

**PROPOSED NEW INVESTOR COMPENSATION  
ARRANGEMENTS**

Hong Kong  
March 2001

## **FOREWORD**

This Paper is published by the Securities and Futures Commission to solicit comments on proposals for new investor compensation arrangements for Hong Kong. Comments are invited from all interested persons.

Comments should be addressed to the Supervision of Markets Division of the Securities and Futures Commission, 12<sup>th</sup> Floor, Edinburgh Tower, 15 Queen's Road Central, The Landmark, Hong Kong and should be submitted before 6 April 2001.

This Paper can also be downloaded from the SFC's website <http://www.hksfc.org.hk>.

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## **I. Executive Summary**

### Prior Consultation

1. In September 1998, the SFC published a Consultation Paper on New Investor Compensation Arrangements for Hong Kong. Taking into account comments received and intervening developments, the SFC is now publishing this Paper describing proposed expanded new compensation arrangements. The comments received on the 1998 Consultation Paper are summarised at Appendix A.

### Objectives

2. The objectives of the new compensation arrangements are set out in paragraph 29 of this Paper. They are essentially the same as the objectives in the 1998 Consultation Paper, but with expanded coverage as described in paragraph 3 below. In summary, the main objectives of the new compensation arrangements are to provide a secure, cost-effective measure of compensation per retail investor in relation to products traded on Hong Kong Exchanges and Clearing Ltd (HKEx), based on the principles of user pays and equal treatment for all retail investors irrespective of the intermediary through whom they trade. *We also seek comments on whether coverage should extend to other products, including overseas products.*

### Expanded Coverage of Intermediaries

3. The arrangements would, as previously proposed, cover defaults by licensed persons authorized to deal in securities and who are exchange participants of the Stock Exchange. The new arrangements would also cover defaults by other licensed persons authorized to deal in securities, licensed persons authorized to deal in commodity futures contracts, and licensed persons authorized to provide securities margin financing (“covered intermediaries”) in relation to products traded on HKEx. This means coverage of all securities and commodity dealers and margin financiers who receive and hold client securities and/or money whether or not they are exchange participants. The SFC also proposes

that coverage should extend to retail investors who deal through authorized persons under the Banking Ordinance who are exempt from SFC licensing and subject to regulation by the Hong Kong Monetary Authority (“HKMA”). *The SFC seeks specific comments on whether coverage should be so extended.*

#### Per Investor Limit

4. As previously proposed, the arrangements would provide a limit of compensation per investor. We believe this can initially be \$150,000, and should be reviewed as necessary. The basis for making compensation claims would largely follow existing arrangements. But specified institutional investors would be excluded from claiming compensation.

#### A New Single Compensation Fund

5. There would be a new single Investor Compensation Fund that would replace the existing Unified Exchange Compensation Fund, the Commodity Exchange Compensation Fund and the Dealers’ Deposit Schemes for non-exchange participant dealers. The new arrangements would eliminate the existing requirements for exchange participant dealers to make deposits to the compensation funds and for other dealers to make deposits to the Dealers’ Deposit Schemes. Existing deposits would be returned to the Exchanges and to non-exchange participant dealers. The arrangements would also remove the existing requirement for the Stock Exchange to replenish amounts paid from the Unified Exchange Compensation Fund.

#### The Investor Compensation Company

6. As previously proposed, the arrangements would be administered by an Investor Compensation Company (ICC) recognized and regulated by the SFC. The ICC would receive and determine claims under rules made by the SFC, make payments to claimants, and pursue subrogated rights against defaulters. We also suggest that the ICC be classified as a public body under the Prevention of Bribery Ordinance.

## Funding

7. Initial funding would come from a transfer of assets in the existing compensation funds, but with sufficient amounts reserved in those funds to cover outstanding liabilities. We consider it desirable to build up the new Fund's assets beyond the level transferred from the existing funds. In order to provide reasonable protection to investors trading in Hong Kong securities and futures products, the SFC estimates that the new Fund should build its reserves to a level of \$1 billion as quickly as possible. This can be achieved effectively by increasing the existing transaction levy on Stock Exchange transactions from 0.01% to 0.012% and having the SFC pay the additional levy into the existing Unified Exchange Compensation Fund for transfer to the new Fund when formed. There would also be a need for other forms of funding to cover catastrophe loss. We propose that the existing \$0.5 levy for each side of a contract executed on the Futures Exchange should continue for the new Fund.

## Securities and Futures Bill

8. The arrangements for the new Fund would be implemented under the Securities and Futures Bill, introduced into the Legislative Council in November 2000. We expect the new arrangements to be put in place at the time of or very soon after the enactment of the Bill. However, we believe that the process of building up the assets for the new Fund should commence as soon as practicable.

## **II. Recent Developments**

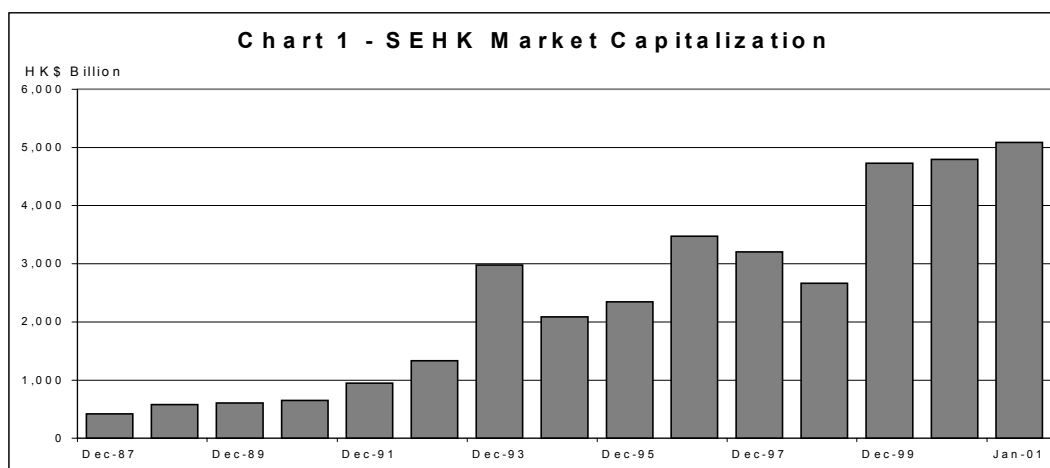
### Merger of Exchanges and Clearing Houses

9. As part of the Financial Secretary's 1999 market reforms, the Exchanges and Clearing Houses (Merger) Ordinance was enacted in February 2000. This facilitated the March 2000 merger of the Stock Exchange, the Futures Exchange, and their three associated clearing houses under the common control of HKEx. HKEx was later listed in

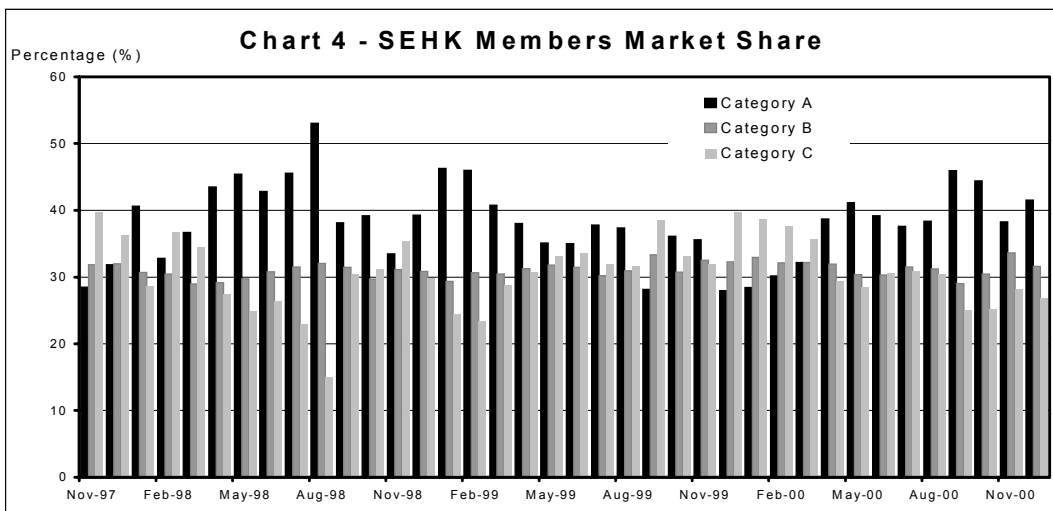
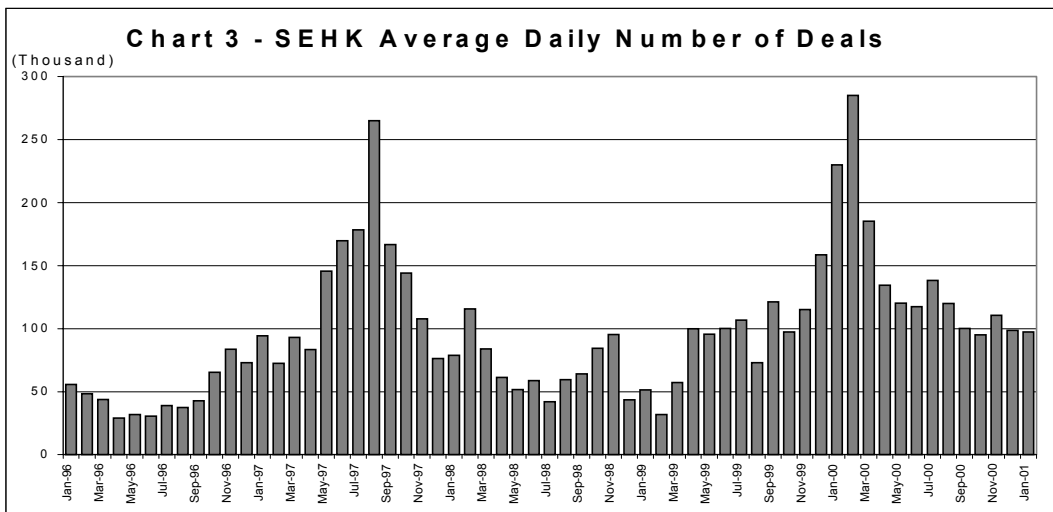
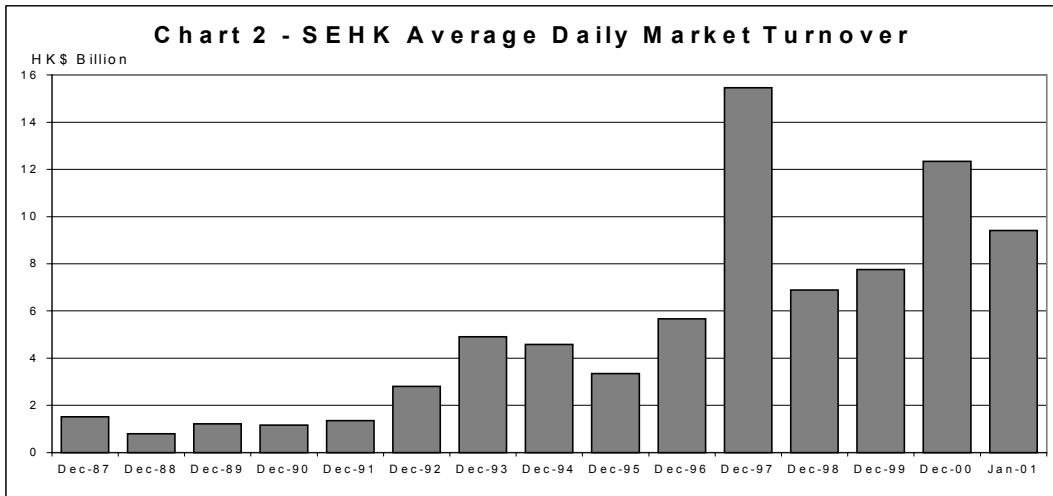
June 2000 as a public company on the Stock Exchange. As an adjunct to the merger, the SFC assumed from the Exchanges the role of front-line regulator of exchange participants in relation to their financial condition and conduct. This means that the SFC is now the front line regulator of all 868 dealing firms licensed by the SFC.

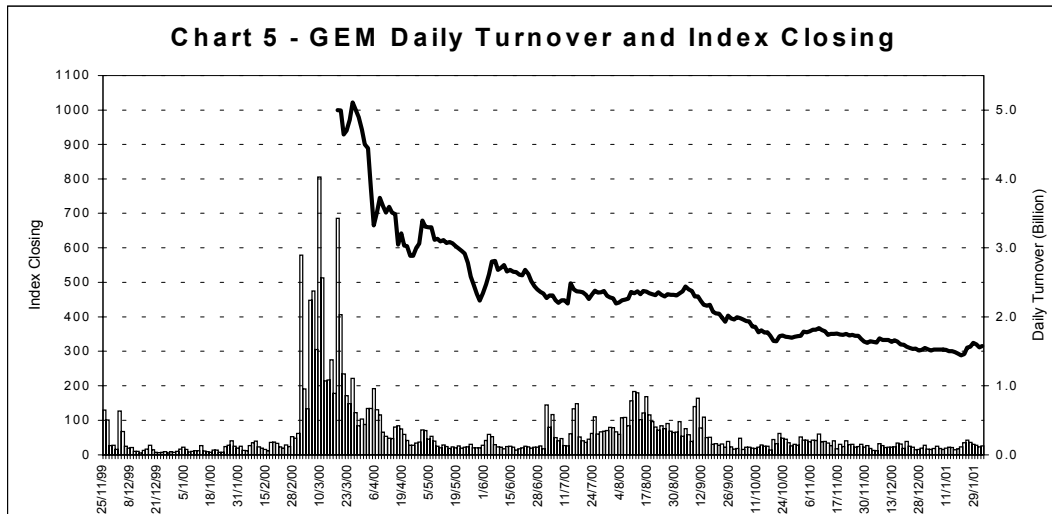
### Updated Market Statistics

10. The Charts below provide an update of the local markets since the 1998 Consultation Paper. Following a decrease in market capitalisation in 1998, total capitalisation rebounded sharply to new highs in 1999/2000. Stock Exchange turnover had fallen sharply in 1998 following the very high levels of 1997. Whilst turnover recovered smartly into 2000, it is still below 1997 levels. The relative market shares of the so-called category A, B and C brokers at the Stock Exchange have stayed more or less in a band with roughly 30% to 40% per category. The Growth Enterprise Market (GEM) was introduced in early 2000 with an initial flurry of volume followed by a consolidation with GEM turnover at roughly 1% to 2% of the main board.

