CompliancePlus Consulting

Submission to the SFC Consultation Paper on the Proposed Guidelines for Securities Margin Financing Activities

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October 2018

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CompliancePlus Consulting Limited understands and agrees that our name and/ or submission may be published to the public.

Introduction

This submission responds to the questions raised by the Consultation Paper ("the Consultation Paper") issued by the Securities and Futures Commission on the Proposed Guidelines for Securities Margin Financing Activities in August 2018.

Unless stated the otherwise, terms used in this submission are same as those terms as defined in the Consultation Paper.

Consultation Questions

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

   We agree that an SMF broker should control its total margin loans with reference to the amount of its capital. Amounts of a firm's capital can serve as a useful and easy proxy for evaluating the SMF broker's ability to loan and meet any material adverse events, such as a sharp drop in the price of the securities held as collateral.

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

   While we agree that the proposed guidelines should provide benchmarks for SMF brokers to follow, we have reservations to the calculation of the total margin loans-to-capital multiple. The numerator, i.e. the total margin loan, does not take into account the quality of the loans, which may be affected by, among other relevant factors, the quality of the securities held as collateral. This provides no incentive for SMF brokers to take higher-quality securities as collaterals.

   It is recommended that the SFC should use and provide a benchmark for a risk-adjusted total margin loans-to-capital multiple and apply appropriate haircuts to higher-quality margin loans in calculating the numerator. The haircuts may be based on the quality of the collaterals (e.g. higher haircut percentages for margin loans secured by constituent stocks of recognized stock indices as collateral).

This would allow SMF brokers, with the same amount of capital, to take more higher-quality margin loans and better align with the SFC's objective in informing SMF brokers of the general regulatory expectations.

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.*

   As suggested in our reply to Question 2, we advise the SFC to consider adjusting the total margin loans of the multiple with respect to the risks involved. Nevertheless, if the total margin loans-to-capital multiple is to be used and a benchmark should be set, we believe that the appropriate quantitative benchmark should be 4 times, as this is the same standard with the regulatory requirements on the Mainland as issued by the China Securities Regulatory Commission.

   At the starting point, we suggest the SFC to adopt a more lenient approach to observe the market impact of setting such benchmark. The more stringent requirement as issued by the Singaporean regulations (3 times of the SMF business' regulatory capital) is therefore not adopted and recommended.

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?*

   We do not 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.

   Approved subordinated loans are usually repaid in two years while margin loans are usually more of a short-term arrangement. Compared to the quality of the total margin loan, the quality of the capital will be less influential and impactful to the financial wellbeing of the SMF broker.

Furthermore, while bad-quality margin loans can be very vulnerable to material adverse events and could therefore drastically affect the SMF broker's financial liquidity, whether or not the broker's regulatory capital comprises of subordinated loans would not usually have the same potential unforeseen impact.

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

   While we agree that the coverage of related margin clients should be extended to including margin accounts which are held by the same beneficial owner for the purposes of monitoring aggregate credit risk exposures, we are concerned about the effectiveness of this policy if the identity of the beneficial owner is not properly reported or disclosed to the SFC.

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?*

   We agree that exposures to different securities held as collateral which are highly correlated should be aggregated for the purposes of monitoring concentration risk. We hope the SFC to provide for the industry more guidance and examples of "highly correlated" to facilitate their compliance with this requirement, if implemented.

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

   There are two compositions in the definition of "highly correlated securities", while we agree with part (a) of the definition (securities issued by the same issuer or by different companies within the same group), we believe that part (b) of the definition would be very burdensome for SMF brokers in practice and may defeat its very purpose of limiting risks.

Part (b) of the definition states that securities exhibiting high correlation in historic price movements and their issuers either have group affiliations, material cross-shareholdings, significant business affiliations or are engaged in the same industry.

Firstly, it would be quite impractical for SMF brokers to study the historical price movements of securities to deduce the correlations of the securities. The proposed Guideline has not provided the extent of expected duration of price data to be taken into consideration.

Secondly, the term “significant business affiliations” could cover a broad range of business relationships which may not be easily confirmed through open resources, such as public announcements and database provided by the HKEX.

