

Fax no. 2523 4598

Our Ref.: C/EPS, M10606

26 March 2002

Ms. Alexa Lam  
SFC FRR,  
12/F., Edinburgh Tower,  
The Landmark,  
15 Queen's Road,  
Central,  
Hong Kong.

Dear Ms. Lam,

**Proposed Amendments to the Current Financial Resources Rules (FRR)**

Thank you for your letter of 5 March 2002 to the President of the Society seeking our comments on the Consultation Document relating to the above subject.

We agree that rules governing firms conducting securities margin financing need to be tightened up but we feel that the proposal does not fully address the basic problem with the current market practice, permitted by the rules, of pooling and re-pledging securities of margin clients. In practice, many margin clients have no choice but to authorise securities dealers to use their collateral in this way as the permission to do so forms part of the "standard" terms of many margin client agreements. Firms conducting securities margin financing are able to re-pledge securities from clients, regardless of whether the particular clients have borrowed from them, to obtain funding for the firms' own working capital.

While the proposed 90% "illiquid collateral" haircut might force firms conducting securities margin financing to provide more of their own funding to finance those clients who pledge illiquid collateral, it would still not prevent firms from re-pledging high quality stocks from "inactive" margin clients who may borrow very little or not at all. The collateral of the latter types of margin client would still be at risk if the firms were to run into financial difficulties. As such, the proposal does not tackle head-on the particular issue of investor protection to which the existing practice gives rise, and thus it may increase the scope for the intention to be circumvented. One possible option for longer term consideration might be to subject securities houses to capital adequacy ratio requirements similar in principle to those applied to authorised institutions, given the scope and nature of financing activities now being conducted, particularly by the larger securities businesses.

As regards the definition of “illiquid collateral”, we doubt whether the simple average of trading records taken during the previous 6 months will always provide a good current indication of the liquidity of particular securities. There may be cases, for example, where a stock with low liquidity suddenly becomes very liquid following an acquisition or other change in circumstances. The use of a simple average of trading volumes may not be sufficiently flexible to take changes of this type into account.

The second proposed amendment to the FRR is to include within a firm’s ranking liabilities the amount of its total borrowings secured by re-pledging margin clients’ securities that is in excess of 50% of the total amount of loans extended to margin clients. We believe that this would be a potentially onerous requirement, even for the larger firms. If, for example, a margin client makes a large loan repayment, this would mean that the firm concerned would need to repay its bank loan simultaneously. In practice, this will mean increasing capital requirements substantially in order to cater for this type of ad hoc event. We also perceive that there may be practical difficulties in implementing the procedures for continuous monitoring that the proposals would necessitate, especially for those firms with very active margin clients.

On the auditing side, if firms have a proper system in place to record the information relevant to the monitoring process, there should in principle be a sufficient audit trail. However, we are concerned that because of the practical difficulties relating to ongoing monitoring, there may well be an increased risk associated with auditing and reporting on the relevant processes.

We understand that there are plans to review the FRR more comprehensively in the near future. In the light of the above concerns, and the proposal to allow a transitional period of three months for existing firms, we have some doubts about the merits of introducing potentially complex amendments to the FRR as an interim measure to improve the assessment and management of credit and liquidity risks.

Yours sincerely,

PETER TISMAN  
DEPUTY DIRECTOR  
(BUSINESS & PRACTICE)  
HONG KONG SOCIETY OF ACCOUNTANTS

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