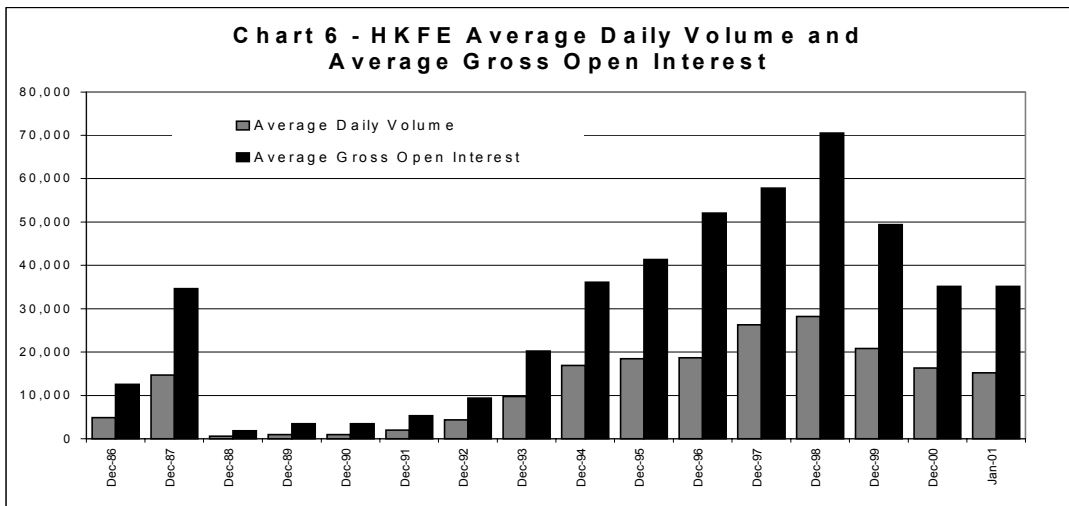


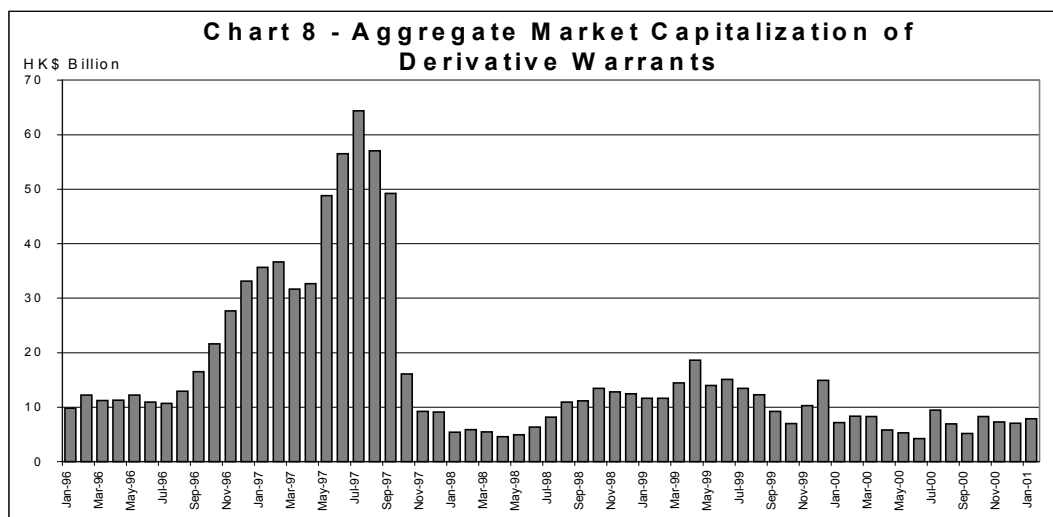
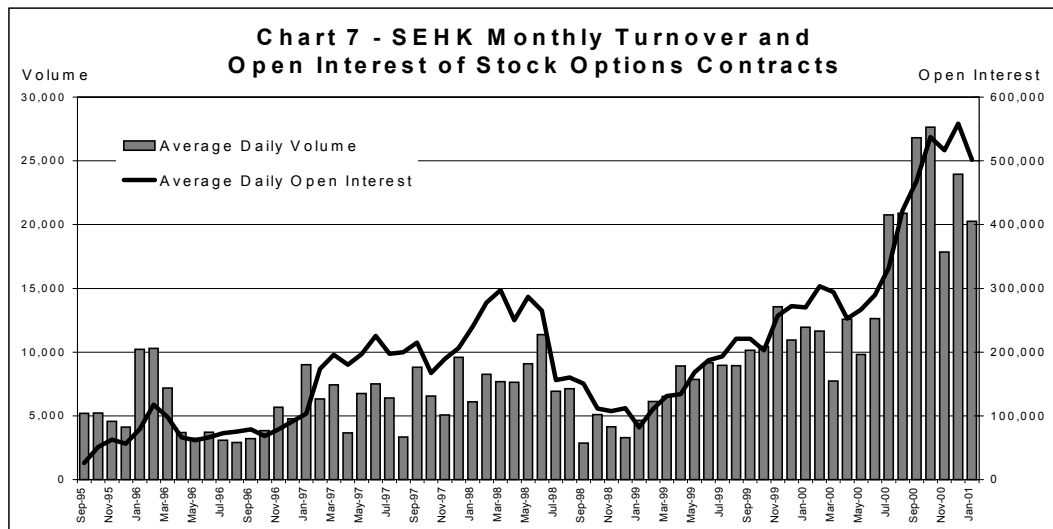






11. Futures Exchange turnover and open interest grew strongly in the seven or eight years into 1998, but have since fallen to 1994/95 levels. Stock options turnover and open interest show a steady increase from 1998 with a spike to record levels in the third quarter 2000. Derivative warrant market capitalisation picked up slightly in 1999 only to retreat to lower levels in 2000, far below the record levels of 1997. Despite the variances in stock and futures market activity in recent years, most statistics show continuing long term growth.





12. Another development since 1998 is a significant increase in clients' assets held by covered intermediaries. This figure rose from approximately \$378 billion in 1998 to approximately \$1,230 billion at year end 1999. Most of this increase we attribute to the general rise in the market during that period and to a movement of client assets from unregulated finance companies to the control of covered intermediaries.

### Deregulation of Brokerage Commissions

13. During 2000, HKEx proposed and the SFC approved rule changes that will eliminate fixed minimum brokerage commissions from 1 April 2002. Meanwhile, a number of non-exchange participants who are not subject to the Exchanges' minimum commission rules introduced

various waivers or rebates of brokerage commission leading to effective rates below the minimum levels set by the Exchanges. These developments are likely to lead to more widespread price competition among brokers with corresponding pressure on brokers' revenues.

#### Market Automation and On-line Trading

14. The Stock Exchange launched its AMS3 fully automated trading system in the fourth quarter 2000. This includes an Internet trading facility available to all brokers and supports other Internet facilities developed by on-line brokers. Earlier in 2000, the Futures Exchange migrated all trading to its electronic HKATS system and closed its trading floor. Overseas on-line brokers have established operations in Hong Kong and many local brokers and a number of Authorized Institutions have developed their own on-line trading systems.
15. A recent survey suggests that more than 200 brokers will provide on-line trading facilities to clients in the coming year, up from 80 odd recently. Experience overseas shows that on-line trading growth can increase trading volumes and the numbers of active retail investors, sometimes dramatically, whilst also adding new operational risks. In this regard, the SFC is conducting jointly with a firm of consultants focused reviews of the application control environment of brokers' on-line trading systems. We also published in December 2000 a Consultation Paper on the Regulation of On-line Trading of Securities and Futures.

#### Broker Initiatives in Investor Insurance Protection

16. During 2000, several Hong Kong brokers introduced new insurance products that provide certain coverage directly to clients in the event of the broker's insolvency. The per investor limit of compensation that would be provided by the new compensation arrangements would likely support further development of these insurance products in Hong Kong. Experience in the United States has been that, because the Securities Investor Protection Corporation (SIPC) covers most historical investor losses, there is relatively attractive pricing of

insurance products purchased by brokers to provide their clients with coverage above the SIPC limits.

#### 1998 Defaults – C.A. Pacific, etc. Update

17. The 1998 Consultation Paper noted the default of four brokers in that year – C.A. Pacific Securities, Chark Fung Securities, Foreground Securities, and Forlux Securities. It also described the special compensation arrangements made for those defaults, which involved paying each claimant the full amount of allowed loss up to a maximum of \$150,000. Since then, there has been one additional default – Win Successful Securities in January 2000. The payment history for these defaults is detailed in Appendix B. In summary, approximately \$458 million was paid to 6,419 claimants, whilst 176 claims have yet to be determined and \$65 million has been provided for to compensate remaining claimants.
18. Also noted in the 1998 Consultation Paper was the decision by the SFC and the Stock Exchange to make contributions of their own funds to the Unified Exchange Compensation Fund. In a series of payments the SFC and the Stock Exchange have since each contributed or made provision to contribute \$300 million of their own funds, for a total of \$600 million.

#### Risk Reduction Measures

19. The 1998 Consultation Paper described the regulatory measures then planned that would reduce risk of broker default and in turn risk to compensation fund assets. These included the plans to regulate share margin financing, changes to the Financial Resources Rules (FRR), and new provisions for safeguarding client assets. These are generally now in place as described below. Also summarised are additional risk reducing measures proposed in the Securities and Futures Bill.

#### Securities (Margin Financing) Amendment Ordinance 2000

20. This Ordinance came into effect in June 2000. It provides a comprehensive regulatory environment for persons providing securities

margin financing. This will address the circumstances of the defaults of C.A. Pacific Securities and other firms in 1998, which were directly related to the wholly unregulated activities of the firms' affiliated finance companies.

21. In summary, the main features of the Ordinance are:–

- SFC licensing of the firm and its representatives/dealing directors.
- Margin financiers must confine their business to share margin financing and can lend only to finance the purchase or holding of listed securities.
- Application of comprehensive liquid capital requirements and segregation of clients' credit balances.
- Restricted scope of dealing with clients' securities.
- Daily/monthly account statements for clients, including all account movements in securities, collateral, and terms of financial accommodation.

22. In addition, the FRR require monthly financial reporting of, among other things, bank facilities outstanding, top 20 clients, concentrations in collateral matched with clients, and reconciliation of clients' ledgers with third-party positions with CCASS and bank lenders. The SFC has implemented separately an automated financial reporting and analysis system in which it tracks and stress tests, among other things, the most active brokers and the concentration of margin loans and securities collateral in the margin financing industry, whilst analysing the impact of stock suspension, price drop of selected stocks and clients' default.

#### Revised FRR

23. Revisions to the FRR for all licensees also took effect in June 2000. The main features of these revisions are –

- Standardised approach to setting regulatory capital for securities and futures dealers and margin financiers.

- Standardised **minimum** required liquid capital of \$3 million (increases the minimum for sole proprietors from \$500,000).
- New **minimum** required paid up share capital (or equivalent for sole proprietors) of \$5 million, \$10 million for those providing margin financing.
- New risk adjustments for concentrated lending/collateral holdings.
- Expanded monthly financial reporting.

### Securities and Futures Bill

24. To address risks similar to those arising from margin financing, provisions in the Bill will apply to associated entities of licensed persons who handle client assets. The Bill would require segregation of such client assets, record keeping, statements of accounts, etc. It also enables the SFC to inspect the associated entities.

### Clients' Rights in Securities

25. The 1998 Consultation Paper noted that there was uncertainty in the C.A. Pacific default of the rights of clients in securities held by the broker and by third-party lenders. Since then, the Court decided that in certain circumstances clients had proprietary rights in securities they held with C.A. Pacific. The Court also decided how securities held by C.A. Pacific should be distributed to clients.

### Scripless Securities

26. The Steering Committee on the Enhancement of the Financial Infrastructure in Hong Kong appointed by the Financial Secretary released a Report in September 1999. The Report recommends, among other things, a move to a scripless securities market, including appropriate updates to the legal and regulatory framework and adoption of globally accepted standards for electronic transactions. We believe

an appropriate scripless system can enhance client protection by providing efficient direct registration of clients' interests whilst further clarifying the issues surrounding clients' rights in securities discussed above.