Thirdly, while high correlation in historical price movement and issuers engaged in the same industry may result in the relevant securities being highly correlated, it may not be suitable to take into account these factors in the current context.

The purpose of defining “highly correlated securities” is to require SMF brokers to set prudent concentration limits to avoid building up excessive exposure to relevant risks.

However, the Hang Seng Index (which comprises of stocks that this Consultation Paper considers as high-quality securities to be collected as collateral) only comprises of 4 industry sectors (namely Finance, Utilities, Properties, and Commerce and Industry) and the Index’s constituent stocks generally has high correlation with regional and global market movements and therefore significant correlation in historical price with one and other.

The proposed definition of “highly correlated securities” would unintentionally punish prudent SMF brokers that collect mainly Hang Seng Index constituent stocks as collaterals and force them to take more volatile non-index stocks as collaterals. This would be in conflict with the objective of the Guideline.

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.*

   We do not agree that constituent stocks of any other stock indices should also be treated as index stocks for the purposes of paragraph 43. The Hang Seng Index and Hang Seng China Enterprises Index are widely recognized for the constituents' quality and price stability. It is arguably difficult to suggest other indices that are equally recognized in the market.

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.*

   It is understood that a tight benchmark will lower the risk in doing the business and more would be able to provide more protection to clients. However, it is believed that it might be too harsh for small firms to follow.

   Upon balancing the acceptances from the industry and risks, we suggest 40% as the benchmark for X, i.e. for securities held as collateral which are constituents of the Hang Seng Index or Hang Seng China Enterprises Index (index stocks). The impact on the broker's ELC under the hypothetical stress scenario mentioned in the previous paragraph shall not be greater than 40% of the ELC.

   Nonetheless, in regards to the benchmark for other securities held as collateral, we suggest to use a strict benchmark, i.e. 20%, to mitigate possible risks that may have arisen from the not well-known or not well-understood securities.

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.*

    We agree that as a quantitative benchmark, margin client concentration should be measured with reference to the broker's shareholders' funds.

The broker's shareholder's funds would provide a relevant proxy to the firm's ability to loan and meet any material adverse events, therefore useful in evaluating the margin client concentration risk.

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.*

    Considering that a similar requirement is provided in the Banking Ordinance which restricts an authorised institution's exposure to a single counterparty to 25% of its capital, we suggest that the quantitative benchmark for margin client concentration should also be 25% of a broker's shareholder's funds.

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

    We agree that using total margin loans as reference to define the significance will be too strict for small brokers or brokers which are in the early stage of developing this business. We also agree that ELC is an appropriate reference in determining the significance.

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.*

    We agree with the SFC that 10% is an appropriate percentage with reference to the broker's shareholders' funds for determining whether a margin loan is significant. It is reasonable that an SMF broker should assess the impact on its ELC prior to granting a margin loan that would hold up and/or affect 10% of its shareholder's funds.

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.*

    We suggest that the haircut percentage set by a re-pledging broker for collateral deposited by margin clients should not be lower than the average of the haircut percentages assigned by its top three lending banks to the same collateral minus 20% and in any event, not lower than the corresponding haircut percentage prescribed in the FRR. Given that the suggested range (15% to 20%) is not very significant, we believe that it is safe and appropriate for the SFC to adopt a more lenient approach at the beginning and further restrict the haircut should it find necessary after observing the reaction and trends of the market.

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.*

    We agree that total unsettled margin calls should not exceed the shareholders' funds of an SMF broker. The shareholders' funds are a reasonable proxy to assess the SMF broker's ability to endure adverse events and to take on new securities margin loans.

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?*

    We suggest that 30 days should be adopted as the benchmark to consider whether a margin call is classified as a long margin call. Unsettled margin calls pose great financial risks to the SMF brokers and should be monitored with high level of scrutiny.

While we suggest the SFC to adopt a more lenient approach in setting the general ratios and multiples, limits that are directly relevant to adverse events should be more strictly set to better protect the interests of the industry.

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.*

We suggest that 20% should be adopted as the benchmark for limiting total long-outstanding margin calls of an SMF broker's shareholders' funds. As mentioned above, long-outstanding margin calls have high chance of default and a more conservative limit should therefore be adopted. It is not too stringent to restrict SMF brokers to allow no more than 20% of their shareholders funds to be placed at high risk of margin loan default.

