

11 October 2018

BY ONLINE SUBMISSION

Securities and Futures Commission,
35/F, Cheung Kong Center,
2 Queen's Road Central,
Hong Kong

Dear Sirs,

Re: Responses to the Consultation Paper on the Proposed Guidelines for Securities Margin Financing Activities published in August 2018

We, _____ would like to extend our sincere thanks to SFC's efforts in publishing this Consultation Paper, with an aim to provide clear guidelines to brokers engaging in Securities Margin Financing ("SMF") and ensuring sound market operations and development.

In response to Consultation Paper on the Proposed Guidelines for Securities Margin Financing Activities (the "Guidelines") published in August 2018, we set out the below our comments in on specific questions raised in the Consultation Paper as well as raised several particular concerns on the Guidelines.

Q1. Do you agree that an SMF broker should control its total margin loans with reference to the amount of its capital?

We agree an SMF broker should control the total margin loans with reference to the amount of its capital. There is a leverage effect between the capital and margin loans provided to clients. Capital is the base to absorb any shocks when there is significant decrease in the value of the margin loans. The higher the broker's leverage, the riskier the broker's liquidity would be when there is market recession.

Q2. Do you agree that the proposed guidelines should provide a benchmark for the total margin loans-to-capital multiple?

We agree to set a benchmark for the total margin loans-to-capital multiple. With a consistent benchmark applied among the industry, this benchmark can help maintaining fair market competition and financial integrity despite that the capital size and structure of each SMF broker varies.

Q3. During the soft consultations, some respondents recommended setting the benchmark for total margin loans-to-capital multiple at two to five times. Within the suggested range of two to five times, what do you think is the appropriate quantitative benchmark for total margin loans-to-capital multiple? Please provide the rationale for your comment or suggestion.

We suggest the total margin loans-to-capital multiple should be no greater than three times. We came to this suggestion after considering and assessing the following factors:

- The multiple should strike a balance between the risk exposure and business operation;
- The multiple, reflecting how much the margin loan value could deteriorate before the capital being hurt, should properly reflect the market volatility during market recessions.

In light of the above, two or five times would be either too conservative or aggressive. We took the assumption that the market (for example, Hang Seng Index ("HSI")) drops 30% in a single trading day, which is a rare case. By adopting 3 times total margin loans-to-capital multiple, the SMF brokers could still provide adequate protection to clients with sufficient confidence level on its loan book under rare market recession scenarios.

Q4. Do you agree that a higher benchmark for total margin loans-to-capital multiple should apply to a broker that does not use approved subordinated loans as regulatory capital than to a broker that does?

We agree that the subordinated loans should be included, which provides consistency with the FRR calculation. We also agree that the different confidence level provided by subordinated loan

and shareholder's fund should be recognized in managing the loan book risk and setting the total margin loans-to-capital multiple.

However, it is unpractical and cannot be properly justified for providing two benchmarks for different calculation methodologies, one for using approved subordinated loan as regulatory capital and another otherwise. It is also confusing whether a broker with subordinated loans are allowed to make a choice on which the calculation methodology to follow, and whether it is expected to stick to the methodology adopted or could switch to another methodology when the latter provides a larger margin loans-to-capital multiple.

Instead of providing a higher benchmark for total margin loans-to-capital multiple for a broker that does not use approved subordinated loans as regulatory capital, we suggest to draw a proper line on the amount/percentage that the subordinated loans can be included in calculating the regulatory capital, to avoid some brokers excessively relying on or overusing the subordinated loans to inflate its capital level. In this aspect, we suggest that the percentage should be no larger than 50%, that is, the amount of the subordinated loan being included as regulatory capital cannot be larger than shareholder funds in the total regulatory capital pool.

Q5. While "group of related margin clients" is defined in section 42(3) of the FRR, do you agree that the coverage of related margin clients should be extended, e.g. to include margin accounts which are held by the same beneficial owner for the purposes of monitoring aggregate credit risk exposures?

We agree that it's reasonable to include margin accounts held by the same beneficial owner in the coverage of "group of related margin clients", which is defined in section 42(3) of the FRR. Brokers with good operation practices already have procedures in place for identifying the ultimate beneficial owner for margin clients, and reviewing such accounts as a whole.