#### HKMA Deposit Protection Paper

27. In October 2000, the HKMA published a Consultation Paper on Enhancing Deposit Protection in Hong Kong. The Paper sought public comment on various ways of enhancing deposit protection, including insurance schemes to cover each depositor up to levels of \$100,000 or \$200,000 funded by premiums paid by banks on covered deposits. Whilst there have been securities and futures market compensation funds in place for more than 20 years, there has never been a formal deposit protection scheme in Hong Kong. There is a preference in favour of depositors up to \$100,000 each as creditors in the winding up of a licensed bank. We do not propose that the investor compensation arrangements involve winding up preferences for investors, although where brokers hold investors' property in trust, these assets are protected in a winding up.

#### Consultancy for New Investor Compensation Arrangement

28. As mentioned below, consultants, Jardine Lloyd Thompson Ltd. and Risk Economics Ltd., assisted the SFC in the preparation of this Paper.

### **III. The Proposals for New Compensation Arrangements**

#### Objectives – Update from 1998

29. The objectives of the new arrangements are essentially the same as those in the 1998 Consultation Paper.



### Main Objectives of New Compensation Arrangements

- To enhance the existing investor compensation arrangement and increase investor confidence whilst keeping costs commensurate with benefits. Also, to avoid creating moral hazards.
- To provide a secure per investor level of compensation for retail investors under a formal and transparent structure that is easy to understand.
- To provide the compensation arrangement through a new and independent entity that includes industry and public interest representatives and is subject to appropriate checks and balances.
- To protect and leverage existing compensation fund assets, including possible use of insurance, while minimising any additional costs to the industry.
- To employ market-based commercial risk management mechanisms and incentives within the arrangements.
- To initially provide a new compensation arrangement in relation to products traded on HKEx, but within a flexible structure that will allow additional arrangements to be developed for other segments of the market.

30. Within the objective of a flexible framework, we have since expanded the scope of covered intermediaries. The continuing objective of flexibility will enable us to consider further expansions of coverage if policy decisions are made to do so.

### Overview of the Securities and Futures Bill regarding Investor Compensation

31. The Bill's approach to investor compensation arrangements is to set up a broad and flexible regulatory framework in primary legislation, leaving most of the details concerning compensation to be contained in

rules. Under Part XII, the SFC must establish and maintain a compensation fund, to be known as the Investor Compensation Fund. Proper accounts of the Fund must be prepared and published by the SFC. There is a provision similar to existing ones giving the SFC subrogated rights against a defaulter upon making payment to a claimant. Part XII of the Bill is reproduced in Appendix C of this Paper.

32. Clause 236(1) enables the Chief Executive in Council to make rules concerning: means of funding the compensation fund; the maximum amount of compensation that may be paid to a claimant; sub-accounting; and for the better carrying out of Part XII. Clause 236(2) enables the SFC to make rules that are not inconsistent with rules made by the Chief Executive in Council and for various matters, including: circumstances entitling a person to claim compensation; manner of claiming; payment of costs and interest; required documentation; persons who may not claim; manner of determining and paying claims; etc.
33. Part III of the Bill covers the recognition and regulation by the SFC of an investor compensation company (ICC) (the relevant clauses of Part III are contained in Appendix C). Clause 80 enables the Chief Executive in Council to transfer by order from the SFC to the ICC any function to which the clause applies (i.e. most of Part XII of the Bill). Clause 84 sets out the duty of the ICC, to supply the SFC with information it may require about the ICC's affairs. Clauses 82 and 83 empower the ICC to make such rules as are necessary or desirable within the remit set out in those clauses and for the SFC to approve the rules made by the ICC.
34. Section V. of this Paper details the steps to be taken under the Bill to wind up the old compensation funds and to put the new arrangements in place.
35. The Bill contains new provisions for the regulation of "automated trading services" (ATS), which raise the question of whether ATS activity will be covered by the new compensation arrangements. As described in this Paper, the new arrangements will extend compensation coverage to all covered intermediaries in relation to products traded on HKEx. We believe this should mean 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 and whether or not it is also traded through an HKEx facility. This may mean that special funding arrangements may be needed in relation to ATS trading that is not done through HKEx facilities to ensure a fair and level playing field. Trading in offshore products through an ATS is not proposed to be covered initially. The existing compensation funds do not cover offshore products, and we propose that they not be covered in the initial stage of the new arrangements.

36. ATS may develop new products for trading in Hong Kong that are not offshore products. If these products were to be made generally available to retail investors in Hong Kong, we believe investor compensation coverage would likely be appropriate. We could do this by expanding the coverage of the new arrangements or devising an entirely new arrangement. In either case, funding would need to be provided for.

#### Expanded Coverage

37. As mentioned, the new arrangements would cover not only exchange participants of the Stock and Futures Exchanges, but also all licensed and exempt persons authorized to deal in securities, deal in futures, and to provide margin financing and in relation to HKEx traded products. The Tables below show the number of licensees who would be covered.

Stock Exchange dealers (corporation)	428
Stock Exchange dealers (individual)	80
Non-exchange securities dealers (corporation)	192
Non-exchange securities dealers (individual)	8
<i>Total</i>	<i>708</i>

Futures Exchange dealers (corporation)	138
Non-exchange futures dealers (corporation)	22
<i>Total</i>	<i>160</i>

38. In summary, the new arrangements would extend coverage to an additional 200 securities dealers and 22 futures dealers, plus 10 securities margin financiers, and 111 exempt dealers which are

Authorized Institutions and 56 exempt dealers which are not Authorized Institutions. The risk implications of the extended coverage are discussed in Section IV. Risk Assessment and Funding.

39. The existing compensation funds do not cover defaults of exempt dealers, who are in most but not all cases Authorized Institutions under the Banking Ordinance. The operations of Authorized Institutions, including securities dealing business and financial soundness, are regulated by the HKMA. Under the principles of user pays and equal treatment, we believe retail investors who deal in products traded on HKEx through exempt Authorized Institutions should also be covered. Currently, exempt dealers include Authorized Institutions and some others. On commencement of Part V of the Securities and Futures Bill, only Authorized Institutions will be eligible to apply for exempt status. Other existing exempt dealers would have 2 years to transit into the new licensing regime but would have to take out a license by the end of that period. During the transitional period, we believe that clients of these persons should be covered under the new investor compensation scheme. *We seek specific public comments on whether the new compensation arrangement should extend coverage to exempt Authorized Institutions.*

#### Elimination of Dealer Deposits and Stock Exchange Replenishment

40. The Securities and Futures Bill Schedule 9 (relevant provisions are reproduced in Appendix C) provides for a winding up of the existing compensation funds and Dealers' Deposit Schemes for non-exchange participant dealers and a return of dealer deposits after outstanding liabilities have been satisfied. For deposits made to the existing compensation funds, the deposits are to be returned to the two Exchanges who may deduct amounts owing to them and then return any balances to the dealers concerned. Deposits from the Stock Exchange are \$50,000 per trading right, deposits from the Futures Exchange are \$100,000 per trading right holder, and deposits from non-exchange dealers are \$50,000 per dealer. Refunds of deposits to the Stock Exchange would amount to \$46.45 million and to the Futures Exchange \$21.10 million. Refunds to non-exchange participant dealers would amount to \$46.15 million.

41. Under the existing compensation fund for the Stock Exchange, the Securities Ordinance requires the Stock Exchange to replenish amounts paid out from the trading right deposits. In practice, following the arrangements made for the C.A. Pacific and later defaults, this has meant a maximum \$8 million replenishment obligation on the Stock Exchange per broker default. The Futures Exchange does not have a replenishment obligation under existing arrangements.
42. The new arrangements detailed in this Paper do not rely on nor contemplate deposits by covered intermediaries nor Exchange replenishment obligations. However, the funding discussion from paragraph 79 of this Paper mentions that assessment of covered intermediaries could be an option but is not recommended. Clause 236 of the Securities and Futures Bill enables the Chief Executive in Council to make rules for the means of funding the new Investor Compensation Fund.

#### Basis for Making a Compensation Claim

43. Under the new arrangements, we envision a rule to be made under the Bill providing that a claim for compensation could be made where a person has a cause of action against a covered intermediary in relation to any money, securities, or futures contracts entrusted to or received by the covered intermediary or any person employed by it. The cause of action would need to relate to securities listed or traded on the Stock Exchange or futures contracts traded on the Futures Exchange.
44. The cause of action would also need to relate to a default by the covered intermediary. Default would mean: bankruptcy or winding up of the covered intermediary; or any breach of trust, defalcation, fraud or misfeasance committed by the intermediary or any person employed by the intermediary.
45. These basic requirements for making a claim are essentially the same as those under the existing compensation funds. But as explained, coverage would be extended to a broader range of intermediaries and the existing separate bases for claims in relation to securities or futures contracts would be combined into one. Coverage would also be limited to claims made in relation to products traded on the Stock Exchange or

the Futures Exchange. *The SFC seeks comments on whether coverage should extend to any other products, including overseas products.*

#### Exclusions from Claiming Compensation for certain Institutions

46. As set out in the 1998 Consultation Paper, an objective of the new arrangements is to provide a level of protection to retail investors. Following this objective, we believe it is appropriate to exclude institutional investors from claiming compensation under the new arrangements. This is consistent with provisions in the existing arrangements that exclude exchange participants from claiming compensation. The new arrangements would expand the exclusions as follows.

*The following persons would not be entitled to claim compensation against a covered intermediary*

- A person licensed under Part V of the Securities and Futures Bill (Bill) and any similar person licensed or regulated in another jurisdiction.
- A person granted an exemption by the SFC under clause 118 of the Bill and any similar person granted a similar exemption in another jurisdiction.
- An authorized institution under the Banking Ordinance and any similar person in another jurisdiction.
- A recognized exchange company, a recognized exchange controller, and a recognized clearing house under the Bill and any similar person in another jurisdiction.
- A person authorized to provide automated trading services under Part III of the Bill and any similar person in another jurisdiction.
- An insurance company licensed in Hong Kong and any similar person in another jurisdiction.
- A unit trust, mutual fund and any similar collective investment

scheme and its management company in Hong Kong or elsewhere.

- A pension fund and its management company in Hong Kong or elsewhere.
- Any associate (as defined in Schedule 1 of the Bill) of the covered intermediary who has committed the default.
- Any government.

### A Single Investor Compensation Fund

47. The new Investor Compensation Fund would be a single Fund to cover defaults of all covered intermediaries. Initial funding would come from residual assets of the existing compensation funds after reserving amounts for outstanding liabilities and returning deposits made by the Stock Exchange and Futures Exchange to the existing funds. As reflected in the table below, we estimate initial funding to be approximately \$655.8 million, which is sensitive to intervening events. The vast bulk of these residual assets represent transaction levy paid by investors in the stock and futures markets and payments made to the existing funds by the SFC and the Stock Exchange. We believe the overall arrangement would be fair to all concerned parties.

<b>Unified Exchange Compensation Fund (UECF)</b>	
Balance in UECF after provision for compensation	\$575.70 million
Plus future replenishment from the Stock Exchange	\$52.20 million
Less refund of deposits to the Stock Exchange	\$(46.45 million)
Balance available for transfer to Investor Compensation Fund	\$581.43 million
<b>Commodity Exchange Compensation Fund (CECF)</b>	
Balance in CECF after provision for compensation	\$95.47 million
Less refund of deposits to the Futures Exchange	\$(21.10 million)
Balance available for transfer to Investor Compensation Fund	\$74.37 million

Total available for transfer to Investor Compensation Fund	<b>\$655.80 million</b>
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Other Changes to the Existing Compensation Funds

48. In December 2000 in the winding-up of Forlux Securities, the Court made several decisions concerning, among other things, the SFC's subrogated rights under the existing compensation funds. In summary, the decision was that upon payment of compensation to a claimant the SFC is entitled to a right of subrogation under section 118 of the Securities Ordinance to shares to which the claimant is entitled, but only to the extent which its payment of compensation bears to the loss claimed. The following example was given. A client has entrusted the broker with shares worth \$500,000. The broker defaults and the SFC pays the client compensation of \$150,000. The client would still have a loss of \$350,000. Shares worth \$100,000 are then recovered in a winding-up. Under the decision, the SFC would take 30% of the shares recovered (i.e. 150,000/500,000) and the client, 70% (i.e. 350,000/500,000). The provisions in the Securities and Futures Bill concerning subrogated rights are more or less the same as in the existing Ordinance. We would therefore expect the SFC's subrogated rights under the new arrangements to operate in line with the decision in Forlux.
49. Currently, the UECF limits the total amount that may be paid to all claimants for a default by an exchange participant to \$8 million (the limit under the CECF is \$2 million). The arrangements for C.A. Pacific and other defaults since 1998 have provided for this limit to be exceeded and for claimants to receive the amount of their losses or \$150,000, whichever is less. In addition, it was provided that no claimants would receive less than what they would have received under the \$8 million limit arrangement. This meant that some claimants with large claims might receive a second payment in addition to the first payment of \$150,000.
50. Under the existing UECF, section 109(3) of the Securities Ordinance provides, in effect, that the first \$8 million received by the SFC under its subrogated rights is to be paid out to claimants who still suffer a loss after receiving initial compensation payments and after receiving any



recoveries in the winding-up. This final payment from the UECF is typically made on a pro-rata basis to each claimant's remaining loss. We have not proposed for this additional payment to continue under the new arrangements. Under the new arrangements, the total that would be paid for any size loss would be the claimant's loss or \$150,000, whichever is less.

