for the purposes of section 11(7) the setting off by the licensed corporation of amounts receivable by it from, and amounts payable by it to, a general clearing participant of HKSCC which arise from transactions in securities that are cleared



by the participant with HKSCC for the licensed corporation or the licensed corporation's clients.

- (6) An approval granted under subsection (1), (4) or (5) shall be subject to such reasonable conditions as the Commission may impose, and the Commission may at any time revoke the approval or amend or revoke any such condition or impose new conditions as may be reasonable in the circumstances.
- (7) The Commission may, for the purposes of section 56(5), approve an online communication system.
- (8) Where the Commission approves an online communication system under subsection (7), it shall as soon as reasonably practicable publish directions and instructions for the use of that system in such manner as it considers appropriate.
- (9) An approval granted under subsection (1), (4), (5) or (7) remains in force—
 - (a) where a period of validity of the approval is specified in the notice of approval, until the expiry of the period; or
 - (b) where no such period is specified, until revoked by the Commission by notice in writing.

59 Withdrawal of elections made under these Rules

A licensed corporation which makes an election under any provision of these Rules shall be bound by the election until such time as the Commission approves the withdrawal of the election under section 58(5)(g).

60 Transitional

- (1) (Omitted as expired)
- (2) (Omitted as spent)
- (3) Notwithstanding section 1 and subject to subsection (5), section 5 does not apply in respect of—
 - (a) a partnership deemed under section 27 of Part 1 of Schedule 10 to the Ordinance to be a licensed corporation; or
 - (b) an individual deemed under section 30 of Part 1 of Schedule 10 to the Ordinance to be a licensed corporation,provided that—
 - (c) in the case of a partnership, the aggregate of amounts maintained in all partners' capital accounts; or
 - (d) in the case of an individual, the amount maintained in his capital account,is not less than the amount of paid-up share capital required of a licensed corporation under section 5, until such time as the specified decision referred to, in the case of a partnership, in section 53(1)(b) of Part 1 of Schedule 10 to the Ordinance or, in the case of an individual, in section 53(1)(c) of Part 1 of Schedule 10 to the Ordinance, takes effect.
- (4) For the purposes of these Rules, a transaction executed by—



- (a) a partnership deemed under section 27 of Part 1 of Schedule 10 to the Ordinance to be a licensed corporation, for the account of a partner of the partnership; and
- (b) an individual deemed under section 30 of Part 1 of Schedule 10 to the Ordinance to be a licensed corporation, for his own account,

shall be treated as a transaction executed by it or him (as the case may be) for a client.

- (5) Notwithstanding section 1 and subject to subsection (6), these Rules do not apply in respect of—

- (a) a partnership deemed under section 27 of Part 1 of Schedule 10 to the Ordinance to be a licensed corporation;
- (b) an individual deemed under section 30 of Part 1 of Schedule 10 to the Ordinance to be a licensed corporation; or
- (c) a licensed corporation,

which is licensed solely for one or more of the following—

- (d) Type 4 regulated activity;
- (e) Type 5 regulated activity;
- (f) Type 6 regulated activity;
- (g) Type 9 regulated activity,

provided that it or he (as the case may be) maintains net tangible assets in an amount of not less than \$500000.

- (6) Subsection (5) shall expire at the expiration of 6 months from the commencement of these Rules.
- (6A) Where a licensed corporation is licensed immediately prior to 1 October 2006 for Type 1 or Type 8 regulated activity, for the period from 1 October 2006 to 30 September 2007, the reference in section 42(2) to 80% shall be construed as a reference to 65%.
- (7) In this section—

capital account (資本帳) means an account in which the amount of capital injected into the business of a partnership or sole-proprietorship is kept;

net tangible assets (有形資產淨值), in relation to a person referred to in subsection (5)(a), (b) or (c), means the person's total assets less-

- (a) the person's intangible assets, including goodwill, copyrights, patents and licences; and
- (b) the person's total liabilities (after excluding any approved subordinated loan provided to the person).



