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The HK Association of Online Brokers
香 港 網 上 經 紀 協 會

18th October 2018

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

Dear Sir,

Response to the Consultation on the Proposed Guidelines for Securities Margin Financing Activities

We are totally in support of having a new set of Guidelines for Securities Margin Financing Activities. However, the approach to be taken should be pragmatic and conducive to the growth of Securities Margin Financing business which is integral of our normal securities brokerage business.

We have the following comments on the questions from the Consultation Paper.

[A. Total Margin Loan Control]

1. Do you agree that an SMF broker should control its total margin loans with reference to the amount of its capital?
2. Do you agree that the proposed guidelines should provide a benchmark for the total margin loans-to-capital multiple?
3. During the soft consultations, some respondents recommended setting the benchmark for total margin loans-to-capital multiple at two to five times. Within the suggested range of two to five times, what do you think is the appropriate quantitative benchmark for total margin loans-to-capital multiple? Please provide the rationale for your comment or suggestion.
4. Do you agree that a higher benchmark for total margin loans-to-capital multiple should apply to a broker that does not use approved subordinated loans as regulatory capital than to a broker that does?

General view:

The securities margin financing ("SMF") business shall be carried out primarily based on the quality of collateral and client's financial capability. We're of the view to oppose to the idea to set the quantitative parameters based on loans-to-capital benchmark, given the SMF business is supported by sound securities collateral and the funding is also backed by broker's banks via re-pledging of collaterals at a certain margin ratio set after the

comprehensive risk-based assessment by the banks. The SMF activities of stocks listed via Initial Public Offer should also be considered to exclude from calculation of the total margin loan control for a certain period of time, given the liquidity in terms of stock turnover. In a nutshell, the existing control measures namely, the Financial Resource Rules ("FRR") is an effective indicator for the SFC to assess the capabilities of brokers in SMF business. SMF brokers are required to submit reports to the SFC periodically for strict monitoring of SMF activities. In order for more prudent practices of SMF brokers, we suggest to tighten the FRR requirements such as a more stringent and straight-forward haircut percentage instead of introducing new haircut requirements which may add administrative workload and/or cause unnecessary confusion in implementation of risk control measures.

[B. Margin client credit limit controls]

5. 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, eg, to include margin accounts which are held by the same beneficial owner for the purposes of monitoring aggregate credit risk exposures?

General view:

We generally agree with the view that the coverage of related margin clients should be implemented, despite the fact that the SMF brokers may encounter difficulties to identify and monitor aggregate credit risk exposures which is held by the same group of beneficial owners.

[C. Securities collateral concentration controls]

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

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

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

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

General view:

We agree that the exposure of securities which are highly-correlated should be aggregated for overall risk monitoring. Nevertheless, we'd like to raise the doubts if the definition of highly-correlated securities is well-established, based on the limitations of requirements in disclosure and filings, e.g. in penny stock crash incidents in Jun 2017, limited information is found in relation to cross-holdings or connections of relatively small-cap listed companies. In essence, it may cause practical difficulties in identifying and monitoring the ultimate beneficial ownership of the stocks, which are deemed as highly-correlated.

As spoken, SMF activities shall be carried out on risk-based assessments of several factors, including but not limited to quality of collateral and client's financial capabilities. Liquidity and financial performance of the stock shall also be counted as evaluation metrics of granting margin loans as well. We'd like to propose certain well-known indices and trackers to be considered by SMF brokers, such as Morgan Stanley Capital International ("MSCI") HK & China or Hang Seng Composite Index ("HSCI") constituents, and/or stocks admitted in Stock Connect. The quality of those securities is relatively high and the risk is comparatively low based on the financial strength of the companies, as well as liquidity in terms of average daily / monthly turnover. According to the suggested ranges of the proposed quantitative benchmarks for implementation, we suggest that X% should be set at 50% and Y% at 25%. Moreover, FRR already covers securities concentration risk by setting haircut ratio in case of illiquid stocks and both of the suggested percentages are still below the haircut ratio.

[D: Margin client concentration controls]

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

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

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

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

General view:

As spoken, FRR is an effective indicator and measure for the SFC to assess the capabilities of brokers in SMF business. We're of the view that the margin client concentration shall be measured with reference to the total margin loan book of the SMF broker. Margin leading policy and procedures to identify and monitor the major client's exposures with reference to the total margin loan should be established to ensure adequacy of the brokers' funding to carry out SMF activities. Significant margin loan concentration can be set at a range around 15-20% of the margin loan book (per client basis) that SMF brokers shall adopt strict monitoring and assessment based several factors, such as quality of collateral and client's financial capability in repayment. Proper actions shall be regularly taken by SMF brokers to mitigate credit risk exposures.

[E: Haircuts for securities collateral]

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

General view:

The existing FRR haircut requirement already sets a comprehensive guideline on the haircut percentage. There may be confusion and administrative difficulties on implementation of both existing FRR haircut requirement and proposed quantitative benchmark. In order to strike a balance between prudent risk management and business competitiveness, the haircut ratio or a list of acceptable securities for margin financing shall be decided and maintained by SMF brokers.

[F: Margin calls, stopping further advances, forced liquidation]

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

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

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

General view:

All SMF brokers should established customized policies, procedures and risk-based assessment approaches to carry out SMF activities complying with the regulatory requirement. The account conduct of a margin client shall be assessed on multiple factors, not only and primarily based on the number of "long-outstanding" margin calls as mentioned in the Consultation Paper. For example, client trading record and financial capability shall also be considered in case that certain extent of waivers on force sale and/or further purchase should be granted.

[G: Stress testing]

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

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

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

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

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

General view:

We agree that stress tests shall be regularly conducted by all SMF brokers in order to maintain effective risk management, e.g. significant intra-day fluctuation or plunge of market indices, abrupt changes of economic conditions , major events that trigger high volatility in a particular sector of stocks.

In general, HSI and HSCEI stocks should be considered in assessment of hypothetical scenario. SMF brokers, based on their pool of collateral, shall also consider liquidity of

stocks included in certain well-known indices and trackers, such as Morgan Stanley Capital International ("MSCI") HK & China or Hang Seng Composite Index ("HSCI") constituents, and/or stocks admitted in Stock Connect.
The significant group of highly correlated re-pledged securities collateral is not yet defined on a comprehensive basis, so that it might be difficult to follow the hypothetical stress scenario in risk assessment.

[H: Implementation timeline]
23. Do you think that a six-month transition period is appropriate? Please provide the reason for your suggestion.

General view:
We recommended that a twelve-month transition period should be provided to enable sufficient time and resources for system enhancement to ensure comprehensive monitoring in case any major changes of monitoring SMF activities are going to be implemented.
Overall speaking, the additional rigid parameters as proposed in the Consultation Paper would reduce the brokers' competitiveness and increase administration costs. SMF brokers shall maintain comprehensive risk management policies which suit their particular business. We recommend the SFC to (1) revisit and revise the requirements of the existing FRR and (2) give a framework with regular visit and enquiry to brokers, rather than setting of simple quantitative benchmarks in relation to SMF activities.