51. The reasons for not continuing the payment arrangements described in paragraphs 49 and 50 relate to the main objectives of the new arrangements set out in paragraph 29. In particular the objective of providing a secure per investor level of compensation for retail investors under a transparent structure that is easy to understand. The payment arrangements concerning the \$8 million limit and the first \$8 million in recoveries are difficult to understand and do not provide a secure level of compensation.

## The ICC

### ICC Governance

52. We believe the ICC Board should include representatives of the various persons interested in the new compensation arrangements. This would include representatives of the SFC and HKEx and a representative from the broker community. We also believe that there should be representation of the "public interest".

### ICC Staffing

53. The major demand on staff would be the processing and investigation of claims. Historically this responsibility has been with the Exchanges. In view of unpredictability of timing of losses and number of claimants, only a skeleton staff would be retained by the ICC. The staff would be able to respond to investor inquiries and handle a certain amount of the claims processing in the event of a default. A full time Chief Executive Officer of the ICC would not yet be warranted, but this would be kept under review, depending on the level and scope of activity that develops at the ICC.

### ICC Outsourcing

54. The collapse of a major retail broker could involve more than 25,000 investors. We believe the ICC should have a goal of claims settlement within 6 months of receipt of satisfactory investor documentation. The workload that is beyond the capacity of the ICC staff, including temporary staff, would be outsourced under ICC control and preliminary costings of \$300 per claim have been obtained from loss adjusters.

### ICC Costs

55. Indications of costs have been obtained for a staff complement of 6, which would consist of a Manager, a Claims Supervisor, 3 Claims Handlers/Clerks and a Secretary, the computer equipment, suitable office space and other associated business costs. The initial annual costs are estimated at \$3,500,000. The additional costs of outsourcing claims are included separately in the modelling referred to in Section IV.

### ICC Computer Systems

56. A new enhanced computer system is proposed for the ICC which would have Internet access facilities for both claimants to monitor the progress of their claim and for the loss adjusters to allow central maintenance of records at the ICC. The proposed system would allow for compilation of statistical records, including key ICC performance indicators and other efficiency-related functions to improve the overall claims process.

## **IV. Risk Assessment and Funding**

### Historical Losses Updated

57. One method of assessing the risk of loss to the new Investor Compensation Fund is to update historical losses and then calculate an

average annual updated historical loss. We updated each historical loss of the Unified Exchange Compensation Fund (UECF) since 1988 to reflect a payment of up to \$150,000 per claimant (prior to 1998 a maximum payout of \$8 million per defaulter was applied). We also calculated losses at per investor limits of \$200,000 and \$250,000. We adjusted each claim to reflect the change in the Hang Seng Index from the date of default to 31 December 1999 (HSI then 17,000). For claims received but not yet determined (see Appendix B) we assumed the claims were valid and would be paid up to the limit. Finally, a concentration factor was applied to reflect the actual change in the number of dealers and an assumed increase in the population of investors of 10% per year.

58. As at 16 October 2000, there had been 6,652 historical successful claims against the UECF with a total allowed amount of \$1.17 billion and actual payments made to claimants of \$492 million. The results of the updating mentioned above show an updated allowed amount of \$2.7 billion and an updated payout at a \$150,000 limit of \$847 million. We then calculated an average annual updated loss of about \$71 million at the \$150,000 limit.

#### Non-exchange Participant Dealers

59. We estimated losses to reflect the extension of coverage to the 200 securities dealers who are not exchange participants of the Stock Exchange. We used SFC data indicating that although trading by these dealers at the Stock Exchange represented 13% of total trading, there were only 13 such firms holding Stock Exchange products for clients amounting to only 0.5% of total assets held by Stock Exchange participants and 2% of the estimated retail assets held. Thus, an increment of 2% of the updated historical losses from exchange participants, or \$1,400,000 per year was added.

#### The Futures Market

60. Next we updated the historical losses of the Commodity Exchange Compensation Fund. The history shows defaults by 22 brokers in 1987 involving 167 successful claimants, and one default since then –

Winton Commence in 1998 involving 21 claimants (see Appendix B). Similar to the updating noted in paragraph 57, we recalculated each historical loss as if there had been a \$150,000, \$200,000, and \$250,000 limit (historically a \$2 million limit per broker has applied). We adjusted the amount of each loss by the change in the Hang Seng Index from the date of default to 31 December 1999. A risk improvement factor was applied to reduce the inflationary effect of the Hang Seng adjustment by 20%, as risk management measures applied since 1987 have clearly impacted on the exposure to CECF and resulted in only one loss in the intervening period. We also adjusted each claim amount by a factor reflecting the increase in the number of Futures Exchange participants and in the growth in contracts traded. Finally, we projected an increase of 10% per annum in the number of claimants. The results show a total updated loss for the period of \$4.1 billion and at a \$150,000 limit an updated payout of \$70 million; this results in an average annual updated historical loss of \$5.8 million.

61. Similar to paragraph 59, we estimated losses to reflect extension of coverage to futures dealers who are not Futures Exchange participants. Our data indicates that in 1999 the 22 such dealers were responsible for 6% of the number of contracts traded at the Futures Exchange and thus \$348,000 was used as an estimate of the additional annual exposure.

#### Exempt Dealers

62. The updating exercise was performed in relation to licensed dealers only, because the SFC possesses detailed data in relation to that sector of the industry. If, as we propose, exempt Authorized Institutions are to be covered by the new compensation arrangements, these figures will require further fine-tuning to take account of the exempt dealers. The data for this exercise is still being gathered but it is not expected that adjusting the model in the light of that data will produce a fundamentally different analysis.
63. We believe the updated historical losses are conservative. The recently introduced regulation of margin financing and revisions to the FRR described at paragraphs 19 to 24 should lessen significantly the chance of a repeat of the margin financing related defaults in 1998. In addition, experience in other markets does not show a high correlation between

investor compensation claims and stock index appreciation and growth in retail investor participation, although we have built such a correlation into the model.

#### Actuarial Results/SIPC model

64. In addition to the analysis of Hong Kong loss experience referred to above, an actuarial analysis was performed by Risk Economics Ltd. that incorporates aspects of SIPC payout experience in the United States but retains the Hong Kong pattern and frequency of losses. This approach reflects payouts without reference to per investor limits, and the results are statistically consistent with actual Hong Kong experience. This is a significant indicator that the updated historical losses discussed in this Paper are statistically credible. The potential payouts and the attendant probabilities that payouts would not exceed the indicated amount are shown in the table below.

	Net Payout	Probability Less than Net Payout
Mean	\$113 million	62.9%
Mean + 1 Standard Deviation	\$252 million	85.6%
Mean + 2 Standard Deviations	\$391 million	94.8%
Mean + 3 Standard Deviations	\$530 million	98.3%

#### ICC Model to Assess Risk and Funding Needs

65. Jardine Lloyd Thomson Ltd. has developed for the SFC a model to assess, among other things, the ICC's risk and funding needs. In this section we describe the basic features of the model, the reasoning behind certain inputs to the model, and some of the conclusions that can be drawn from the model. The model used for the purposes of this Paper was able to draw on the extensive data possessed by the SFC in relation to the experience of broker defaults. In order to increase its accuracy and usefulness as a planning tool for the ICC, it is currently undergoing adjustment to take into account the impact of the judgement in the Forlux Securities case on expected recovery rates and to integrate data being gathered with respect to exempt dealers. Notwithstanding that these adjustments have not yet been made, the

model is sufficiently flexible to have allowed the examination of a wide range of scenarios and we believe it permits valid general conclusions to be drawn.

66. The model contains various inputs of revenue for the ICC, including initial contributions, interest income, and proceeds of a market levy. There are also inputs for compensation payments made by the ICC due to updated historical losses and catastrophe losses, and for administration expenses. Based on these and other inputs, the model calculates a profit and loss statement, balance sheet, and cash flow statement for the ICC. The model simulates borrowings by the ICC captioned “contingent capital” in the model, and interest expense. There is also a feature that simulates insurance coverage and related costs.

Several key aspects of the model are:

*Contributions* – includes \$655.8 million of residual assets from the existing compensation funds and \$165 million in recoveries expected from defaults since 1998, assuming a recovery rate of 30% or approximately the historical rate.

*Transaction Levy* – Volume inputs are based on approximations of historical per annum volume of trades. Stock Exchange volumes are projected to grow at 16% per year, a smoothing of the recent historical rate of 22%. Futures Exchange volumes are projected to grow at 10% per year. There is provision in the models both for an ongoing levy and a special levy to cover a catastrophe loss. The model can simulate an ad valorem or a flat rate levy.

*Salaries and Overhead* – simulates administration costs of the ICC based on the discussion at paragraph 55.

*“Known Losses”* – the potential losses that could arise from known margin finance exposure stemming from 1998.

*“Expected Losses”* – initial inputs are derived from the updated average annual historical losses described from paragraph 57 to 63. In future years, the updated historical loss estimates are increased in

severity in the model by assuming a 10% per year increase in the size of each claim due to assumed Hang Seng Index growth and a 10% per year increase in the number of claimants. Payments from the Fund are assumed to lag by one year. Recoveries are assumed to lag four years from payment.

*Cat Losses* – simulates catastrophe losses over and above the “expected losses”.

*Contingent Capital* – simulates borrowings and related costs.

*Max Loss per Investor* – simulates compensation limits per investor of \$150,000, \$200,000, and \$250,000.

*Net Assets* – simulates the annual net assets of the ICC based on the other variable inputs to the model.

67. The model was used to simulate the condition of the ICC over a ten-year period with no regular levy for income and with updated historical losses as explained above. In this scenario, the net assets of the ICC decline steadily except for one year where a large recovery was assumed. This deteriorating financial condition is largely explained by the growth in historical losses exceeding investment income. Of course if the assumed historical losses did not recur or were less than assumed, the financial condition of the ICC would be better; if historical losses were worse than expected, ICC’s condition would be worse. In addition, a levy could be added to the scenario to generate income and improve the ICC’s financial condition.
68. Another scenario simulated catastrophe losses in years 3 and 6. These catastrophe losses simulate the severity of the C.A. Pacific default, but with severity increased by increasing investor losses by 10% per year and increasing the number of investors by 10% per year. The gross amounts of these losses amount to \$2.84 billion and \$5.37 billion. The model reduces these to net payouts based on sample distributions of clients' account sizes and reflecting the \$150,000 per investor limit. Net losses amount to \$582 million and \$914 million. Note also that the updated historical losses continue to apply and that these include the

C.A. Pacific default updated, thus this scenario simulated in a ten-year period three C.A. Pacific losses with severity updated as indicated.

69. A third scenario simulated an extreme catastrophe loss in year 3 of a gross amount of \$23.625 billion, resulting in a catastrophe payout of \$5.9 billion. This effectively represents the largest retail stockbroker licensed with the SFC in 2000, but with assets and numbers of clients each increased by 10% per year.
70. In each of these two scenarios, the Fund is required to borrow at commercial rates to meet the additional claims but is able to restore itself to a comfortable financial position over the next several years by charging a relatively low rate of additional levy on transactions.
71. It is important to note that the scenarios described above are indicative only. The model is sensitive to the major inputs and assumptions. For example, higher levy rates or higher market volumes would result in higher revenues and vice versa, with knock on effects to the rest of the model. Higher (lower) losses would lead to a worse (better) financial condition for the ICC. Prior to implementation of the new arrangements, changing market conditions or broker defaults could lead to very different results from the model. Importantly, the model would be used by the ICC to regularly update inputs to reflect actual experience.

#### Conclusions for Funding Needs

72. We believe the results of the modelling lead to several conclusions. First, the assumption that adjusted historical losses continue, the assets of the Fund will be depleted unless it has a regular source of funding. It would be imprudent to relax this assumption until sufficient additional experience had been built up to justify the conclusion that the risk of loss had been reduced. Secondly, as discussed in paragraphs 68 and 69, the Fund could suffer quite large losses under some scenarios. It is a question of judgement how provision should be made for such scenarios in advance of a crisis occurring. To build the Fund to a size sufficient to cover extreme catastrophe losses would involve imposing significant costs on the market that might prove to be unnecessary. It follows that the Fund would need back-up funding



arrangements at least to cover extreme contingencies. On the other hand, to set the size of the Fund too low would not only be inconsistent with the objective of promoting investor confidence, but would increase the likelihood of needing to resort to back-up funding arrangements, with the additional cost this would entail. Balancing these factors, we believe the Fund should build its assets to \$1 billion as quickly as possible.

### *Transaction Levy*

73. The levy rates simulated in the scenarios are in our view sufficiently low as not to have an adverse effect on transaction costs or market participant behaviour, even where extreme catastrophe losses are involved. An initial and ongoing levy on market transaction value could also be seen as fairly having collected revenue from those who subsequently might make or be the subject of claims for compensation. A levy could be raised as a part of the transaction levy received by the SFC and the Stock Exchange under section 54 of the Securities and Futures Commission Ordinance.
74. We are mindful that Hong Kong already has relatively high transaction costs. The Stock Exchange and Futures Exchange maintain fixed minimum brokerage commissions, but these are due to be eliminated in April 2002. The present minimum rate at the Stock Exchange is .25% of the trade value. In addition, stamp duty is charged on Stock Exchange trades at the rate of .1125% of the trade value. The Government has indicated that this may be reduced as fixed minimum commissions fall away. There is also a transaction levy of .01% of trade value split equally between the SFC and the Stock Exchange. The table below shows a transaction cost breakdown for various trade sizes at the Stock Exchange, including a .002% compensation fund levy. Also included is the CCASS stock settlement fee of .002% of value (but subject to a \$2.00 minimum and a \$100 maximum).