Schedule 1

Financial resources requirements

[sections 2 & 5]

Table 1
Paid-up share capital

Regulated activity	Minimum amount of paid-up share capital
Type 1—	
(a) in the case where the licensed corporation in question provides securities margin financing	\$10000000
(b) in any other case	\$5000000
Type 2	\$5000000
Type 3—	
(a) in the case where the licensed corporation in question is an approved introducing agent	\$5000000
(b) in any other case	\$30000000
Type 4	\$5000000
Type 5	\$5000000
Type 6—	
(a) in the case where the licensed corporation in question is not subject to the no sponsor work licensing condition	\$10000000
(b) in any other case	\$5000000
Type 7	\$5000000
Type 8	\$10000000
Type 9	\$5000000



Regulated activity

Minimum amount of
paid-up share capital

Type 10

\$5000000

Table 2
Required liquid capital

Regulated activity

Minimum amount of
required liquid capital

Type 1—

(a) in the case where the licensed corporation in question is an approved introducing agent or trader \$500000

(b) in any other case \$3000000

Type 2—

(a) in the case where the licensed corporation in question is an approved introducing agent, futures non-clearing dealer or trader \$500000

(b) in any other case \$3000000

Type 3—

(a) in the case where the licensed corporation in question is an approved introducing agent \$3000000

(b) in any other case \$15000000

Type 4—

(a) in the case where the licensed corporation in question is subject to the specified licensing condition \$100000

(b) in any other case \$3000000

Type 5—



Regulated activity	Minimum amount of required liquid capital
(a) in the case where the licensed corporation in question is subject to the specified licensing condition	\$100000
(b) in any other case	\$3000000
Type 6—	
(a) in the case where the licensed corporation in question is subject to the specified licensing condition	\$100000
(b) in any other case	\$3000000
Type 7	\$3000000
Type 8	\$3000000
Type 9—	
(a) in the case where the licensed corporation in question is subject to the specified licensing condition	\$100000
(b) in any other case	\$3000000
Type 10—	
(a) in the case where the licensed corporation in question is subject to the specified licensing condition	\$100000
(b) in any other case	\$3000000

Schedule 2

Haircut percentages

[sections 2 & 43]

Table 1

Haircut percentages for listed shares ~~listed in Hong Kong for the purposes of these rules (except for the purpose of calculating the haircut amount under section 22(1)(b)(i))~~



Item	Description	Haircut- Percentage %
1.	Shares which are listed on a recognized stock market—	
	(a) — being a constituent of the Hang Seng Index or the Hang Seng Hong Kong LargeCap Index	15
	(b) — to the extent not already covered in paragraph (a), being a constituent of the Hang Seng Hong Kong MidCap Index	20
	(c) — being any share not referred to in paragraph (a) or (b)	30
2.	Shares which are listed on a recognized stock market but are not stratified according to stock indices	30

<u>Item</u>	<u>Description</u>	<u>Haircut Percentage %</u>
1.	<u>Except for the purposes of calculating the haircut amount under section 22(1)(b)(i), shares which are listed on a recognized stock market—</u>	
	<u>(a) — being a constituent of the Hang Seng Index</u>	<u>15</u>
	<u>(b) — not being a constituent of the Hang Seng Index but being a constituent of the Hang Seng Composite LargeCap Index</u>	<u>20</u>
	<u>(c) — not being a constituent of the Hang Seng Index or the Hang Seng Composite LargeCap Index</u>	<u>30</u>
2.	<u>Shares which are listed on a specified exchange in the United Kingdom—</u>	
	<u>(a) — other than shares which are listed on London Stock Exchange plc – SEAQ—</u>	
	<u>(i) — being a constituent of the FTSE 100 Index</u>	<u>15</u>
	<u>(ii) — not being a constituent of the FTSE 100 Index</u>	<u>20</u>



