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SFC circular warning asset managers on margin financing activities disguised as investments: wider market implications

Background

The Securities and Futures Commission said in a circular issued earlier this month that it believes some licensed corporations carrying out asset management may have assisted "unlicensed affiliates or third parties" to provide securities margin financing in the guise of investments and notes that this arrangement is illegal. Securities margin financing constitutes the Type 8 regulated activity under the Securities and Futures Ordinance, and in addition to the fact that the third parties involved are unlicensed for performing Type 8 activities, such arrangements also provide the parties involved with a way of avoiding compliance with capital, conduct and disclosure requirements associated with securities margin financing.

The latest circular appears to be part of the SFC's on-going supervision of asset managers: two other circulars issued by the SFC in July and September last year (on the deficiencies the SFC had identified in its supervision of asset managers) were specifically mentioned and LCs and their senior management were reminded to read all three circulars together to ensure that they meet legal and regulatory requirements and standards expected of them by the SFC. Nevertheless, the latest circular was addressed to "Licensed Corporations" so it would be prudent for asset managers and LCs carrying on other regulated activities to consider the scope of application of this circular and its effect on their business.

Effect of the SFC circular

The SFC cautioned asset managers against assisting "unlicensed affiliates or third parties" to provide securities margin financing in the guise of investments. Looking at the definition of "securities margin financing", the Type 8 regulated activity involves the provision of financial accommodation in order 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; and

b) (where applicable) the continued holding of those securities,

whether or not those or other securities are pledged as security for the accommodation. This is the statutory definition in the SFO and certain exclusions apply to such definition.

The SFC noted in its circular that "suspected margin financing arrangements" are set up or operated in different forms. However, where the relevant business or activity does not involve the provision of financial accommodation by the LC to facilitate the acquisition of listed securities and (where application) their continue holding, then the activity is not securities margin financing. LCs with equity and/or fixed income derivatives businesses who are concerned about the application of the

SFC circular on some of their activities (e.g. entering into total return swaps over listed equities or fixed income securities, issuing structured notes linked to listed securities, where leverage may be provided in both cases) should make their assessment on this basis.

Where an LC arranges for a special purpose vehicle to issue repackaging securities linked to listed securities, there may sometimes be an acquisition of listed securities by the SPV as collateral for the repackaging securities. Particularly in the case where there is tranching in the structure with senior and junior tranches of securities, care must be taken to ensure that the arranger or dealer is not "aiding and abetting" the provision of securities margin financing by unlicensed affiliates or third parties. Exclusions to the definition of securities margin financing may be available to Type 1 arrangers or dealers where the statutory provisions to the relevant exclusions are satisfied.

Where a fund arrangement is being contemplated by an LC (with no Type 8 licence) as arranger, particular care should be taken to ensure that there is no "securities margin financing" element in the structure or an exclusion can be relied on. The example given in the SFC circular on private funds or discretionary accounts focussed on the requirement to meet "margin calls" (which may take the form of a requirement to provide additional capital) by one class of fund investors if the investments fall below a certain level, and the right of another class of fund investors to receive a guaranteed yield. Asset managers with a Type 9 licence should also note that the SFC has emphasised in its earlier circular (and repeated in the most recent one) that it considers the exercise of discretion over asset management as a crucial element of the Type 9 regulated activity. Where a Type 9 asset manager arranges a fund arrangement with securities margin financing elements and no discretion is being exercised by the manager, it will likely be subject to tighter regulatory scrutiny.

If you have any questions about the SFC's circular, please get in touch with one of the contacts below.

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This publication is intended merely to highlight issues and not to be comprehensive, nor to provide legal advice. Should you have any questions on issues reported here or on other areas of law, please contact one of your regular contacts, or contact the editors.

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