

Bills Committee on Securities and Futures Bill and Banking (Amendment) Bill 2000

**Summary of public comments on Securities and Futures Bill
Part XII – Investor Compensation**

Clause no.	Respondent	Respondent's comments	Administration's response
Part XII – Investor Compensation			
General	HKSA	There is no authority under the Securities and Futures Bill (SF Bill) for the investor compensation fund to receive a stock distribution. But if an investor compensation company (ICC) benefits from a subrogated claim, the distribution may include stocks.	To satisfy the SFC's subrogated rights where the subrogation is to proprietary rights in securities, a liquidator of an insolvent broker would deliver securities to the SFC valued at the time equal to the compensation paid to the claimant. In practice, the SFC would appoint a broker to receive securities on its behalf and to sell those securities, and the proceeds would then be paid into the fund. Alternatively, the liquidator may obtain the SFC's permission as subrogee, or the permission of the court, to sell those securities to satisfy the SFC's subrogated rights. Clause 230(1)(c) authorizes the compensation fund to receive all amounts recovered by the SFC or an ICC under clause 87 or 235, which includes the proceeds from the realization of the aforesaid securities.
General	KGI	The compensation fund should provide protection to the clients of stockbrokers who are Exchange participants as well as clients of SFC licensed securities dealers and advisers.	<p>On 7 March 2001, the SFC released for public consultation till 6 April a paper entitled "Proposed New Investor Compensation Arrangements" (the "Consultation Paper"). In the Consultation Paper, the SFC has proposed to extend the coverage of the new compensation fund to defaults by all persons who are licensed, or where applicable, exempted, for dealing in securities, futures contracts or providing securities margin financing in relation to products traded on the Hong Kong Exchanges and Clearing Limited (HKEx), irrespective of whether they are participants of the two exchanges.</p> <p>Respondents have expressed support of the expanded coverage proposed in the Consultation Paper.</p> <p>It should be noted that defaults by representatives of those covered by the new compensation fund are themselves covered if not made good by the firm employing the representative licensee e.g. the firm itself defaults.</p>

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General	Group of nine investment bankers	<p>The range of persons required to contribute to the compensation fund, and the types of claim that can be made against the fund are not spelt out in the legislation. It appears that overseas stock exchanges which are authorised as providers of automated trading services (ATS) may need to contribute to the fund (and, presumably, claims could be made against the fund if such an exchange went into default).</p> <p>There remains a concern about the risk of cross-subsidization between different sectors of the industry, and the "moral hazard" issue.</p> <p>The funding of the compensation scheme, and the scope of the claims that can be made against the scheme are so fundamental that they should be set out in the legislation. Failing this, it is essential to have extensive public consultation on the rules to be made under the Bill by the Chief Executive in Council, the SFC and/or the ICC.</p>	<p>The funding and coverage of the compensation fund will be prescribed in subsidiary legislation to be made, as appropriate, by the Chief Executive in Council, or the SFC in consultation with the Financial Secretary. We have set out in the response immediately above the proposed expanded coverage. The interpretation is that an investor who deals through a "covered intermediary" in any HKEx traded product should be covered, even if the product is traded through an ATS provider. Thus, additional funding arrangements may be needed in relation to ATS trading that is not done through HKEx facilities to ensure investor protection and also for a level playing field. However, trading in offshore products through an ATS provider is not proposed to be covered at the initial stage of the new arrangements. The existing compensation funds do not cover offshore products.</p> <p>Concerning cross-subsidization, paragraphs 13 and 22 of Paper 11/01 explain that there should generally be no cross subsidy. Overall, whilst the majority of funds for the new scheme will come from the existing stock exchange fund, the majority of historical losses have come from the stock market. If in future losses were to turn out to be much higher in relation to the futures exchange, we would propose ways to address the imbalance, such as by a higher levy on transactions on the futures exchange. We also note that the comments received on the SFC's Consultation support the proposal of a single fund for all HKEx traded products.</p> <p>Concerning moral hazard, we believe a number of factors weigh against moral hazard being a problem under the new scheme. First is the compensation limit of \$150,000. Assets in excess of the limit held with a covered intermediary will not be eligible for compensation. Second, claimants would need to go through certain procedures in making the claims. Third, the SFC and HKMA regulate the covered intermediaries using risk-based methods that either prohibit certain risky practices or impose added capital requirements. Finally, investor compensation arrangements are the norm in developed overseas markets.</p> <p>The prescription of the funding of the compensation arrangements and the scope of claims are through rules (a form of subsidiary legislation) to be made by the Chief Executive in Council, and the SFC in consultation with the Financial Secretary as appropriate. We agree that there should be extensive consultation on the rules to be made. To illustrate this, we have sought public comment on the proposed new compensation arrangements through the consultation between 7 March and 6 April 2001, and the finalized proposals would form the basis of some of the rules to be made.</p>