<u>Item</u>	<u>Description</u>	<u>Haircut Percentage</u> <u>%</u>
	(b) <u>being shares which are listed on London Stock Exchange plc – SEAQ</u>	<u>30</u>
<u>3.</u>	<u>Shares which are listed on a specified exchange in the United States of America—</u>	
	(a) <u>other than shares which are listed on the NASDAQ Stock Market LLC – NASDAQ Global Market or the NASDAQ Stock Market LLC – NASDAQ Global Select Market—</u>	
	(i) <u>being a constituent of the S&P 500 Index</u>	<u>15</u>
	(ii) <u>not being a constituent of the S&P 500 Index</u>	<u>20</u>
	(b) <u>being shares which are listed on the NASDAQ Stock Market LLC – NASDAQ Global Market or the NASDAQ Stock Market LLC – NASDAQ Global Select Market</u>	<u>30</u>
<u>4.</u>	<u>Shares which are listed on a specified exchange in Japan—</u>	
	(a) <u>other than shares which are listed on the Tokyo Stock Exchange, Inc. – JASDAQ—</u>	
	(i) <u>being a constituent of the Nikkei Stock Average</u>	<u>15</u>
	(ii) <u>not being a constituent of the Nikkei Stock Average</u>	<u>20</u>
	(b) <u>being shares which are listed on the Tokyo Stock Exchange, Inc. – JASDAQ</u>	<u>30</u>
<u>5.</u>	<u>Shares which are listed on a specified exchange specified in Part 1 of Schedule 3, other than an exchange in the United Kingdom, the United States of America or Japan—</u>	
	(a) <u>being a constituent of the Euro Stoxx 50 Index</u>	<u>15</u>
	(b) <u>not being a constituent of the Euro Stoxx 50 Index</u>	<u>20</u>
<u>6.</u>	<u>Shares which are listed on a specified exchange specified in Part 2 of Schedule 3</u>	<u>30</u>
<u>7.</u>	<u>Shares which are listed on a stock exchange (other than an exchange referred to in items 1 to 6) which is a member of the World Federation of Exchanges</u>	<u>50</u>
<u>8.</u>	<u>Shares which are listed on a stock exchange not referred to in items 1 to 7</u>	<u>75</u>

**Table 1A**

Haircut percentages for shares listed in Hong Kong for the purpose of calculating the haircut amount under section 22(1)(b)(i)

Item	Description	Haircut Percentage %
1.	<u>For the purpose of calculating the haircut amount under section 22(1)(b)(i), s</u> Shares which are listed on a recognized stock market—	
(a)	being a constituent of the Hang Seng Index or the Hang Seng Hong Kong LargeCap Index	15
(b)	being a constituent of the Hang Seng Hong Kong MidCap <u>Composite LargeCap</u> Index	20
(c)	being a constituent of the Morgan Stanley Capital International Inc. Hong Kong Index or the Morgan Stanley Capital International Inc. China Index	30
(d)	being a constituent of the Hang Seng Composite Index	30
(e)	being any share <u>that is</u> not <u>a constituent of an index</u> referred to in paragraph (a), (b), (c) or (d)—	
(i)	for a licensed corporation which does not repledge securities collateral	30
(ii)	for a licensed corporation which repledges securities collateral	60
2.	Shares which are listed on a recognized stock market but are not stratified according to stock indices—	
(a)	for a licensed corporation which does not repledge securities collateral—	30
(b)	for a licensed corporation which repledges securities collateral—	60

Table 2

~~Haircut percentages for shares listed in the United Kingdom, the United States of America and Japan~~



Item	Description	Haircut- Percentage %
1.	Shares which are listed on a specified exchange in the United Kingdom (other than the London Stock Exchange plc—SEAQ International), the United States of America (other than the Nasdaq Stock Market, Inc.—Nasdaq National Market) or Japan (other than the Japanese Association of Securities Dealers Automated Quotations)—	
	(a) —being a constituent of the FTSE-100 Index, Nikkei 500 Index or Standard & Poor's 500 Index; or	15
	(b) —being any share not referred to in paragraph (a)	20
2.	Shares which are listed on a specified exchange in the United Kingdom (other than the London Stock Exchange plc—SEAQ International), the United States of America (other than the Nasdaq Stock Market, Inc.—Nasdaq National Market) or Japan (other than the Japanese Association of Securities Dealers Automated Quotations), but are not stratified according to stock indices	20