Q6. Do you agree that exposures to different securities held as collateral which are highly correlated should be aggregated for the purposes of monitoring concentration risk?

Agree.

Q7. Do you agree with the definition of "highly correlated securities" set out in paragraph 38 above?

Acceptable.

Q8. Do you consider that constituent stocks of any other stock indices should also be treated as index stocks for the purposes of paragraph 43 above? Please provide the rationale for your suggestion.

Under paragraph 43, the constituent stocks is proposed to include the constituents of the Hang Seng Index ("HSI") and Hang Seng China Enterprises Index ("HSCEI"). As at 2 October 2018, HSI and HSCEI each has 50 constituent stocks.

We are of the view that this scope (i.e. HSI plus HSCEI) is too narrow for assessing higher-quality securities. As at 2 October 2018, there are 2268 stocks listed on Hong Kong Stock Exchange while the total number of higher-quality securities is less than 100 (as some stocks are both HSI and HSCEI constituents), which means the percentage of higher-quality securities on the market is less than 4.5%. Such a small fraction for higher-quality securities failed to provide a meaningful benchmark to the industry. A large portion of SMF brokers may not even have any higher-quality securities as collaterals for their margin loan. More importantly, the idea for higher-quality securities are securities which bears lower event risk. From this concept, a larger pool of securities should be qualified as higher-quality securities.

In light of the above analysis, we strongly recommend SFC to include **Hang Seng Composite LargeCap & MidCap Index ("HSLMI")** as index stocks for the purpose of paragraph 43. HSLMI has 299 constituent stocks as at 2 October 2018 and the percentage of higher-quality securities on the market would be around 15%, which provide a more meaningful benchmark to the industry and better reflects the associated risk profile (i.e. low event risk) of higher-quality securities. In addition, it is noted that this approach is also consistent with current calculation methodology for FRR, which provides better consistency and transparency in the industry.

Q9. During the soft consultations, some respondents suggested setting X% at between 30% and 50%, and Y% at between 20% and 25%. Within these suggested ranges, what percentages do you consider as appropriate benchmarks? Please provide the rationale for your suggestion.

We suggest to set X% between 40% to 50% as the higher-quality securities bear lower event risk and lower market volatility, and set Y% between 30% to 40% (a stand-alone figure in this range is reasonable from our view).

However, we would like to further reiterate our serious concerns on the scope of higher-quality securities under paragraph 43, and strongly recommend SFC to include HSLMI as index stocks, apart from HSI plus HSCEI.

Q10. Do you think that as a quantitative benchmark, margin client concentration should be measured with reference to the broker's shareholders' funds? If not, what is your alternative suggestion? Please provide the rationale for your suggestion.

Agree.

Q11. During the soft consultations, some respondents recommended setting the quantitative benchmark for margin client concentration at between 20% and 40% of a broker's shareholders' funds. Within this suggested range, what percentage do you think is appropriate for benchmarking purpose? Please provide the rationale for your suggestion.

20% is an appropriate benchmark. SMF brokers should exercise extra caution in handling margin client concentration. If a SMF broker overly concentrates on a particular margin client, any event risk realized on this client will significantly affect the broker's capital position. Such concentration lowers the efficiency of risk diversification, puts the broker at a larger risk of violating FRR rules, and in worst case, hurts client's interest.

Any percentage over 20% is excessive, and poses risk over which the broker could barely effectively manage. SFC should be very careful and exercise extra caution if the benchmark is set over 20%.

Q12. Do you have any comment on the basis for determining whether a margin loan is a significant margin loan?

We propose to classify any margin loan that is greater than 10% of broker's shareholder's fund as significant.

Q13. What should be the appropriate percentage with reference to the broker's shareholders' funds for determining whether a margin loan is significant? Please provide the rationale for your suggestion.

We propose 10% being the proper benchmark for determining whether a margin loan is significant.

Q14. During the soft consultations, some respondents commented that X% in paragraph 64(b) above should be set at 15% to 20%. What percentage point within this range do you think is appropriate? Please provide the rationale for your suggestion.

Any X% between 15% and 20% in our view is acceptable.

Q15. Do you agree that total unsettled margin calls should not exceed the shareholders' funds of an SMF broker? Please provide the reason for your comment.

