

Securities and Futures Bill
Part XII – Investor Compensation

Proposed New Investor Compensation Scheme - Summary of Consultation
Conclusions and Proposed Rulemaking

Introduction

1. When considering Part XII of the Securities and Futures Bill (the “Bill”) at the Bills Committee meeting on 4 May 2001, Members asked for more information on the rules to be made under this Part upon enactment of the Bill for implementing the new investor compensation regime.
2. This note summarises the main conclusions reached concerning public consultation on the Proposed New Investor Compensation Arrangements conducted by the Securities and Futures Commission (the “SFC”) in March/April 2001¹. Based on these conclusions, it also summarises the rules the SFC will propose (the “proposed rules”) to make under Part XII following enactment of the Bill.

Expanded coverage of intermediaries

3. Public comments supported the expansion of compensation fund coverage to include all intermediaries licensed or exempt under the Bill for dealing in securities, dealing in commodity futures contracts, and providing securities margin financing (collectively “covered intermediaries”). The proposed rules will provide that a claim may be made against prescribed defaults by clients of any of the covered intermediaries. The SFC's Code of Conduct will require these intermediaries to inform clients of compensation coverage, including in their agreements with clients.

¹ The SFC March 2001 Consultation Paper entitled Proposed New Investor Compensation Arrangements (Paper Ref.: CB(1)784/00-01) was considered by the Bills Committee on 4 May 2001. At the meeting, the Administration also briefed the Bills Committee on the preliminary outcome of the consultation. The paper was also considered by the Legislative Council Financial Affairs Panel on 29 March 2001.

Per investor limit

4. There was overall support for a per investor limit of compensation, which will initially be set at \$150,000, in line with present arrangements. This limit will be set by a rule to be made by the Chief Executive in Council under clause 236(1) of the Bill. The proposed rules will provide that the \$150,000 limit is available for a securities trading account and an additional \$150,000 limit is available for a futures trading account with the same intermediary, which will parallel the case today where separate coverage is provided for securities and futures trading. The proposed rules will also clarify that the total maximum compensation for all the securities trading accounts (or futures trading accounts, as the case may be) of the same beneficial client with the same intermediary is limited to \$150,000.
5. Several comments expressed concern with moral hazard. Whilst there may be some moral hazard with the new scheme, this is mitigated by three factors - (a) there will be a compensation limit of \$150,000; (b) claimants will still experience inconvenience and delay when making claims; and (c) the covered intermediaries are already regulated by the SFC using risk-based regulation. In addition, investor compensation schemes are the norm in developed overseas markets.

Basis for making a claim

6. There were no objections to the proposal that the basis for making a claim follow existing law. This will be reflected in the proposed rules, which will provide that a claim can be made where a client of the covered intermediary has a cause of action in relation to money, securities, futures contracts, or other property entrusted to or received by the intermediary. The cause of action must relate to a default, meaning bankruptcy, winding up, or any breach of trust, defalcation, fraud, or misfeasance, as are to be further prescribed through the proposed rules.
7. Comments were split on whether the arrangement should be confined to local investments or extend also to overseas investments, but there was significant support for confining coverage to local investments. The proposed rules will confine coverage to claims relating to securities listed or traded on the Stock Exchange of Hong Kong and futures contracts traded on the Hong Kong futures Exchange. The SFC will study intermediary and investor activities in overseas investments to determine further whether coverage might be appropriate and if so how it might best be funded.

Exclusions from claiming compensation

8. There was both support and opposition to the proposal to exclude institutional investors from claiming compensation. The main objective of the arrangement is to provide compensation to retail investors, not institutional investors. Moreover, we believe the per investor limit of \$150,000 is not a meaningful amount for institutions. The proposed rules will therefore exclude institutions as listed in the consultation paper from claiming compensation. This is consistent with provisions in existing arrangements that exclude exchange participants from claiming compensation. In the UK regime, claims from large companies, financial institutions, government and municipal authorities and persons connected with the failed firm are also excluded.

A new single compensation fund

9. There were no objections to the creation of a new single compensation fund as provided for in the Bill to provide the described coverage for securities and futures market investments and defaults by covered intermediaries. The SFC will keep records of the money in the fund derived from the existing funds and from any levies in the securities and futures markets, and compare these to defaults in the two markets with a view to preventing any significant cross subsidies between the markets.

The Investor Compensation Company (ICC)

10. There was general support for the new arrangements to be administered by an ICC to be recognized and regulated by the SFC, and classified as a public body under the Prevention of Bribery Ordinance. One comment suggested that both industry and public interest representatives be represented on the ICC governing body. We agree and had proposed this in the consultation paper. Another comment was concerned with the cost of running the ICC. In this regard, the SFC will study further the costs and benefits of a small size ICC versus outsourcing most of the ICC operations. The SFC also expects to assist in the ICC's work.

The SFC's subrogated rights

11. Several comments opposed the SFC's subrogated rights. We shall propose Committee Stage Amendments to clauses 87 and 235 to restrict the SFC's subrogated rights and the priority of such rights to be

proportional to that in relation to the claimant, along the lines of the Court decision in Forelux Securities Limited.

Funding

12. There was broad market and public support for the proposed funding via a 0.002% levy on stock trading. However, certain institutional investors expressed concern as they would not be covered by the new scheme.
13. The levy is a fair and effective way to build up the new compensation fund. Using the model developed by the consultant engaged by the SFC and with the expanded coverage of the new scheme, it is considered that the new fund should have its assets built up to a size of \$1 billion at an early stage in order to provide prudential protection to investors. Any funding for the new scheme would be effected under rules made by the Chief Executive in Council under clause 236(1). Following the enactment of the Bill, the SFC will review the funding needs of the new scheme when the fund has accumulated to the target level.
14. As a matter of background, a levy of 0.002% for contribution to the existing Unified Exchange Compensation Fund (UECF) was approved by the Legislative Council on 11 July and will take effect on 1 September 2001. As undertaken in moving the second reading debate of the Revenue No.3 (Amendment) Bill, the Administration has agreed that after the assets of the UECF reach \$800 million, a review of the needs of the UECF will be conducted as to whether the levy should continue. In conducting the review, we shall take into account views and deliberations of the Bills Committee on Part XII of the Bill and progress in implementing the new compensation regime.
15. Moreover, we have proposed under Part XII of the Bill that the SFC may, having regard to the amounts estimated to be necessary to meet any claims against the UECF and to refund the deposit in cash by exchange participants under section 104 of the Securities Ordinance, transfer the remaining assets of the existing compensation fund to the new compensation fund.