Table 3
Haircut percentages for other shares

Item	Description	Haircut- Percentage %
1.	Shares listed on a specified exchange specified in Part 1 of Schedule 3 (other than the London Stock Exchange plc—SEAQ International, the Nasdaq Stock Market, Inc.—Nasdaq National Market or the Japanese Association of Securities Dealers Automated Quotations)	20
2.	Shares listed on a specified exchange specified in Part 2 of Schedule 3	30



Item	Description	Haircut- Percentage %
3.	Shares listed on the London Stock Exchange plc— SEAIQ International, the Nasdaq Stock Market, Inc.— Nasdaq National Market or the Japanese Association- of Securities Dealers Automated Quotations	30
4.	Shares listed on any other stock exchange which is a member of the World Federation of Exchanges	50
5.	Listed shares not referred to in item 1, 2, 3 or 4 or Table 1, 1A or 2—	75

Table 4

Haircut percentages for qualifying debt securities, by issuer or guarantor, etc.

Tier	Description	Haircut Percentage %
1.	Where the issuer or guarantor of the qualifying debt securities—	0
	(a) is the Central People's Government of the People's Republic of China or the People's Bank of China;	
	(b) is the Government;	
	(c) is the Hong Kong Exchange Fund; or	
	(d) has an issue or issues currently rated by—	
	(i) Moody's Investors Service at Aaa or Prime-1; or	
	(ii) Standard & Poor's Corporation at AAA or A-1; <u>or</u>	
	<u>(iii) Fitch Ratings at AAA or F1</u>	



Tier	Description	Haircut Percentage %
2.	Where the qualifying debt securities are any certificate of deposit, the issuer of which is an authorized financial institution or an approved bank incorporated outside Hong Kong	0
3.	<p>To the extent not already covered in Tier 1 or Tier 2—</p> <p>(a) where the issuer or guarantor of the qualifying debt securities has an issue or issues currently rated by—</p> <p>(i) Moody's Investors Service at Aa, A or Prime-2; or</p> <p>(ii) Standard & Poor's Corporation at AA, A or A-2; <u>or</u></p> <p><u>(iii) Fitch Ratings at AA, A or F2; or</u></p> <p>(b) where the issuer of the qualifying debt securities is the Hong Kong Mortgage Corporation; or</p> <p>(c) where the qualifying debt securities are listed on a recognized stock market</p>	2
4.	<p>To the extent not already covered in Tier 1, Tier 2 or Tier 3, where the issuer of the qualifying debt securities has an issue or issues currently rated by—</p> <p>(a) Moody's Investors Service at Baa or Prime-3; or</p> <p>(b) Standard & Poor's Corporation at BBB or A-3; <u>or</u></p> <p><u>(c) Fitch Ratings at BBB or F3</u></p>	5

Table 5

Haircut percentages for qualifying or special debt securities, by remaining term to maturity



Note: In this Table—

category 1 qualifying or special debt securities (第 1 類合資格或特別債務證券) means qualifying debt securities or special debt securities with a fixed rate coupon or a floating rate coupon, except qualifying debt securities or special debt securities that have no maturity date or a remaining term to maturity exceeding 30 years;

category 2 qualifying or special debt securities (第 2 類合資格或特別債務證券) means qualifying debt securities or special debt securities that do not fall within category 1 qualifying or special debt securities;

fixed rate coupon (定息), in relation to qualifying debt securities or special debt securities, means that interest is payable periodically calculated by reference to a predetermined fixed interest rate;

floating rate coupon (浮息), in relation to qualifying debt securities or special debt securities, means that interest is payable periodically calculated by reference to a variable interest rate that is reset periodically to equate to a money market or interbank reference interest rate that is widely quoted plus or minus a specified rate (if any).