Trade size (HKD)	50,000	% Total	150,000	% Total	500,000	% Total
Brokerage	125.00	66.05%	375.00	66.40%	1,250.00	66.40%
Stamp duty	56.25	29.72%	168.75	29.88%	562.50	29.88%
Transaction levy	5.00	2.64%	15.00	2.66%	50.00	2.66%
CCASS settlement fee	2.00	1.06%	3.00	0.53%	10.00	0.53%
Compensation levy at .002%	1.00	0.53%	3.00	0.53%	10.00	0.53%
Total	189.25	100.00%	564.75	100.00%	1,882.50	100.00%

75. We believe a small compensation levy would not harm Hong Kong's competitiveness. Any possible reduction in stamp duty and elimination of fixed brokerage commission should lead to a significant lowering of overall transaction costs. This would offset by far the effect of a small compensation levy.
76. A percentage of trade value levy is how the existing transaction levy works. One option would be to provide funds as needed for the new compensation arrangements out of the existing transaction levy revenues. This has the advantage of not being perceived to impose a "new" transaction cost on the market, unless the levy had to be increased to cover a catastrophe loss.
77. However, this approach would divert funds now used to fund the SFC and thereby reduce the SFC's revenues. The amount involved would be roughly 40% of the SFC's annual transaction levy income. This might result in the SFC having to resume the past practice of seeking funding under provisions that enable an annual payment to fund the SFC out of general revenue in an amount as may be appropriated by the Legislative Council. This would result in general revenues being used to fund the SFC/compensation arrangements, rather than funding from the markets. We note that the SFC has not sought this annual grant since 1993, but the amount involved would be of the same order of magnitude as the amount required to fund adjusted historical losses.

#### *Direct Government funding*

78. There is an option that has been used in other contexts for the Government to directly pay for the compensation arrangements. For example, and as mentioned in the 1998 Consultation Paper,

Government has committed to inject \$600 million into the Mandatory Provident Fund Compensation Fund. This approach would avoid further taxing the markets, but would result in the general public rather than market participants funding the compensation arrangements.

*Assessment of covered intermediaries*

79. Another option used in other markets is to assess the covered intermediaries, either on a regular basis or following a default. In this regard, the levy discussed above could be imposed on the covered intermediaries rather than directly on investors. This would give the option to the covered intermediaries to absorb the levy themselves or pass it on to investors. In some overseas markets levies are imposed on covered intermediaries not on a per trade basis, but based on a brokers' revenues or as a lump sum share of a default. This would make it difficult for covered intermediaries to pass the cost on to investors on a uniform per trade basis and each intermediary would determine itself how to pay the cost. These funding alternatives collect the cost from the class of persons who are responsible for defaults, but this is arguably unfair to non-defaulting intermediaries and those dealing for institutional investors who will not receive compensation from the new Fund.
80. In the deposit protection context, one option put forth by HKMA is to collect "premiums" from banks based on "covered deposits", meaning only those deposits that would receive protection (e.g. each covered deposit up to a \$100,000 or \$200,000 limit). This could conceivably be done with brokerage accounts by collecting funds from each broker for each account up to a \$150,000 limit. This has similar pros and cons to the paragraph above, and would include an administrative cost as well.
81. Although the new Investor Compensation Fund will need funding from a levy or some other source as discussed, we would not wish to see the Fund accumulate amounts beyond what is necessary. We believe the SFC and the ICC should adopt a policy that compensation fund assets and income should not exceed a prudent base amount of assets with annual income sufficient to cover updated average annual historical losses plus any likely future adjustments in the per investor limit upon review. If these amounts were to be exceeded, the SFC and the ICC

would look to consulting the market and recommending an increase in the compensation limit and/or a reduction or elimination of any levy that might apply at the time.

82. The modelling also shows the need for back-up borrowing facilities in the event of contingency. These might take the form of, among others, contingent capital from the insurance market or lines of credit from the banking industry. This would have a cost which has yet to be input into the model. We understand that potential lenders would be concerned with the certainty of the levy or other payback arrangements. The availability and cost of back-up financing would vary with the financial condition of the ICC and the certainty of repayment of borrowings.

### *Conclusion*

83. Taking all of these considerations into account, we consider that the new Fund should build its assets to \$1 billion. Approximately \$650 million of this can be provided from the assets of the existing Compensation Funds but the rest will need to be provided from one of the sources discussed above. On the whole, we favor providing the additional funding gradually from an increase in the existing pro rata transaction levy charged on Stock Exchange transactions. As shown above, the effect on total transaction costs need not be large and the transaction levy provides an administratively straightforward way of collecting the necessary funding to provide protection for retail trading in Hong Kong products irrespective of whether the intermediary used is an exchange participant, a licensed person who is not an exchange participant or an exempt Authorized Institution, since all transactions are ultimately consummated on or reported to the Exchange. (The principles in relation to ATS are set out at paragraphs 35 and 36). There is a trade-off between building up the assets of the new Fund quickly and imposing additional costs on the market. The growth of the Fund largely will depend on whether the historical patterns of losses continues or is reduced by the factors discussed at paragraphs 19 to 24 above. We believe an additional levy of .002% would be adequate to build the assets of the new Fund up to the desired level over time, although this is sensitive to the rate of growth in Stock Exchange transactions, as well as the rates of losses. We believe that

the process of building up the assets should commence as soon as practicable. Pending the enactment of the Bill, the process could start by increasing the existing transaction levy and having the SFC pay it into the existing Unified Exchange Compensation Fund for transfer to the new Fund when formed.

84. We considered whether additional levy, over and above the existing levy of \$0.50 per contract per side, should also be charged on Futures Exchange transactions but decided against this, essentially because the model indicates that the major source of claims is expected to arise from Stock Exchange-related business. Should this assumption prove to be incorrect, so that the ICC finds it is facing disproportionate claims in relation to the futures industry, it will be open to it and the SFC to consult the market and to recommend to the Government a corresponding increase in the futures transaction levy.
85. We would expect the additional levy imposed to be terminated once the new Fund had reached assets of \$1 billion. We also expect that the ICC will continually re-evaluate its funding needs by using the model developed by Jardine Lloyd Thompson and updating it in the light of the ICC's actual claims experience. Should this reveal that the Fund is likely to be depleted below a prudent level, it would be open to the ICC and SFC to consult the market and to recommend to the Government the resumption of a levy or the increasing of the Fund's assets by some other means.

#### Alternative Risk Transfer Mechanisms

86. Because of the nature of the underlying losses to the Investor Compensation Fund, which occur as a result of financial default, we believe that only limited traditional insurance capacity would be available. Insurers might be available to underwrite Alternative Risk Transfer programmes that include an element of risk transfer where some premium is paid away for a limit of indemnity. This type of programme would make funds available to enable the ICC to continue to operate and pay compensation claims through periods which would otherwise present liquidity problems, with the "borrowed" funds being paid back over time.

87. The downside of such an arrangement would be that it is relatively expensive in terms of the required premium and the insurer's margin. Furthermore, the available limit would be governed by the amount of premium paid into an experience account, plus any risk transfer amounts. The benefits would be that short term liquidity problems could be overcome, risk transfer elements might be included and that if the funds were not used, they would be substantially returned to the ICC with interest at the end of the term.
88. Both the banking sector and the insurance market may be available to provide contingent capital to the ICC. This would be by way of a standby credit facility to be utilised in the event that the available funds to the ICC breach a pre-agreed threshold.
89. The availability of credit commands an option price which would be payable annually on the amount of credit facility available. Once drawn upon to provide funds to the ICC the drawn amount would be subject to an interest rate.
90. The benefits of a contingent capital facility would include the ready availability of liquid funds from a first class credit counterparty in a simple format and potentially at relatively low additional cost. In addition, it is likely that the size of such a facility could be increased. The downside would be that in the event of a good experience, there would be no return to ICC of the option price paid.
91. A combined experience account, contingent capital and pure risk transfer structure might offer attractive options for the ICC. Support from the Hong Kong Government to provide comfort to potential counterparties with regard to the ability of the ICC to repay amounts loaned, via guaranteed income streams from transaction levy or other sources, would be influential in the final determination.

### Government Guarantees/Loan

92. An alternative source of liquidity would be for the Government to make a credit facility available to the ICC whereby the ICC would pay commercial interest rates on any amount drawn down. In commercial markets, the ability of the ICC to secure credit would be affected by the extent of guarantee provided by the Government to potential counterparties. We note that in the C.A. Pacific arrangements, the Government indicated that it would seek funding from the Legislative Council if necessary. This approach could be continued.

## **V. Implementation**

93. Following enactment of the Securities and Futures Bill (Bill), the following steps would need to be taken to bring the new investor compensation arrangements into place.

### Constitute the ICC

94. The ICC would need to be incorporated, provisions made for its staffing and operations, including information technology systems, and its Board constituted. The SFC would need to recognize the ICC following consultation with the Financial Secretary under clause 79 of the Bill, including considering whether to apply any conditions to recognition.

### Rules to be Made by the Chief Executive in Council

95. The Chief Executive in Council would need to make rules under clause 236(1) to set, among other things, the maximum amount that can be paid to a claimant. Rules might also be made to set the framework for funding as discussed in Section IV. The Chief Executive in Council would also be asked to transfer certain functions of the SFC to the ICC, with concurrent exercise of those functions by the SFC, in particular relating to ICC's handling of monies and administration of the compensation arrangements.

### Rules to be Made by the SFC

96. The SFC in consultation with the Financial Secretary would need to make the main rules for the compensation arrangements under clause 236(2) and consistent with rules made by the Chief Executive in Council. The SFC would need to approve the ICC's rules under clause 83. The SFC would also need to make rules under clause 88 to set reporting requirements for the ICC.

### Winding up of the Old Funds, etc.

97. Under Schedule 9 of the Bill (clauses 72 and 73), the SFC would need to determine the amounts needed in the old compensation funds to pay outstanding liabilities and to return deposits to the Exchanges and to transfer other amounts to the new Investor Compensation Fund. There are numerous other procedures to be followed under Schedule 9, including in relation to the Dealers' Deposit Funds. Also under Schedule 9, the Secretary for Financial Services would need to set the appointed days for the start of the new arrangements. Finally, the SFC would need to undertake a public awareness and education programme for the new arrangements.

Encl.



## Appendix A

### Summary of Comments Received on the SFC's Consultation Paper on New Investor Compensation Arrangements for Hong Kong, September 1998

Nineteen written submissions on the proposals were received. Responses were received from the Stock and Futures Exchanges, the Hong Kong Securities Clearing Company Limited, securities firms, brokers' associations, Consumer Council, professional bodies, Government departments, insurance companies and a political party. A breakdown of the comments received is as follows :-

a) General Support for New Arrangements

With only a few exceptions (from the securities firms) there was broad agreement in principle to the scheme and to the setting up of an independent investor compensation company.

b) Structure/Operating Costs

Not many specific comments received. Some concern expressed over proper oversight of expenses.

c) Proposed Financing Structure

In respect of the proposed financing structure (i.e. the three tiered structure of risk retention by NewCo, insurance and a back-up credit facility from Government or private lenders), concerns were expressed that the assets of NewCo could be quickly depleted. The \$250 million retention risk is viewed as too high.

d) Imposition of a Levy for Funding

Those who commented gave general support to the proposal for the imposition of a levy, should it be necessary, in order to raise funds for the compensation arrangements. Some suggested that the levy should be paid, in part at least by investors.

e) Setting of Per-Investor Compensation Limits

Broad support (a broker's association and two securities firms being the exceptions) was given to the proposal to abolish the per broker payment limit in favor of a per investor payment limit.

f) *Imposition of a Contingent Premium on SEHK Members*

Comments were mixed, with the SEHK and Law Society giving some support. Concern was expressed by a brokers association. The Hong Kong Society of Accountants expressed concern.

g) *Improved Audit Requirements*

Responses were mixed from those commenting. Some support was given by the SEHK, but concerns were expressed by the Hong Kong Society of Accountants.

h) *Improving Client's Rights in Securities*

Those who commented were supportive of the proposal.

i) *Including Dealers Who Are Not Exchange Members*

Of those commenting on the proposal, several suggested that these other entities should purchase compulsory fidelity insurance instead.