Agree.

Q16. During the soft consultations, some respondents indicated that a margin call which has remained outstanding for more than 30 days to 90 days should be treated as a long-outstanding margin call. Within this suggested range, at which point do you think a margin call should be treated as a long-outstanding margin call?

It is acceptable to us to treat any margin call outstanding for more than 30 days as long-outstanding margin call.

However, we suggest a buffer period should be given to clients to settle the calls with proper internal control and monitoring measures in place. Under some circumstances, one or more stocks' value could drop in a short period of time which triggers a margin call, while some clients based overseas may need time to transfer money to Hong Kong for settling the calls even if they have committed to cover the margin shortfall. Having said that, SMF brokers should have proper policies and procedures on timely following up any long-outstanding margin calls, and performing force liquidation immediately when long-outstanding margin call is unreasonable. Senior management of SMF brokers should be given the flexibility to exercise judgement in determining whether force liquidation should be conducted or extra grace period can be granted.

Q17. During the soft consultations, some respondents recommended limiting total long-outstanding margin calls to between 20% and 25% of an SMF broker's shareholders' funds. Within this suggested range, what percentage do you think is appropriate? Please provide the rationale for your suggestion.

The total long-outstanding margin calls limit at 20% is reasonable considering the going concerns risk for SMF brokers. Given the margin calls are already long-outstanding (i.e. remained outstanding for at least 30 days), the probability that the margin deficit will realize is considered relatively high, and SMF brokers should take a conservative benchmark for safeguarding its financial integrity for the interest of its clients and ensuring its going concerns.

Q18. During the soft consultations, some respondents suggested applying a 15% to 30% hypothetical price drop where the collateral pool mainly comprised index stocks, whereas for a collateral pool comprised few index stocks, the hypothetical price drop should be between 30% and 50%. Do you have any suggestions on the hypothetical price drop percentage to be applied in each of the scenarios (i.e. X%, Y% and Z%) suggested in paragraph 85 above? Please provide the reason for your suggestion.

The stress test scenarios do not seem realistic even in the historical financial crisis. 50% hypothetical price drop of HSI is highly unlikely and not reasonable from the past experience. 30% price drop should be sufficiently conservative to reflect stress scenarios. A 15% hypothetical price drop where the collateral pool mainly comprised index stocks and a 30% hypothetical price drop whereas for a collateral pool comprised few index stocks should be sufficiently conservative and reasonable for conducting stress test scenarios.

Having said the above, we would like to reiterate that Hang Seng Composite LargeCap & MidCap Index ("HSLMI") should be included as index stocks, which makes the stress test scenarios more realistic, reasonable and meaningful.

Q19. As regards the weighting of index stocks in the collateral pool in each of the hypothetical scenarios suggested in paragraph 85 above (i.e. 75% and 25%), do you agree with the suggested thresholds as the dividing line for distinguishing a high-quality collateral pool from a low-quality collateral pool? Please provide the reason for your suggestion.

We agree to distinguish a high-quality collateral pool from a low-quality pool. However, to classify a collateral pool as high-quality only when 75% or more of the pool in term of the market value are index stocks is unpractically unrealistic and logically unreasonable, as FRR rules has already reflected this distinction. We suggest to set the threshold for distinguishing a high-quality collateral pool from a low-quality collateral pool as 50% and 25% respectively for the hypothetical scenarios suggested in paragraph 85, which is more appropriate and reflects both industry operations and existing FRR rules.

Q20. Do you consider that constituent stocks of any other stock indices should be treated as index stocks for the purposes of paragraph 85 above? Please provide the reason for your suggestion.

We suggest the constituent stock of Hang Seng Composite LargeCap & MidCap Index ("HSLMI") should be included as index stocks.

Q21. Do you agree that 10% is an appropriate threshold for the definition of "significant group of highly correlated securities"? Please provide the reason for your suggestion.

10% threshold seems relatively low. 15% to 20% is more reasonable.

A more key issue here is how to quantify the price correlation among a group of securities. Defining price correlation in the industry faces challenges on its underlying rationale as stock prices may be statistically correlated, but the companies are completely independent (for example, in completely different industry and not associated with each other in any way).