Remaining term to maturity

(I)

(II)

~~Qualifying debt securities with a fixed coupon or with a floating rate coupon~~
Category 1 qualifying or special debt securities

~~Qualifying debt securities other than those with a fixed coupon or with a floating rate coupon~~
Category 2 qualifying or special debt securities

Haircut Percentage

Haircut Percentage

%

%

(a) Less than 6 months

1

1

(b) 6 months to less than 3 years

3

3

(c) 3 years to less than 5 years

4

5

(d) 5 years to less than 10 years

7

10

(e) 10 years or more, or infinite

10

22



Table 6

Haircut percentages for special debt securities

Note: In this Table—

1. The following terms have the meaning given by section 2A(2)—

- (a) **permitted interest rate;**
- (b) **permitted securities;**
- (c) **permitted underlying type of asset;**
- (d) **permitted underlying type of rate or index;**
- (e) **tradable commodity index;**
- (f) **tradable currency exchange rate index;**
- (g) **tradable securities index.**

2. **P**, in relation to special debt securities referred to in item 1(b)(i), 2(d) or 3 of this Table, means the percentage calculated according to the following formula—

$$P = A + B$$

where—

A is the percentage specified in column 3 of Table 4 in this Schedule opposite a description set out in tier 1, 3 or 4 in column 2 of the Table of an issuer or guarantor of qualifying debt securities, being a description which is applicable to—

- (a) for special debt securities referred to item 1(b)(i) of this Table, the rating given by Moody's Investors Service, Standard & Poor's Corporation or Fitch Ratings to the applicable jurisdiction referred to in the definition of **permitted interest rate** (許可利率) in section 2(A)(2); or
- (b) for special debt securities referred to item 2(d) or 3 of this Table, the issuer or guarantor of the special debt securities; and

B is—

- (a) for special debt securities referred to item 1(b)(i) of this Table, the percentage specified in column 2 of Table 5 in this Schedule opposite the description of a remaining term to maturity of debt securities set out in column 1 of the Table which would, if the description was of the tenor of an interest rate, apply to the permitted interest rate underlying the special debt securities; or
- (b) the percentage specified in the following column of Table 5 in this Schedule opposite the applicable description of the remaining term to maturity of the special debt securities set out in column 1 of the Table—
 - (i) for special debt securities referred to item 2(d) of this Table, if the special debt securities fall within the meaning of —
 - (A) **category 1 qualifying or special debt securities** as defined in Table 5, column 2; or



(B) category 2 qualifying or special debt securities as defined in Table 5, column 3; or

(ii) for special debt securities referred to item 3 of this Table, column 3.

Item	Description	Haircut Percentage
1.	Special debt securities being <u>indexed bonds a structured note where—</u>	<u>same as that applicable to the underlying assets</u>

	<u>(a) the permitted underlying type of asset is a single type of—</u>	
	<u>(i) permitted securities</u>	<u>same as that applicable to the permitted securities</u>
	<u>(ii) tradable commodity</u>	<u>40%</u>
	<u>(b) the permitted underlying type of rate or index is a single type of—</u>	
	<u>(i) permitted interest rate</u>	<u>P</u>
	<u>(ii) currency exchange rate or tradable currency exchange rate index</u>	<u>5%</u>
	<u>(iii) tradable securities index</u>	<u>same as that applicable to the highest of the haircut percentages applicable to the permitted securities which constitute the basket underlying the index</u>
	<u>(iv) tradable commodity index</u>	<u>40%</u>

2. Special debt securities being—

- (a) convertible debt securities; or
- (b) bonds with non-detachable warrants under which the holder of the bond has the right to buy a specified number of shares in the corporation which issued the bond,

where—

- (c) their market value is more than their par value or nominal value; or
- same as that applicable to the assets underlying the securities or bonds concerned underlying shares or, for an underlying basket of



Item	Description	Haircut Percentage
		<u>shares, the highest of the haircut percentages applicable to the shares which constitute the basket</u>
(d)	their market value is equal to, or less than, their par value or nominal value	same as that applicable to the qualifying debt securities referred to in column 2 in relation to Tier 1, Tier 3 or Tier 4 in Table 4 and with the same remaining term to maturity <u>P</u>
3.	Special debt securities being non-interest bearing debt securities	105% of the haircut percentage applicable to the qualifying debt securities referred to in column 2 in relation to Tier 1, Tier 3 or Tier 4 in Table 4 and with the same remaining term to maturity. <u>P</u>