### Unified Exchange Compensation Fund Claims History

Name	Year	No. of Claims Allowed	Allowed Amount	Average Allowed Claim	Apportionment	Total Payments
Myra Kan & Co.	1988	11	889,000	80,818.18	100%	1,097,000
Gisella Ma & Co.	1987	6	1,273,000	212,166.67	100%	1,617,000
Bonus Securities Co.	1987	117	23,453,000	200,452.99	17%	4,000,000
Blooming Stock Co.	1990	15	1,036,000	69,066.67	100%	1,258,000
Tri-Pro Stocks & Shares Co.	1991	34	6,327,000	186,088.24	32%	2,000,000
HW Securities Co. Ltd.	1992	24	5,295,000	220,625.00	38%	2,000,000
Hung Wai Securities Co.	1992	11	898,000	81,636.36	100%	1,060,000
W.H. & Company	1987	1	6,000	6,000.00	100%	10,000
Top-Fit Securities Co.	1987	15	6,180,000	412,000.00	32%	2,000,000
Youngs Family Investment	1990	1	211,000	211,000.00	100%	282,000
Wei Xin Securities Ltd.	1996	8	25,808,000	3,225,000.00	31%	8,000,000
Cheong Woon Securities Co.	1996	32	10,920,000	341,250.00	73%	8,000,000
C.K. Securities Co.	1996	53	10,423,000	196,603.77	77%	8,000,000
Foreground Sec. Co. Ltd.	1998	58	25,865,002	445,948.31	\$150,000.00 per claimant limit	5,491,613.78 <u>Note 1</u>
C.A. Pacific Sec. Ltd	1998	3,872	864,643,390	223,306.66	\$150,000.00 per claimant limit	295,490,569.79 <u>Note 2</u>
Forlux Sec. Co. Ltd.	1998	430	56,903,947	132,334.76	\$150,000.00 per claimant limit	30,518,931.42 <u>Note 3</u>
Chark Fung Sec. Co. Ltd	1998	2,059	214,834,789	104,339.38	\$150,000.00 per claimant limit	126,861,262.03 <u>Note 4</u>
Win Successful Sec. Ltd	2000	Pending <u>Note 5</u>	-	-	-	-

**Note 1** : Out of 61 claims received, so far 58 claims are allowed and 2 claims are disallowed. Outstanding claim pending determination of SEHK is 1.

**Note 2** : Out of 5,168 claims received, so far 3,872 claims are allowed and 1,164 claims are disallowed. Outstanding claims pending determination of SEHK are 132.

**Note 3** : After payments were made to all the claimants whose claims were allowed in full or partially allowed, additional payments amounting to \$544,170.49 were made to eight claimants to bring their compensation payments up to their respective pro rata entitlements.

**Note 4** : Out of 2,255 claims received, so far 2,059 claims are allowed and 153 claims are disallowed. Outstanding claims pending determination of SEHK are 43.

**Note 5** : 285 claims pending determination by SEHK.

## Commodity Exchange Compensation Fund Claims History

Name	Year	No of Claims Allowed	Amount Allowed	Average Amount Claimed	Apportionment	Total Payments (Before Interest)	Total Payments (Incl. Interest)
Chin Tung Futures Ltd.	1987	7	102,455,249	14,636,464.21	1.95%	2,000,000	2,348,298.00
Danny Futures Co.	1987	6	951,502	158,583.61	100.00%	951,502	1,117,204.74
Elic Limited	1987	14	2,372,461	169,461.50	84.30%	2,000,000	2,348,298.00
Henyep NCZ Ltd.	1987	1	176,388	176,388.00	100.00%	176,388	207,105.79
Joyee Investment (HK) Ltd.	1987	9	20,875,246	2,319,471.72	9.58%	2,000,000	2,348,298.00
Kobayashi (HK) Ltd.	1987	4	508,134	127,033.50	100.00%	508,134	596,625.03
Malahon Commodities Futures Ltd.	1987	19	1,910,427	100,548.77	100.00%	1,910,427	2,243,125.45
Manishing Investment Ltd.	1987	6	4,873,519	812,253.17	41.04%	2,000,000	2,348,298.00
Nishida (HK) Co. Ltd.	1987	2	53,098	26,549.00	100.00%	53,098	62,344.96
Onapal Ltd.	1987	1	81,000	81,000.00	100.00%	81,000	95,106.07
Polosum Trading Ltd.	1987	9	4,705,792	522,865.72	42.50%	2,000,000	2,348,298.00
Right Time Commodities	1987	1	484,111	484,111.07	100.00%	484,111	568,418.53
Whittal Commodities Co. Ltd.	1987	5	8,730,173	1,746,034.50	22.91%	2,000,000	2,348,298.00
Wing Hung Kee Commodities Ltd.	1987	1	71,150	71,149.50	100.00%	71,150	83,540.11
Wintakly Commodity Ltd.	1987	7	1,192,767	170,395.28	100.00%	1,192,767	1,400,486.16
Winton Commence Ltd.*	1998	21	3,746,203	178,390.61	100.00%	3,746,203	3,993,427.65

\*In the Winton case, the total allowed amount exceeded the statutory limit of HK\$2 million per broker under the Commodities Trading Ordinance ("CTO"). Hong Kong Futures Exchange, with SFC's approval, increased the limit under CTO section 90(5) to enable payment to claimants of the full amounts allowed.

## PART XII

## INVESTOR COMPENSATION

**228. Interpretation of Part XII**

In this Part, unless the context otherwise requires—

“compensation” (賠償) means compensation payable out of the compensation fund under rules made under section 236;

“Futures Exchange Compensation Fund” (期交所賠償基金) means the compensation fund established under Part VIII of the repealed Commodities Trading Ordinance;

“Unified Exchange Compensation Fund” (聯交所賠償基金) means the compensation fund established under Part X of the repealed Securities Ordinance.

**229. Establishment of compensation fund**

The Commission shall establish and maintain a compensation fund, to be known as the Investor Compensation Fund in English and “投資者賠償基金” in Chinese, for the purposes of this Part.

**230. Money constituting the compensation fund**

(1) The compensation fund shall consist of—

- (a) all amounts paid to the Commission or a recognized investor compensation company in accordance with rules made under this Part;
- (b) all amounts paid into the compensation fund under sections 72(2) or (8)(b), 73(2) or (8)(b) and 74(11) of Schedule 9;
- (c) all amounts recovered by the Commission or a recognized investor compensation company in exercise of a right of action conferred by section 87 or 235;
- (d) all amounts borrowed under subsection (2);

- (e) any return or profit received on an investment made under section 233;
  - (f) all other amounts lawfully paid into the compensation fund.
- (2) With the consent in writing of the Financial Secretary, the Commission may, for the purposes of the compensation fund, borrow from any authorized financial institution on such terms and at such rates of interest as it considers acceptable and may charge any investments acquired under section 233 by way of security for any such loan.

### 231. Money to be kept in account

The Commission shall open at one or more authorized financial institutions one or more accounts and shall, pending their application in accordance with this Part, pay into or transfer to such account or accounts all amounts forming part of the compensation fund.

### 232. Accounts of compensation fund

- (1) The Commission shall keep proper accounts of the compensation fund.
- (2) The Commission may, if it considers it necessary to do so—
- (a) maintain separate accounts in respect of the amounts that are respectively paid into the compensation fund under sections 72, 73 and 74 of Schedule 9;
  - (b) maintain separate accounts in respect of the compensation fund—
    - (i) for different—
      - (A) recognized exchange companies;
      - (B) markets operated by recognized exchange companies;
      - (C) persons providing automated trading services; or
      - (D) classes of investors; or
    - (ii) for the better and more effectual management or administration of the fund;
  - (c) maintain sub-accounts in respect of the separate accounts referred to in paragraph (a) or (b) in such manner as it considers appropriate.
- (3) The Commission shall in respect of the financial year beginning before and ending after the day on which this section commences, and in respect of each subsequent financial year, prepare—
- (a) a financial statement made up to (and including) the last day of that year; and
  - (b) in the case where separate accounts are maintained under subsection (2)(a) or (b) or sub-accounts are maintained under subsection (2)(c)—

- (i) a consolidated financial statement made up to (and including) the last day of that year, in respect of the separate accounts or sub-accounts (as the case may be); and
- (ii) a separate financial statement made up to (and including) the last day of that year, in respect of each separate account or sub-account (as the case may be).

(4) A financial statement prepared under subsection (3) shall be signed by the chairman and at least one non-executive director of the Commission.

(5) The Commission shall appoint an auditor to audit the compensation fund.

(6) The auditor so appointed shall annually audit the accounts of the compensation fund and shall audit, and prepare an auditor's report in respect of, each financial statement prepared under subsection (3) and shall submit the report to the Commission.

(7) An auditor's report prepared under subsection (6) shall contain a statement made by the auditor as to whether in his opinion the financial statement gives a true and fair view of the matters to which the statement relates.

(8) The auditor appointed under this section may call for and inspect such books and records of the Commission or any recognized investor compensation company as he may require in order to perform his functions under this section.

(9) Not later than 4 months after the end of each financial year the Commission shall cause—

- (a) a copy of—
  - (i) each audited financial statement in respect of that financial year; and
  - (ii) the auditor's report on each such financial statement, to be sent to the Financial Secretary; and
- (b) a copy of each such audited financial statement to be published in the Gazette.

(10) In this section, "financial statement" (財務報表) means a statement which contains all of the following documents—

- (a) a revenue and expenditure account;
- (b) a balance sheet; and
- (c) a cash flow statement.

### 233. Investment of moneys

(1) The Commission may invest any money which forms part of the compensation fund and is not immediately required for any other purposes provided for by this Part—

- (a) on fixed deposit with an authorized financial institution; or

(b) in securities in which trustees are authorized by law to invest trust funds.

(2) Any return or profit on an investment of moneys by the Commission under subsection (1) shall be added to the compensation fund.

(3) A fixed deposit receipt and other document evidencing the investment of money under subsection (1) may be kept in the office of the Commission or deposited for safe keeping with an authorized financial institution.

#### 234. Payments out of the compensation fund

(1) Subject to this Part, there shall from time to time be paid out of the compensation fund as required and in such order as the Commission may determine one or more of the following amounts—

- (a) all legal and other expenses incurred—
  - (i) in investigating or defending claims for compensation made under rules made under this Part;
  - (ii) in relation to the compensation fund;
  - (iii) in the exercise by the Commission of the rights, powers, and authorities vested in it by this Part or rules made under this Part in relation to the compensation fund;
  - (iv) in the exercise by a recognized investor compensation company of a function transferred to it under section 80 or provided for under rules made under this Part;
- (b) the expenses incurred in the management or administration of the compensation fund;
- (c) the expenses incurred in obtaining insurance, surety, guarantee or other security, or in making any financial arrangement, in respect of claims for compensation made under rules made under this Part;
- (d) interest on any sum borrowed under section 230(2);
- (e) the amounts of claims for compensation, costs of and incidental to the making and proving of such claims and interest on compensation, as allowed under rules made under this Part;
- (f) all other money payable out of the compensation fund in accordance with rules made under this Part.

(2) Where the Commission considers that the amount at credit in either the Unified Exchange Compensation Fund or the Futures Exchange Compensation Fund is insufficient to enable—

- (a) the payment of the amounts which the Commission considers to be necessary to meet any claims or likely claims against the Unified Exchange Compensation Fund or the Futures Exchange Compensation Fund (as the case may be); and



- (b) the repayment of the amounts deposited in cash with the Commission under section 104 of the repealed Securities Ordinance or section 82 of the repealed Commodities Trading Ordinance (as the case may be),

then the Commission shall, subject to subsection (3), pay into the Unified Exchange Compensation Fund or the Futures Exchange Compensation Fund (as the case may be) out of the compensation fund such amount as it considers equitable.

(3) The aggregate amounts paid under subsection (2) to the Unified Exchange Compensation Fund or the Futures Exchange Compensation Fund shall not exceed the respective aggregate amounts paid into the compensation fund under section 72(2) or 73(2) of Schedule 9 (as the case may be).

(4) In the event that the compensation fund is dissolved, the Commission may, in its absolute discretion, after the satisfaction of all outstanding liabilities against the compensation fund, pay—

(a) to the Stock Exchange Company or, if the Stock Exchange Company is in liquidation, to the liquidator of the Stock Exchange Company the whole or a portion of that part of the compensation fund which is derived from the Unified Exchange Compensation Fund under section 72(2) and (8)(b) of Schedule 9, and on any such payment being made those amounts shall form part of the assets of the Stock Exchange Company or, if it is in liquidation, shall be available to the liquidator for distribution in accordance with the Companies Ordinance (Cap. 32); and

(b) to the Futures Exchange Company or, if the Futures Exchange Company is in liquidation, to the liquidator of the Futures Exchange Company the whole or a portion of that part of the compensation fund which is derived from the Futures Exchange Compensation Fund under section 73(2) and (8)(b) of Schedule 9, and on any such payment being made those amounts shall form part of the assets of the Futures Exchange Company or, if it is in liquidation, shall be available to the liquidator for distribution in accordance with the Companies Ordinance (Cap. 32).

**235. Subrogation of the Commission to rights,  
etc. of claimant on payment from  
compensation fund**

(1) Where the Commission makes any payment out of the compensation fund in respect of any claim for compensation made under rules made under this Part—

- (a) the Commission shall be subrogated, to the extent of that payment, to all the rights and remedies of the claimant in relation to the loss sustained by him by reason of the default on which the claim was based; and
  - (b) the claimant shall have no right in bankruptcy or winding up or by legal proceedings or otherwise to receive in respect of the loss any sum out of the assets of the exchange participant or other person concerned who is in default, or where the loss was caused by the defalcation, fraud or misfeasance of an employee of that exchange participant or that other person, the assets of that employee, until the Commission has been reimbursed the full amount of its payment.
- (2) All amounts recovered by the Commission under subsection (1) shall become part of the compensation fund.