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 (i.e., X%, Y% and Z%) suggested in paragraph 85 above? Please provide the reason for your suggestion.*

We suggest the hypothetical price drop percentage to be 15%, 30% and 50% for scenario where the collateral pool mainly comprised index stocks, for a collateral pool comprised with 25% to 75% of index stocks and for a collateral pool comprised few index stocks respectively.

We believed that setting 15% for collateral pool which mainly comprised with index stocks would encourage clients to use indexed stocks which are having a more stable stock price than others.

Regarding to the pool of collateral which consist less than 25% of indexed stocks, we suggest to use 50% as benchmark for stress testing as the quality of collateral are unknown and there are higher potential risks. We have chosen 30% for

collateral consist 25% to 75% of indexed stocks because it is roughly the mean of both scenarios.

19. *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 with the weighting of index stocks in the collateral pool in each of the hypothetical scenarios as suggested, i.e. 75% and 25%. It is common in the industry and convenient in statistics to use percentage quartiles as dividing lines. The dividing lines are also reasonably defined considering the proposed Guideline's objective to promote more conservative securities margin financing activities.

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.*

    We do not consider constituent stocks of any other stock indices to treat as index stocks for the purpose mentioned. As mentioned in our reply to Question 8 above, we believe that it will be difficult to include other indices in the market that are equally highly recognized in the market for the quality and stability of its constituents.

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.*

    We agree that 10% is an appropriate threshold for the definition of "significant group of highly correlated securities". However, please also refer to our reply to Question 7 for the definition of "significant group of highly correlated securities".

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.*

    We 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".

    Nevertheless, please refer also to our reply to Question 7 which states our concern to practical difficulties in researching and tracking the high correlation in historical price movements and significant business affiliations of securities under the definition of "highly correlated securities".

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

    Given that the proposed guidelines may significantly affect SMF brokers' financial arrangements and their margin loans with existing clients, we believe that a transition period of at least 12 months is more appropriate.

    We believe that the investors' interests in the short term will not be jeopardized by a longer transition period as the SFC has also proposed to take immediate actions, such as imposing licensing conditions, in urgent cases to prevent the risks from deteriorating.

Conclusion

We appreciate the SFC's effort in formulating the Guidelines for Securities Margin Financing Activities. In light of the destructive competition in the brokerage industry where brokers are forced to charge minimal trade commissions, brokers have turned to securities margin financing activities as a major tool for attracting customers and an important source of income, instead of offering margin loans as an ancillary service.

This has, as evidenced by the SFC's SMF review, resulted in the deterioration of the quality of the margin loans and the financial health of SMF brokers. The implementation of the proposed Guidelines is necessary to clarify, codify and standardize the risk management practices expected of brokers conducting SMF activities.

Generally, we agree with the measures proposed by the SFC. We believe that the proposed Guidelines will effectively change the excessively risky practices of SMF brokers and better communicate the regulatory expectations. However, the SFC must recognize that the proposed Guidelines can be a double-edged sword.

The objective of the Guidelines is to promote reasonable and prudent securities margin financing activities instead of outright discouraging the offering of such service, which is still essential for the development and liquidity of the capital markets. Thresholds proposed in the Guidelines should be specifically targeted at risky margin loans and the SFC should avoid harming the interests of other proper SMF brokers.

Thresholds and limits that do not take into account the quality of collaterals should be better defined. The SFC should also consider the additional resources, skills, time and technology required to fulfill the requirements stated in the proposed Guidelines. For instance, it can be foreseen that SMF brokers will be forced to incur significant costs and may face great difficulties analyzing the correlation among the numerous securities under the proposed definition of "highly correlated securities".

The SFC proposed a 6-month transition period for the industry to ensure compliance after the gazettal of the Guidelines. In practice, SMF brokers may have to increase shareholders' funds, negotiate new terms with major margin clients, review and amend their existing internal controls and policies and provide adequate training to its staff to adhere to the new standards. Given that this is a brand-new set of codified Guidelines to be issued and that existing margin clients may be affected, a transition period of at least 12 months may be more appropriate and reasonable.

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