Table 7
Haircut percentages for specified securities

Item	Description	Haircut Percentage
1.	Specified securities being w Warrants listed on a specified exchange	100%
2.	Specified securities being e Equity-linked instruments	same as that applicable to the underlying securities <u>assets or the underlying index</u>
3.	Specified securities being units in any unit trust or shares in any mutual fund— (a) which is authorized under section 104 of the Ordinance; or	



Item	Description	Haircut Percentage
	(b) under a Recognized Jurisdiction Scheme specified in an Appendix to the Code on Unit Trusts and Mutual Funds published by the Commission,	
	where their nature is—	
	(c) the same as that of a warrant fund, futures and options fund, leveraged fund or hedge fund referred to in that Code; or	40%
	(d) not the same as any of the funds mentioned in paragraph (c)—	20%
3.	<u>Units in a unit trust or shares in a mutual fund (the fund) which is an authorized fund, a recognized jurisdiction fund or a specified exchange traded fund, where the fund has features or characteristics that—</u>	
	<u>(a) satisfy the descriptions in the UT Code for—</u>	
	<u>(i) warrant funds</u>	<u>40%</u>
	<u>(ii) futures and options funds</u>	<u>40%</u>
	<u>(iii) hedge funds</u>	<u>40%</u>
	<u>(iv) structured funds</u>	<u>40%</u>
	<u>(v) funds that invest in financial derivative instruments</u>	<u>40%</u>
	<u>(vi) money market and cash management funds</u>	<u>5%</u>
	<u>(vii) index funds, and tracks an equity index (being an index that is calculated by reference to a basket of equities) or a debt securities index (being an index</u>	<u>same as that applicable to the underlying equity index or underlying debt securities index</u>



Item	Description	Haircut Percentage
	<u>that is calculated by reference to a basket of debt securities)</u>	
(b)	<u>satisfy the descriptions in the Code on Real Estate Investment Trusts published by the Commission under section 399 of the Ordinance for a REIT</u>	<u>30%</u>
(c)	<u>satisfy the descriptions in more than one of the funds referred to in paragraph (a) or (b)</u>	<u>same as the highest applicable percentage</u>
(d)	<u>do not satisfy the descriptions of any of the funds referred to in paragraph (a), (b) or (c)</u>	<u>20%</u>

Table 8
Haircut percentages for specified investments

Item	Description	Haircut Percentage %
1.	Specified investments being— (a)—gGold coin or gold bullion; or (b)—investments in gold which are prescribed in the Schedule to the Securities and Futures (Collective Investment Schemes) Notice (Cap 571 sub. leg. M) and authorized by the Commission under section 104 of the Ordinance	10
2.	<u>Interests in a collective investment scheme which—</u> <u>(a) falls within the meaning of paragraph (b) of the definition of collective investment scheme in section 1 of Part 1 of Schedule 1 to the Ordinance; and</u> <u>(b) is authorized by the Commission under section 104 of the Ordinance</u>	<u>10</u>
	Note— <u>Paragraph (a) refers to arrangements for the purchase of gold coins or gold bullion, as described in item 1 of the Schedule to the Securities</u>	



Item	Description	Haircut Percentage %
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23.	Specified investments being physical commodities of a quantity, quality and condition suitable for delivery under a futures contract or options contract traded on a specified exchange <u>Tradable commodities</u>	40
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Table 9

Haircut percentages for illiquid and miscellaneous investments

<u>Item</u>	<u>Description</u>	<u>Haircut Percentage %</u>
<u>1.</u>	<u>Illiquid investments</u>	<u>100</u>
<u>2.</u>	<u>Miscellaneous investments</u>	<u>100</u>

Schedule 3

Specified exchanges

[section 2 & Schedule 2]

Part 1

~~American Stock Exchange LLC~~

~~Australian Stock Exchange~~ ASX Limited

Australian Securities Exchange Limited

Board of Trade of the City of Chicago, Inc.

~~Bolsa de Madrid~~

Borsa Italiana S.p.A.