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General	HKEx	The detailed rules to be made under Part XII should address 2 fundamental issues: (1) the funding model under the new compensation arrangements and (2) the scope of coverage of the compensation fund, in particular whether or not it should cover clients of non-Exchange Participants.	As said, we have released a paper for public consultation on the proposed compensation arrangements. Both issues raised in the market submission have been addressed. We have already covered the point on "coverage" above. As regards "funding", the SFC has proposed "residual amounts" of the existing two compensation funds and transaction levies as two major sources of funding, together with other funding options should a catastrophe occur.
234(1)(e)	HKSA	The Bill should specifically provide for payments to third parties (e.g. liquidators, accountants) who have assisted the Commission in the calculation or determination of compensation claims.	As a general response, specific clauses to provide for payment to third parties are not necessary, given clause 234(1)(a) is drafted broadly and does not preclude such payment. However, this does not mean we are receptive to paying liquidators for routine assistance in the determination of compensation claims, which should be left to the Courts. For example, the High Court in the 1999 case of C A Pacific (No.2) set out guidance on payment of liquidators' fees and expenses out of trust assets.
235	HKSA	<p>If the rights of an individual claimant are intended to be restricted only until the payment made to him is recovered, the words "to that claimant" or similar wording should be added at the end of clause 235(1)(b).</p> <p>It is not clear how the Commission deals with the situation where a claimant who has received compensation repays that compensation in order to commence (or join in) legal proceedings against the exchange participant (or defaulter). It is also not certain as to whether such a repayment be permitted.</p>	<p>We shall propose a Committee Stage Amendment to replace "its payment" at the end of clause 235(1)(b) with "that payment". This will have the effect of making clear that the rights of the individual are intended to be restricted until payment to the individual claimant is recovered.</p> <p>Clause 235(1)(b) restricts the right of action by the claimant only until the recognized investor compensation company has been reimbursed the full amount of its payment to the claimant. There is no prohibition in the legislation against reimbursement made by the claimant. The SFC has stated publicly that such repayment is permitted under cl. 235(1)(a) or (b); and if made, the SFC would release its subrogated rights.</p>

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236	KGI	<p>The rules to be made under this clause by the SFC should ensure that investors' right to the compensation fund is not relegated to an inferior right under the new law and there is certainty and improvement on the compensation coverage under the new compensation fund.</p> <p>The Administration should clarify whether the rules to be made under clause 236 are subsidiary legislation or mere administrative arrangements.</p>	<p>We agree. In particular, a per investor compensation limit is proposed in the Consultation Paper, in place of the existing per broker default compensation limit. This is an improvement to the existing law by providing greater certainty in the level of investor protection.</p> <p>The rules will be subsidiary legislation.</p>
236(2)(a)	HKSA	<p>It is not clear what rights or remedies a claimant would have regarding the Commission's decisions about who is entitled to claim, the manner and the amount of the compensation.</p> <p>The Bill should specify or give guidance on how the liquidator should pay the ICC if a claimant is only partially compensated by the compensation fund what is permitted under the proposed framework.</p>	<p>The detail of the compensation regime will be set out in subsidiary legislation to be made under clause 236. This will be subject to the usual legislative checks and balances. In terms of remedies, there is the possibility of a judicial review. We are considering including a right of appeal regarding the amount of compensation to the SFAT.</p> <p>See the responses to the HKSA's comment in relation to clause 235 and to their general comment in relation to Part XII, respectively. See also the numerical illustration in the footnote of Paper 11/01.</p>
236(2)(i)	HKSA	<p>It may not be appropriate for the SFC to make rules to govern its own procedures and requirements.</p>	<p>The rules referred to deal with the submission of a claim for compensation as a proof of debt in any winding up or bankruptcy proceedings, to pay compensation in the form of securities and to purchase securities for that purpose; and to require the assignment of a claimant's rights of action as a pre-conditions for the payment of compensation. They will be subject to consultation as a normal practice, and also usual legislative checks and balances. The intention is that the SFC will under Part III recognize an investor compensation company to perform on its behalf the various functions in the administration of the compensation fund, in accordance with the rules made by the SFC. The arrangement is similar to, for example, that under the Financial Services and Markets Act. The Financial Services Authority shall establish a body corporate to administer the scheme for compensation. Under sections 213 and 214 of the Act, the authority has wide-ranging rule making powers including those on procedures and requirements.</p>

Details of Submissions referred to in the Comment/Response Table

Date Received	Organization/Party
15 January 2001, 1 March 2001	Hong Kong Exchanges and Clearing Limited (“HKEx”)
18 January 2001, 31 January 2001	Hong Kong Society of Accountants (“HKSA”)
23 January 2001, 15 February 2001	Linklaters & Alliance representing <ul style="list-style-type: none"> - Bear Stearns Asia Limited - Credit Suisse First Boston (Hong Kong) Limited - Dresdner Kleinwort Wasserstein - Goldman Sachs (Asia) L.L.C. - Merrill Lynch (Asia Pacific) Limited - JP Morgan - Morgan Stanley Dean Witter Asia Limited - Salomon Smith Barney Hong Kong Limited - UBS Warburg (“Group of nine investment bankers”)
23 January 2001	KGI Asia Limited (“KGI”)

Financial Services Bureau
27 April 2001