**236. Rules by Chief Executive in Council and Commission**

- (1) The Chief Executive in Council may make rules for the following matters—
- (a) the means of funding the compensation fund;
  - (b) the maximum amount of compensation that may be paid to a person making a claim for compensation;
  - (c) the maintenance of sub-accounts under section 232(2)(c), payments to be made from such sub-accounts and the apportionment between different sub-accounts of expenses incurred in relation to the compensation fund and of interest earned on the fund;
  - (d) providing for the better carrying out of the objects and purposes of this Part.
- (2) Without prejudice to section 384(9) and (10), the Commission may, subject to subsection (3), make rules which are not inconsistent with rules made by the Chief Executive in Council under subsection (1), for the following matters—
- (a) the circumstances in which a person is entitled to claim compensation;
  - (b) the manner in which the claim for compensation is to be made;
  - (c) the payment of costs of and incidental to the making and proving of a claim for compensation;
  - (d) the payment of interest on the amount of compensation;
  - (e) the information or documents to be supplied to the Commission for the purpose of enabling the Commission to determine the application;

- (*f*) the persons or classes of persons who are not entitled to make a claim for compensation;
  - (*g*) the circumstances and manner in which the Commission may call for claims for compensation;
  - (*h*) the circumstances and manner in which the Commission may determine, deal with and pay a claim for compensation;
  - (*i*) enabling the Commission—
    - (i) to submit a claim for compensation as a proof of debt in any winding-up or bankruptcy proceedings;
    - (ii) to pay compensation in the form of securities and to purchase securities for that purpose; and
    - (iii) to require the assignment of a claimant's rights of action as a pre-condition for the payment of compensation;
  - (*j*) the functions of a recognized investor compensation company in relation to the management or administration of the compensation fund;
  - (*k*) the formulation of proper accounting and auditing systems with respect to the management or administration of the compensation fund for which a recognized investor compensation company may be responsible upon a transfer of a function to it under section 80;
  - (*l*) arrangements that are to be made when a recognized investor compensation company is wound up;
  - (*m*) the obtaining of such insurance, surety, guarantee or other security or the making of such financial arrangement as may be necessary or appropriate for the better carrying out of the objects and purposes of this Part;
  - (*n*) providing for the better carrying out of the objects and purposes of this Part.
- (3) The Commission shall consult the Financial Secretary before making rules under subsection (2) for the matters specified in paragraphs (*a*) and (*f*) of that subsection.

**Division 5—Investor compensation companies****79. Recognition of investor compensation company**

- (1) Where the Commission is satisfied that it is appropriate to do so—
- (a) in the interest of the investing public or in the public interest; or
  - (b) for the facilitation of the management and administration of the compensation fund under Part XII,

it may, after consultation with the Financial Secretary, by notice in writing served on a company, recognize the company as an investor compensation company—

- (i) subject to such conditions as it considers appropriate specified in the notice; and
  - (ii) with effect from a date specified in the notice for the purpose.
- (2) Without limiting the generality of conditions which may be specified in a notice under subsection (1), the Commission may, by notice in writing served on a recognized investor compensation company, amend or revoke any condition specified in the first-mentioned notice or impose new condition, where the Commission—

- (a) is satisfied that it is appropriate to do so on a ground specified in paragraph (a) or (b) of that subsection; and
  - (b) has consulted the Financial Secretary.
- (3) Where the Commission amends or revokes any condition or imposes any new condition by a notice under subsection (2), the amendment, revocation or imposition takes effect at the time of service of the notice or at the time specified in the notice, whichever is the later.
- (4) Where a company becomes a recognized investor compensation company, the Commission shall cause notice of that fact to be published in the Gazette.
- (5) Where a company is seeking to be a recognized investor compensation company and the Commission is minded not to recognize the company under subsection (1), the Commission shall give the company a reasonable opportunity of being heard before making a decision not to recognize the company.

#### 80. Transfer and resumption of functions of Commission

- (1) The Commission may request the Chief Executive in Council to transfer, by order (“transfer order”) published in the Gazette, to a recognized investor compensation company (“designated investor compensation company”), a function to which this section applies, if the Commission is satisfied that the designated investor compensation company is willing and able to perform the function.
- (2) This section applies to a function of the Commission under Part XII (other than section 236(2)) or rules made under that Part.
- (3) For the purposes of subsection (2), the function of the Commission under Part XII to maintain the compensation fund includes a function to maintain all or any part of the compensation fund, and the other provisions of this Ordinance shall apply accordingly.
- (4) A function to which this section applies may be transferred by a transfer order either in whole or in part, and the transfer may be subject to—
- (a) a reservation that the Commission is to perform the function concurrently with the designated investor compensation company; and
  - (b) such other conditions as the Commission considers appropriate.
- (5) A transfer order may contain such incidental, supplemental and consequential provisions as may be necessary or expedient for the purpose of giving full effect to the order.
- (6) The Commission may at the request or with the consent of a designated investor compensation company resume a function transferred by a transfer order, but the resumption takes effect only by order of the Chief Executive in Council.

(7) The Chief Executive in Council may order that the Commission resume a function transferred to a designated investor compensation company by a transfer order if the Commission so requests and if it appears to the Chief Executive in Council to be in the public interest to do so.

### 81. Immunity, etc.

(1) Without limiting the generality of section 368(1), no civil liability, whether arising in contract, tort, defamation, equity or otherwise, shall be incurred by—

- (a) a recognized investor compensation company; or
  - (b) any person acting on behalf of a recognized investor compensation company, including—
    - (i) any member of the board of directors of the company; or
    - (ii) any member of any committee established by the company,
- in respect of anything done or omitted to be done in good faith in the discharge or purported discharge of the duties to which this subsection applies.

(2) The duties to which subsection (1) applies are those—

- (a) that relate to or arise out of a function that has been transferred to the recognized investor compensation company under section 80; or
- (b) to which the company is subject under rules made under Part XII.

(3) Any failure by a recognized investor compensation company to comply with its rules in relation to a matter does not prevent the matter from being treated for the purposes of this Ordinance as done in accordance with the rules so long as the failure does not substantially affect the rights of a person entitled to require compliance with the rules.

### 82. Rules by recognized investor compensation company

Without limiting any of its other powers to make rules, a recognized investor compensation company may make rules for such matters as are necessary or desirable—

- (a) for the proper and efficient management and operation of the company;
- (b) for the obtaining of such insurance, surety, guarantee or other security or the making of such financial arrangement by the company as may be necessary or appropriate for the purposes of its operation;
- (c) for the proper and efficient performance of a function transferred to the company under section 80.

**83. Approval of rules or amendments to rules of recognized investor compensation companies**

(1) Subject to subsection (7), no rule (whether or not made under section 82) of a recognized investor compensation company or any amendment thereto shall have effect unless it has the approval in writing of the Commission.

(2) A recognized investor compensation company shall submit or cause to be submitted to the Commission—

(a) for its approval the rules and every amendment thereto that require approval under subsection (1), together with explanations of their purpose and likely effect, including their effect on the investing public, in sufficient detail to enable the Commission to decide whether to approve them or refuse to approve them; and

(b) for its information the rules which belong to a class the subject of a declaration under subsection (7) and every amendment to the rules, as soon as reasonably practicable after they have been made.

(3) The Commission shall, not later than 6 weeks after the receipt of a submission under subsection (2)(a) from a recognized investor compensation company, by notice in writing served on the company, give its approval or refuse to give its approval (together with its reasons for the refusal) to the rules or amendment of the rules (as the case may be) or any part thereof, the subject of the submission.

(4) The Commission may give its approval under subsection (3) subject to requirements which shall be satisfied before the rules or amendment of the rules or any part thereof take effect.

(5) The Commission may in a particular case, with the agreement of the recognized investor compensation company concerned, extend the time prescribed in subsection (3).

(6) The Financial Secretary may, after consultation with the Commission and the recognized investor compensation company concerned, extend the time prescribed in subsection (3).

(7) The Commission may, by notice published in the Gazette, declare any class of rules of a recognized investor compensation company to be a class of rules which are not required to be approved under subsection (1) and, accordingly, any rules of the company which belong to that class (including any amendment thereto) shall have effect notwithstanding that they have not been so approved.

(8) A recognized investor compensation company shall make its rules available to the public in a manner approved by the Commission.

(9) Neither the rules under section 82 nor a notice under subsection (7) is subsidiary legislation.

**84. Production of records, etc. by recognized investor compensation company**

(1) The Commission may, by notice in writing served on a recognized investor compensation company, require the company to provide to the Commission, within such period as the Commission may specify in the notice—

- (a) such books and records kept by it in connection with or for the purposes of its business or in respect of the management and administration of the compensation fund under Part XII; and
- (b) such other information relating to its business or the management and administration of the compensation fund under Part XII,

as the Commission may reasonably require for the performance of its functions.

(2) A recognized investor compensation company served with a notice under subsection (1) which, without reasonable excuse, fails to comply with the notice commits an offence and is liable on conviction to a fine at level 5.

**85. Withdrawal of recognition of investor compensation company**

(1) Subject to subsections (2), (3) and (4), the Commission may, after consultation with the Financial Secretary, by notice in writing served on a recognized investor compensation company, withdraw the company's recognition as an investor compensation company with effect from a date specified in the notice for the purpose.

(2) The Commission may only serve a notice under subsection (1) in relation to a recognized investor compensation company that—

- (a) fails to comply with any requirement of this Ordinance or with a condition imposed under section 79;
- (b) is being wound up;
- (c) ceases to perform any function transferred to it under section 80;
- or
- (d) requests the Commission to do so.

(3) Except where responding to a request under subsection (2)(d), the Commission shall not exercise its power under subsection (1) in relation to a recognized investor compensation company unless it has given the company a reasonable opportunity of being heard.

(4) Except where responding to a request under subsection (2)(d), the Commission shall give the recognized investor compensation company not less than 14 days' notice in writing of its intention to serve a notice under subsection (1) and the grounds for doing so.



(5) Where the Commission withdraws a company's recognition as an investor compensation company under subsection (1), it shall cause notice of that fact to be published in the Gazette.

(6) A notice served under this section shall take effect immediately.

#### **86. Appeals**

(1) A company served with a notice under section 85(1) may appeal against the notice to the Chief Executive in Council not later than 14 days after the date of service of the notice or such longer period (if any) as the Commission specifies in the notice.

(2) The decision of the Chief Executive in Council on an appeal under subsection (1) shall be final.

#### **87. Subrogation of recognized investor compensation company to rights, etc. of claimant on payment from compensation fund**

(1) Where a recognized investor compensation company makes any payment out of the compensation fund in respect of any claim made under rules made under Part XII—

(a) the company shall be subrogated, to the extent of that payment, to all the rights and remedies of the claimant in relation to the loss sustained by him by reason of the default on which the claim was based; and

(b) the claimant shall have no right in bankruptcy or winding up or by legal proceedings or otherwise to receive in respect of the loss any sum out of the assets of the exchange participant or other person concerned who is in default, or where the loss was caused by the defalcation, fraud or misfeasance of an employee of that exchange participant or that other person, the assets of that employee, until the company has been reimbursed the full amount of its payment.

(2) All amounts recovered by the recognized investor compensation company under subsection (1) shall be paid in such manner as the Commission may direct and shall become part of the compensation fund.

#### **88. Financial statements of a recognized investor compensation company**

(1) Subject to subsection (3), a recognized investor compensation company shall—

- (a) prepare such financial statements and other documents, for such periods, as are prescribed by rules made under section 384 for the purposes of this section; and
  - (b) submit the financial statements and other documents, together with an auditor's report, to the Commission not later than 4 months after the end of the financial year to which they relate.
- (2) Without limiting the generality of subsection (1), the requirements under that subsection relating to the financial statements and other documents, and the auditor's report, referred to in that subsection include the requirements that—
- (a) the financial statements and other documents are to relate to such matters and contain such particulars as are prescribed by rules made under section 384 for the purposes of this section;
  - (b) the auditor's report is to contain such particulars, including such statement of opinion, as are prescribed by the rules;
  - (c) the financial statements and other documents, and the auditor's report, are to be prepared in accordance with such principles or bases as are prescribed by the rules; and
  - (d) without limiting the generality of section 129B of the Companies Ordinance (Cap. 32), the financial statements and other documents are to be signed by the chief executive officer of the recognized investor compensation company, by which they are prepared.
- (3) On an application in writing by the recognized investor compensation company by which any financial statements and other documents, and any auditor's report, are required under subsection (1) to be submitted, the Commission may, where it is satisfied that there are special reasons for so doing, extend the period within which the financial statements and other documents, and the auditor's report, are required to be submitted, for such period and subject to such conditions as the Commission considers appropriate, and upon the Commission granting the extension, subsection (1) shall apply subject to the extension accordingly.
- (4) A recognized investor compensation company shall cause a copy of each of the financial statements and other documents and the auditor's report that are required under subsection (1) to be submitted by it to be sent to the Financial Secretary and to be published in the Gazette.

**89. Employees of and delegations by a recognized investor compensation company**

- (1) The Commission may arrange for any of its officers, employees, agents or consultants to assist in the operations of a recognized investor compensation company.

(2) A recognized exchange company or recognized exchange controller may, with the consent of a recognized investor compensation company, arrange for any of its officers, employees agents or consultants to assist in the operations of that recognized investor compensation company.

(3) A recognized investor compensation company may by resolution and subject to the approval of the Commission, with or without restrictions or conditions as the company considers appropriate, delegate in writing to any person any of its powers and duties other than its power under section 82.