Unless SFC can provide a proper and well justified methodology/model for the industry to follow, so that the SMF broker could consistently apply regulator's approach in quantifying price correlation, such threshold would not have practical meaning and it would cause great confusion, variety and inconsistency among the industry.

In addition, we suggest consideration should be given to the liquidity and quality of the securities when defining the percentage. Highly liquid and good-quality securities should be subject to a higher threshold while low-quality securities should be subject to a lower threshold. It is also not meaningful or reasonable to include blue-chip stocks in the assessment of price correlation, as such stock are usually highly price correlated due to market herding behaviors of investors while given their good-quality and sufficient liquidity, the blue chip stocks do not pose any significant risks to a SMF broker.

Q22. Do you agree that 10% is an appropriate threshold for the definition of "significant re-pledged securities collateral" and "significant group of highly correlated re-pledged securities collateral"? Please provide the reason for your suggestion.

Applying the 10% threshold across the board for "significant re-pledged securities collateral" and "significant group of highly correlated re-pledged securities collateral" without considering the quality of the collateral is not reasonable. Consideration should be given to the quality of re-pledged collateral. For any high-quality securities, the 10% threshold is too high and does not match with the low risk associated with such re-pledging.

In addition, the concept of "significant group of highly correlated re-pledged securities collateral" faces the same challenges as we discussed under Q21. Unless an objective assessment criterion on "highly correlated" could be provided by the SFC, the benchmark would not have practical meaning and would cause great confusion, variety and inconsistency among the industry.

Q23. Do you think that a six-month transition period is appropriate? Please provide the reason for your suggestion.

Six-month transition period is not sufficient. We suggest that at least one-year transition period would be reasonable and practical based on the following reasons. Sufficient transition time is very crucial of avoiding unnecessary market volatility and protecting investors' interest.

- One-year transition period can allow SMF brokers gradually adopt the requirements under the Guidelines and minimize the market disturbance. Without sufficient transitional time, SMF brokers would be rush to force liquidate and thus create high selling pressure on a large amount of mid-cap and small-cap stocks in a short period, which is quite likely to cause market crash.

- In addition to the potential significant drop in stock valuations due to the massive release of the stocks, the increased market volatility would lead to further sell down of high quality stocks, especially from those program-trading funds, which would add further pressure to the already fragile market.

Timing of implementation is also important for ensuring market stability, as:-

- A lot of firms would face liquidity tightening issue due to bank capital control policy and their own capital control policies at the year end. The decreased capital flow and liquidity will limit the firms' ability to answer the margin calls in financial year end period and cause higher market volatility.
- The weak market sentiment, casted with worries of slowing economic growth amid the ongoing US-China trade war, makes the market fragile and under great pressure of capital outflow. SFC should be particularly careful for any new guidelines to be launched under such weak market sentiment as reducing systemic risks in the industry and assisting the Government in maintaining Hong Kong's financial stability are SFC's regulatory objectives to achieve.

Apart from the above, we suggest that existing margin ratios for existing clients can be maintained for a period of time and the new margin ratios on new clients could be implemented by different phases.

Further Questions to SFC regarding the Consultation Paper on the Proposed Guidelines for SMF Activities (the "Guidelines")

In addition to the above, we would like to further raise several concerns on the implementation of the Guidelines, which are crucial for the market to have clear understanding on the proposed requirements as well as upcoming operational details.

1. We noted that SFC launched a consultation on proposed changes to the Securities and Futures (Financial Resources) Rules ("FRR") in July 2017, in which SFC made various proposals on haircut arrangement for FRR calculation. With reference to point 5.7 on page 29, we strongly recommend SFC to make it clear to the market on the relevant haircut requirement in this consultation paper to be followed, that is, whether the haircut requirements refers to the relevant requirements of the current FRR rules or the new proposals made in the FRR consultation paper.

2. Further guidance on the "notification requirement" is required, including but not limited to the detailed timeline for submitting relevant notifications, the format (by email or signed letter) for submitting the notification and the principles to be followed if a particular reporting incident is covered both by the Guidelines and the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures.

We, once again, appreciates SFC's efforts in
clarifying, codifying and standardizing the risk management practices for SMF brokers and
continuous efforts in fostering fair competition, maintaining market integrity and protecting
investor's interest.

Yours faithfully,