~~Bourse de Montreal, Inc.~~



Chicago Board Options Exchange, Inc. ~~orporated-~~
Chicago Mercantile Exchange, Inc.
Commodity Exchange, Inc. ~~(New York)~~
~~Copenhagen Stock Exchange A/S~~
Deutsche Borse AG
Eurex Frankfurt AG
Eurex Zurich AG
Euronext Amsterdam N.V.
Euronext Brussels S.A./N.V.
Euronext Paris S.A.
~~Helsinki Securities and Derivatives Exchange, Clearing House Ltd.~~
Hong Kong Futures Exchange Limited
ICE Futures Canada, Inc.
ICE Futures Europe
ICE Futures U.S., Inc.
~~Japanese Association of Securities Dealers Automated Quotations~~
~~Korea Futures Exchange~~
Korea ~~Stock~~ Exchange, Inc.
~~LIFFE Administration and Management~~
The London Metal Exchange Limited
London Stock Exchange plc
~~Luxembourg Stock Exchange~~
Montreal Exchange Inc.
Nagoya Stock Exchange, Inc.
NASDAQ Copenhagen A/S
NASDAQ Helsinki Ltd
NASDAQ PHLX LLC
NASDAQ Stockholm AB
The Nasdaq NASDAQ Stock Market, Inc. LLC - Nasdaq NASDAQ National Global Market
The NASDAQ Stock Market LLC - NASDAQ Global Select Market
~~New York Cotton Exchange~~
~~New York Futures Exchange, Inc.~~
New York Mercantile Exchange, Inc.
New York Stock Exchange, ~~Inc.~~ LLC
~~New Zealand Futures and Options Exchange Limited~~
~~New Zealand Stock Exchange~~



NYSE Arca, Inc.
NYSE MKT LLC
NZX Limited
Osaka Dojima Commodity Exchange
~~Osaka Securities Exchange Co., Ltd, Inc.~~
Oslo Bors ASA
~~Pacific Exchange, Inc.~~
~~Philadelphia Stock Exchange, Inc.~~
Sociedad Rectora de la Bolsa de Valores de Madrid, S.A. (Sociedad Unipersonal)
Societe de la Bourse de Luxembourg S.A.
The Stock Exchange of Hong Kong Limited
~~Stockholmsborsen AB~~
SWX SIX Swiss Exchange Ltd
~~Sydney Futures Exchange Limited~~
Tokyo Commodity Exchange, Inc.
~~Tokyo Grain Exchange~~
Tokyo ~~International~~ Financial ~~Futures~~ Exchange Inc.
Tokyo Stock Exchange, Inc.
~~Toronto Stock Exchange, TSX~~ Inc.
Wiener Borse AG
~~Winnipeg Commodities Exchange, Inc.~~

Part 2

BM&FBOVESPA S.A. – Bolsa de Valores, Mercadorias e Futuros
BSE Limited
Bursa Malaysia Derivatives Berhad
Bursa Malaysia Securities Berhad
China Financial Futures Exchange
Dalian Commodity Exchange
~~Kuala Lumpur Stock Exchange~~
~~Malaysian Derivatives Exchange Berhad~~
National Stock Exchange of India Limited
The Philippine Stock Exchange, Inc.
Shanghai Futures Exchange
Shanghai International Energy Exchange



[Shanghai Stock Exchange](#)

[Shenzhen Stock Exchange](#)

Singapore Exchange Derivatives Trading Limited

Singapore Exchange Securities Trading Limited

[The Stock Exchange of Thailand](#)

[Taiwan Futures Exchange Corporation](#)

[Taiwan Stock Exchange Corporation](#)

[Thailand Futures Exchange Public Company Limited](#)

[Zhengzhou Commodity Exchange](#)

Schedule 4

Financial commitments

[sections 49 & 50]

Table 1
Interest rate swap agreements

Item	Remaining term to maturity	Percentage %
1.	Less than 3 months	0
2.	3 months or more but less than 1 year	0.05
3.	1 year or more but less than 2 years	0.1
4.	Each year in addition to the period referred to in item 3	0.1

