LEGCO FINANCIAL AFFAIRS PANEL
PAPER FOR THE MEETING ON 29 MARCH 2001

PROPOSED NEW INVESTOR COMPENSATION ARRANGEMENTS

Purpose

1. This paper outlines the salient points of the consultation paper entitled "Proposed New Investor Compensation Arrangements" published by the Securities and Futures Commission ("SFC") on 7 March 2001 (copies of the paper were distributed to members of Panel on the same day).

General Principles

2. The 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 pay and providing compensation for all retail investors irrespective of the intermediary through whom they trade.

The Proposed New Arrangements

Expanded Coverage of Intermediaries

3. The SFC is proposing to extend the coverage of the new arrangements to defaults by all persons who are licensed to deal in securities, commodity futures contracts or securities margin financing in relation to products traded on the HKEx. This includes participants of the stock and futures exchanges and non-exchange participants. The SFC also proposes that coverage should extend to defaults by Authorized Institutions who are exempt from SFC licensing and subject to regulation by the Hong Kong Monetary Authority.

Per Investor Limit

4. The existing compensation funds of the Stock Exchange of Hong Kong ("SEHK") and the Hong Kong Futures Exchange ("HKFE") have a statutory per broker default limit of $8 million and $2 million respectively. The new arrangements would replace the per broker limit with a limit of compensation per investor, thus giving certainty of

compensation level to investors. The limit is proposed to be $150,000 initially and would be reviewed as necessary.

Basis for making claims

5. The basis for making compensation claims would largely follow existing arrangements, under which a claim 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 as a result of default by the covered intermediary. Specified institutional investors would not be eligible for claiming compensation. This is consistent with provisions under existing arrangements.

A New Single Investor Compensation Fund

6. A new single Investor compensation Fund would be set up to replace the two existing compensation funds and the Dealers' Deposit Schemes for non-exchange participant dealers. The new arrangements would eliminate the existing requirements for exchange participant dealers to make refundable deposits to the compensation funds and for other dealers to make deposits to the Dealers' Deposit Schemes. Existing deposits in the total amount of about $114 million 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 compensation amounts paid out.

The Investor Compensation Company

7. The compensation 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. It is proposed that the ICC Board should include representatives of the SFC, HKEx, the intermediary community and the "public interest". The ICC would only have a skeleton staff and the initial annual costs are estimated at $3,500,000. ICC could outsource claims processing if the workload is beyond its capacity.

Risk assessment

8. The SFC has set out in the consultation paper a model to assess, among other things, ICC's risk and funding needs. The model draws on the data

from the experience of the historical broker defaults and the data collected from brokers during surveys. Such data are used to estimate what the losses to investors and what the expense to the Fund might be were the historical losses to be updated to allow for the growth of the market, the increase in the number of investors and the payment of a per investor level of compensation. 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.

9. The model was used to simulate the condition of the ICC over a ten-year period under various scenarios. The simulations show that ICC can be expected to need additional funds and/or a regular funding source to sustain its operation unless historical losses were to decrease significantly. Simulation of catastrophe losses over the ten-year period show that in these cases, there would be a need for contingency funding and for additional levy on transactions for a few years to pay off the loan and interest. Assuming no catastrophe, the SFC estimates that it would be desirable to build up the assets of the new Fund up to the desired level of $1 billion.

Funding

10. Initial funding for the Fund would come from a transfer of assets in the existing compensation funds, but with sufficient amounts reserved in those funds to cover outstanding liabilities. The initial funding from this source is approximately $655.8 million, which is sensitive to possible intervening default cases. In order to provide reasonable protection to investors, the SFC recommends 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 securities transactions in the SEHK by 0.002 percentage points and having the SFC pay the additional 0.002% levy into the existing UECF for transfer to the new Fund when formed. Meanwhile, the existing $0.5 levy for each side of a contract executed on the HKFE is proposed to continue for the new Fund.

11. As announced by the Financial Secretary in his Budget Speech, the proposed increase of 0.002 percentage point to the levy on securities transactions is to last until such time as the new Compensation Fund has accumulated HK$ 1 billion. The proposed increase would be implemented at the same time with the proposed reduction of stamp duty on securities transactions from 0.225% to 0.2%. This will have the combined effect of lowering the cost of securities transactions in Hong Kong.

12. Were a catastrophe to occur, alternative risk transfer mechanisms, contingent capital in the form of credit facility or support from the Hong Kong Government in the form of guarantee or loan would be possible options for funding the ICC.

Market Response

13. The market and the brokerage industry have indicated support to the proposed new compensation arrangements, which would enhance protection for investors and confidence in the market. We would take into consideration any further views obtained during the consultation exercise that will end on 6 April 2001 in finalising the new investors compensation arrangements.

Implementation

14. Under the Securities and Futures Bill, the Chief Executive in Council may make rules to set, amongst other things, the maximum amount that can be paid to a claimant, while the SFC may make rules under the Bill to provide for various matters for the operation of the ICC and the new Fund. The SFC may also determine the amount to be retained in the old funds to provide for outstanding liabilities and to return deposits to the Exchanges and then transfer the balance to the new Fund. We would proceed to make the relevant rules and incorporate the ICC after the enactment of the Securities and Futures Bill.

15. The legislative amendment to increase the rate of levy on securities transactions for contribution to the new Investors Compensation Fund will be introduced into the Legislative Council soon together with the proposal to reduce the stamp duty rate.

Securities and Futures Commission
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