**90. Further activities of recognized investor compensation company**

(1) A recognized investor compensation company may, in addition to performing a function transferred to it under section 80, conduct such activities or businesses as may be approved in writing by the Commission.

(2) The Commission shall not approve the conduct of any activities or businesses referred to in subsection (1) unless it is satisfied that such activities or businesses are incidental to the management or administration of the compensation fund under Part XII.

## Part XII of this Ordinance (Investor compensation)

71. (1) In sections 72 to 74—

“Futures Exchange Compensation Fund” (期交所賠償基金) and “Unified Exchange Compensation Fund” (聯交所賠償基金) have the meanings respectively assigned to them in section 228 of this Ordinance;

“repealed Commodities Trading Rules” (已廢除的《商品交易規則》) means the Commodities Trading (Dealers, Commodity Trading Advisers and Representatives) Rules (Cap. 250 sub. leg.) repealed under section 392 of this Ordinance;

“repealed Contract Levy Rules” (已廢除的《合約徵費規則》) means the Commodities Trading (Contract Levy) Rules (Cap. 250 sub. leg.) repealed under section 392 of this Ordinance;

“repealed Securities Rules” (已廢除的《證券規則》) means the Securities (Miscellaneous) Rules (Cap. 333 sub. leg.) repealed under section 392 of this Ordinance.

(2) For the avoidance of doubt, it is hereby declared that nothing in sections 72 to 74 shall be construed as enabling a claim to be made which is barred under any enactment or rule of law.

## Unified Exchange Compensation Fund

72. (1) Despite the repeals effected by section 392 of this Ordinance, Part X of the repealed Securities Ordinance shall, subject to this section, continue to apply to and in relation to—

- (a) any claim for compensation from the Unified Exchange Compensation Fund made under that Part before the appointed day; or
- (b) any default occurring before the appointed day,

as if that section had not been enacted, subject to the following modifications—

- (i) section 112 of that Part X shall cease to apply as from the appointed day;
- (ii) for any reference to the Unified Exchange, there shall be substituted a reference to a recognized stock market within the meaning of this Ordinance;
- (iii) for any reference to the Exchange Company, there shall be substituted a reference to the Stock Exchange Company within the meaning of this Ordinance; and
- (iv) the expressions “dealing in securities”, “exchange participant”, “listed”, “securities” and “trading right” shall respectively be construed in accordance with this Ordinance.

(2) The Commission may after the appointed day pay into the compensation fund such sum of money from the Unified Exchange Compensation Fund as it considers appropriate, having regard to—

- (a) the amounts which the Commission considers to be necessary to meet any claims or likely claims against the Unified Exchange Compensation Fund; and
- (b) the amounts deposited in cash under section 104 of the repealed Securities Ordinance.

(3) As soon as reasonably practicable after the appointed day, the Stock Exchange Company shall publish in one or more English language newspapers and one or more Chinese language newspapers, published daily and circulating generally in Hong Kong, a notice specifying a date, not being earlier than 3 months after the publication of the notice, on or before which a claim for compensation from the Unified Exchange Compensation Fund may be made by any person.

(4) Where, in respect of a default occurring prior to the appointed day, a person wishes to start a claim for compensation from the Unified Exchange Compensation Fund, he shall lodge his claim in writing with the Stock Exchange Company—

- (a) if a notice under subsection (3) has been published, on or before the date specified in the notice; or
- (b) if no such notice has been published, within 6 months after he became aware of the default giving rise to the claim.

(5) A claim made under subsection (4) shall be regarded as a claim made under section 109 of the repealed Securities Ordinance and other provisions of Part X of that Ordinance shall apply accordingly.

(6) A claim that is not made within the time limited by subsection (4) shall, unless the Stock Exchange Company otherwise determines, be barred.

(7) After—

- (a) all claims made or continued under this section have been disposed of; and
- (b) all outstanding liabilities against the Unified Exchange Compensation Fund have been satisfied,

the Commission shall apply any balance remaining in the Fund in accordance with subsection (8).

(8) Any balance mentioned in subsection (7) shall—

- (a) be used to repay the Stock Exchange Company or, if the Stock Exchange Company is in liquidation, the liquidator of the Stock Exchange Company, the amounts deposited in cash under section 104 of the repealed Securities Ordinance, to the extent that the balance is sufficient for this purpose and provided such deposits have not previously been repaid; and on any such payment being made those amounts shall form part of the assets of the Stock Exchange Company and, if it is in liquidation, shall be available to the liquidator for distribution in accordance with the Companies Ordinance (Cap. 32); and
- (b) if there is any remaining balance, be paid into the compensation fund.

(9) Where a claim for compensation from the Unified Exchange Compensation Fund is allowed (whether in full or in part) but the amount allowed cannot be paid to the claimant because the Commission is unable to locate the claimant, then the Commission shall hold for the claimant the amount allowed for 3 years beginning with the date on which the claim is allowed, after which time the Commission shall apply the amount in accordance with subsection (8).

(10) Except as provided in this section, no claim for compensation from the Unified Exchange Compensation Fund may be made after the appointed day.

(11) The Secretary for Financial Services may by notice published in the Gazette appoint a date as the appointed day for the purposes of this section.

(12) In this section—

“appointed day” (指定日期) means the date appointed under subsection (11);

“default” (違責) means a default referred to in section 109(1) of the repealed Securities Ordinance.

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#### Futures Exchange Compensation Fund

73. (1) Despite the repeals effected by section 392 of this Ordinance, Part VIII of the repealed Commodities Trading Ordinance and the repealed Contract Levy Rules shall, subject to this section, continue to apply to and in relation to—

- (a) any claim for compensation from the Futures Exchange Compensation Fund made under that Part before the appointed day; or
- (b) any default occurring before the appointed day,

as if that section had not been enacted, subject to the following modifications—

- (i) section 89 of that Part VIII shall cease to apply as from the appointed day;
- (ii) for any reference to the Commodity Exchange, there shall be substituted a reference to a recognized futures market within the meaning of this Ordinance;
- (iii) for any reference to the Exchange Company, there shall be substituted a reference to the Futures Exchange Company within the meaning of this Ordinance; and
- (iv) the expressions “exchange participant”, “futures contracts” and “trading right” shall respectively be construed in accordance with this Ordinance.

(2) The Commission may after the appointed day pay into the compensation fund such sum of money from the Futures Exchange Compensation Fund as it considers appropriate, having regard to—

- (a) the amounts which the Commission considers to be necessary to meet any claims or likely claims against the Futures Exchange Compensation Fund; and
- (b) the amounts deposited in cash under section 82 of the repealed Commodities Trading Ordinance.

(3) As soon as reasonably practicable after the appointed day, the Futures Exchange Company shall publish in one or more English language newspapers and one or more Chinese language newspapers, published daily and circulating generally in Hong Kong, a notice specifying a date, not being earlier than 3 months after the publication of the notice, on or before which a claim for compensation from the Futures Exchange Compensation Fund may be made by any person.

(4) Where, in respect of a default occurring prior to the appointed day, a person wishes to start a claim for compensation from the Futures Exchange Compensation Fund, he shall lodge his claim in writing with the Futures Exchange Company—

- (a) if a notice under subsection (3) has been published, on or before the date specified in the notice; or
- (b) if no such notice has been published, within 6 months after he became aware of the default giving rise to the claim.

(5) A claim made under subsection (4) shall be regarded as a claim made under section 87 of the repealed Commodities Trading Ordinance and other provisions of Part VIII of that Ordinance shall apply accordingly.

(6) A claim that is not made within the time limited by subsection (4) shall, unless the Futures Exchange Company otherwise determines, be barred.

(7) After—

- (a) all claims made or continued under this section have been disposed of; and
- (b) all outstanding liabilities against the Futures Exchange Compensation Fund have been satisfied,

the Commission shall apply any balance remaining in the Fund in accordance with subsection (8).

(8) Any balance mentioned in subsection (7) shall—

- (a) be used to repay the Futures Exchange Company or, if the Futures Exchange Company is in liquidation, the liquidator of the Futures Exchange Company, the amounts deposited in cash under section 82 of the repealed Commodities Trading Ordinance, to the extent that the balance is sufficient for this purpose and provided such deposits have not previously been repaid; and on any such payment being made those amounts shall form part of the assets of the Futures Exchange Company and, if it is in liquidation, shall be available to the liquidator for distribution in accordance with the Companies Ordinance (Cap. 32); and
- (b) if there is any remaining balance, be paid into the compensation fund.

(9) Where a claim for compensation from the Futures Exchange Compensation Fund is allowed (whether in full or in part) but the amount allowed cannot be paid to the claimant because the Commission is unable to locate the claimant, then the Commission shall hold for the claimant the amount allowed for 3 years beginning with the date on which the claim is allowed, after which time the Commission shall apply the amount in accordance with subsection (8).

(10) Except as provided in this section, no claim for compensation from the Futures Exchange Compensation Fund may be made after the appointed day.

(11) The Secretary for Financial Services may by notice published in the Gazette appoint a date as the appointed day for the purposes of this section.

(12) In this section—

“appointed day” (指定日期) means the date appointed under subsection (11);

“default” (違責) means a default referred to in section 87(1) of the repealed Commodities Trading Ordinance.

#### Dealers Deposit Scheme

74. (1) Despite the repeals effected by section 392 of this Ordinance—

- (a) sections 52 (except subsections (1), (1A) and (6)) and 52A of the repealed Securities Ordinance;

(b) rules 2, 4, 5 and 6 (other than rule 6(4)) of the repealed Securities Rules;  
 (c) section 33 of the repealed Commodities Trading Ordinance; and  
 (d) Parts I and III (other than rule 15(5)) of the repealed Commodities Trading Rules,  
 shall, subject to this section, continue to apply for the purposes of this section as if that section 392 had not been enacted.

(2) Where, prior to the appointed day—

(a) there arises any of the circumstances described in section 52(2) or (11) of the repealed Securities Ordinance or section 33(1) or (11) of the repealed Commodities Trading Ordinance; and

(b) no transfer, payment, forfeiture or application for release of the deposit (as the case may be) paid or deposited by the dealer concerned has been made pursuant to either of those sections,

then such transfer, payment, forfeiture or application for release and any subsequent application of such deposit may be made under the applicable provisions specified in subsection (1).

(3) A claim for compensation made before the appointed day in respect of a default occurring prior to that day that has not been disposed of may be continued and disposed of under subsection (1).

(4) As soon as reasonably practicable after the appointed day, the Commission shall publish in one or more English language newspapers and one or more Chinese language newspapers, published daily and circulating generally in Hong Kong, a notice specifying a date, not being earlier than 3 months after the publication of the notice, on or before which a claim for compensation against the deposit forfeited under section 52(2)(c) of the repealed Securities Ordinance or section 33(1)(c) of the repealed Commodities Trading Ordinance may be made.

(5) Where, in respect of a default occurring prior to the appointed day, a person wishes to start a claim for compensation against any deposit referred to in subsection (4), he shall lodge his claim in writing with the Commission—

(a) if a notice under subsection (4) has been published, on or before the date specified in the notice; or

(b) if no such notice has been published, within 6 months after he became aware of the default giving rise to the claim.

(6) A claim made under subsection (5) shall be regarded as a claim made under rule 6(5) of the repealed Securities Rules or rule 15(6) of the repealed Commodities Trading Rules (as the case may be), and other provisions of the Rules shall apply accordingly.

(7) A claim that is not made within the time limited by subsection (5) shall, unless the Commission otherwise determines, be barred.

(8) Where a claim made or continued under this section is not allowed or the amount or amounts determined to be payable as compensation do not exceed the amount of the deposit, the Commission shall repay the deposit to which the claim relates or the remaining balance of the deposit (as the case may be) to the dealer concerned.

(9) Where—

(a) a deposit made under section 52 of the repealed Securities Ordinance or section 31 of the repealed Commodities Trading Ordinance has not been or is not required to be disposed of under the Ordinance; and

(b) the deposit is not required to be disposed of under this section,

the Commission shall repay the deposit to the dealer concerned.

(10) Where a claim made or continued under this section is allowed (whether in full or in part) but the amount allowed cannot be paid to the claimant because the Commission is unable to locate the claimant, then the Commission shall hold for the claimant the amount allowed for 3 years beginning with the date on which the claim is allowed, after which time the Commission shall repay the amount to the dealer concerned.

(11) Where—

(a) a deposit or its remaining balance is required to be repaid to a dealer under subsection (8) or (9) or any amount is required to be repaid to a dealer under subsection (10); but

(b) the Commission is unable to locate the dealer for the purpose of repayment during the period of 3 years beginning with—

(i) in the case of subsection (8), the date of the determination of the claim;

(ii) in the case of subsection (9), the appointed day; or

(iii) in the case of subsection (10), the end of the 3-year period referred to in that subsection,  
the Commission shall pay the deposit or the remaining balance or the amount (as the case may be) to the compensation fund.

(12) Except as provided in this section, no claim for compensation may be made against any deposit forfeited under section 52(2)(c) of the repealed Securities Ordinance or section 53(1)(c) of the repealed Commodities Trading Ordinance after the appointed day.

(13) The Secretary for Financial Services may by notice published in the Gazette appoint a date as the appointed day for the purposes of this section.

(14) In this section—  
“appointed day” (指定日期) means the date appointed under subsection (13);  
“default” (違責) means a default referred to in rule 6(2) of the repealed Securities Rules or rule 15(2) of the repealed Commodities Trading Rules.