Table 2
Foreign exchange agreements



Item	Description	Percentage
1.	The counterparty of the foreign exchange agreement is an authorized financial institution or an approved bank incorporated outside Hong Kong and the remaining term to maturity is—	
(a)	less than 3 business days	0%
(b)	3 business days or more but less than 1 year	0.2%
(c)	1 year or more	0.5% where the remaining term to maturity of the agreement is less than 2 years, plus 0.3% for each additional full year after 1 year, subject to a maximum of 5%
2.	The counterparty of the foreign exchange agreement is a person other than a person referred to in item 1 and the remaining term to maturity is—	
(a)	less than 3 business days	0%
(b)	3 business days or more	5%

Schedule 5

Note issuance and revolving underwriting facilities

[section 52]

Item	Remaining term to maturity	Percentage %
1.	Less than 1 year	1
2.	1 year or more but less than 5 years	2.5
3.	5 years or more	5



Appendix 2: List of respondents (in relation to the consultation paper issued in July 2015) (excluding four respondents who requested that their names not be published)

(in alphabetical order)

1. Alternative Investment Management Association
2. BNP Paribas Securities Services
3. CompliancePlus Consulting Limited
4. Credit Suisse (Hong Kong) Limited
5. Ernst & Young
6. Haitong International Securities Company Limited
7. Hong Kong Investment Funds Association
8. Hong Kong Securities Association
9. International Swaps and Derivatives Association, Inc.
10. ITG Hong Kong Limited
11. The Hongkong and Shanghai Banking Corporation Limited
12. The Northern Trust Company of Hong Kong Limited
13. Yu, Chan & Yeung Solicitors



Appendix 3: List of respondents (in relation to the consultation paper issued in May 2011)

(in alphabetical order)

1. Clifford Chance
2. ComplianceAsia
3. CompliancePlus Consulting Limited
4. Hong Kong Securities Association
5. The Law Society of Hong Kong



Appendix 4: Personal information collection statement

Personal information collection statement

1. This Personal Information Collection Statement (“**PICS**”) is made in accordance with the guidelines issued by the Privacy Commissioner for Personal Data. The PICS sets out the purposes for which your Personal Data⁵⁵ will be used following collection, what you are agreeing to with respect to the SFC’s use of your Personal Data and your rights under the Personal Data (Privacy) Ordinance (Cap. 486) (“**PDPO**”).

Purpose of collection

2. The Personal Data provided in your submission to the SFC in response to this paper may be used by the SFC for one or more of the following purposes:
 - (a) to administer the relevant provisions⁵⁶ and codes and guidelines published pursuant to the powers vested in the SFC;
 - (b) in performing the SFC’s statutory functions under the relevant provisions;
 - (c) for research and statistical purposes; or
 - (d) for other purposes permitted by law.

Transfer of personal data

3. Personal Data may be disclosed by the SFC to members of the public in Hong Kong and elsewhere as part of the public consultation on this paper. The names of persons who submit comments on this paper, together with the whole or any part of their submissions, may be disclosed to members of the public. This will be done by publishing this information on the SFC’s website and in documents to be published by the SFC during the consultation period or at its conclusion.

Access to data

4. You have the right to request access to and correction of your Personal Data in accordance with the provisions of the PDPO. Your right of access includes the right to obtain a copy of your Personal Data provided in your submission on this paper. The SFC has the right to charge a reasonable fee for processing any data access request.

Retention

5. Personal Data provided to the SFC in response to this paper will be retained for such period as may be necessary for the proper discharge of the SFC’s functions.

Enquiries

⁵⁵ Personal Data means personal data as defined in the Personal Data (Privacy) Ordinance (Cap. 486).

⁵⁶ The term “relevant provisions” is defined in section 1 of Part 1 of Schedule 1 to the Securities and Futures Ordinance (Cap. 571) and refers to the provisions of that Ordinance together with certain provisions in the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32), the Companies Ordinance (Cap. 622) and the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance (Cap. 615).



6. Any enquiries regarding the Personal Data provided in your submission on this paper, or requests for access to Personal Data or correction of Personal Data, should be addressed in writing to:

The Data Privacy Officer
Securities and Futures Commission
35/F Cheung Kong Center
2 Queen's Road Central
Hong Kong

7. A copy of the Privacy Policy Statement adopted by the SFC is available upon request.