

For discussion
on 16 September 2002

Paper No.24/02

**Subcommittee on Draft Subsidiary Legislation to be made
under the Securities and Futures Ordinance**

Securities and Futures (Insurance) Rules

This paper sets out the proposals of the Securities and Futures Commission (SFC) to make rules under section 116(5) of the Securities and Futures Ordinance (SFO) (Cap. 571) to specify the insurance coverage to be taken out and maintained by specified licensed corporations in relation to specified risks, and provide for related matters.

Proposal

2. The SFC proposes to make the Securities and Futures (Insurance) Rules, now in draft at **Annex 1**, under section 116(5) of the SFO.

Power to make the Rules

3. Section 116(3)(c)(ii) of the SFO provides that the SFC shall refuse to grant a licence to carry on a regulated activity under section 116(1) unless the applicant satisfies the SFC that it is insured in accordance with rules made under section 116(5). Section 116(5) of the SFO empowers the SFC to make rules, for the purposes of section 116(3)(c)(ii), that provide for insurance coverage for specified amounts to be taken out and maintained by a licensed corporation in relation to specified risks, the terms on which the insurance is to be taken out and maintained and any other matter relating to the insurance.

4. The SFC is of the view that the draft Rules would be *intra vires* if made as drafted.

Major features of the draft Rules

5. The draft Rules at Annex 1 –

- (a) require licensed corporations that are licensed to carry on dealing in securities, dealing in futures contracts or providing securities margin financing, to take out and maintain insurance, subject to certain exceptions for licensed corporations that are not exchange participants (clause 3);
- (b) specify the amounts for which, and the risks in relation to which, insurance coverage is required (clause 4 and Schedules 2 and 3);
- (c) provide that the SFC may arrange a scheme of insurance under which licensed corporations shall take out and maintain the requisite insurance (clauses 5 and 6);
- (d) provide for the powers of the SFC in arranging the scheme of insurance, including the power to engage persons to assist it (clause 7);
- (e) requiring licensed corporations to submit to the SFC information that it requires for the purpose of arranging the scheme of insurance, and for disclosure by it of that information to other persons for that purpose (clause 9); and
- (f) prescribe minimum credit ratings to be possessed by insurers with whom insurance is taken out and maintained (clauses 3 and 6 and Schedule 4).

6. The SFC considers that by requiring licensed corporations to take out and maintain insurance as specified, the draft Rules would be consistent with the SFC's objectives in section 4(c) of the SFO "to provide protection for members of the public investing in or holding financial products" and section 4(e) "to reduce systemic risks in the securities and futures industry".

Public consultation

7. The SFC released a consultation document and an exposure draft of the Rules on 26 June 2002 for comment by the public. A total of 9 submissions were received. The SFC has considered all the comments received and revised the draft Rules as appropriate. We attach the following documents for Members' reference –

- (a) Consultation Document on the draft Rules, at **Annex 2**, which sets out the underlying policy, together with the exposure draft of the

Rules. The revised draft Rules are at Annex 1 for Members' consideration; and

- (b) Consultation Conclusion and Summary of Comments and SFC's Responses, at **Annex 3**, which set out the conclusions from the consultation and the SFC's responses, in the form of a table, to the comments received. A list of respondents is attached to the Summary of Comments and SFC's Responses.

Way forward

8. Subject to Members' views, the SFC will proceed to make the Rules under the authority vested in it and publish the Rules so made in the Gazette for tabling before the Legislative Council in the normal manner. The intention is that the Rules will come into operation a few months after the commencement of the SFO to coincide with the expiry of the current Brokers' Fidelity Insurance Scheme arranged by the Stock Exchange of Hong Kong Limited for its participants.

Securities and Futures Commission
Financial Services Bureau
7 September 2002

DRAFT

Annex 1

[cf : Section 116 of the Securities and Futures Ordinance]

SECURITIES AND FUTURES (INSURANCE) RULES

CONTENTS

| Section | | Page |
|------------|--|------|
| 1. | Commencement | 1 |
| 2. | Interpretation | 1 |
| 3. | Application | 2 |
| 4. | Duty to insure against specified risks for specified amounts | 5 |
| 5. | Duty to take out and maintain insurance under scheme of insurance | 5 |
| 6. | Commission to arrange scheme of insurance | 6 |
| 7. | Powers of Commission in arranging scheme of insurance | 6 |
| 8. | No refund of premium | 7 |
| 9. | Consent to disclosure of information by Commission for purposes of arranging insurance | 7 |
| 10. | Commission may amend credit ratings | 7 |
| Schedule 1 | Regulated activities in respect of which insurance is required | 8 |
| Schedule 2 | Risks in relation to which insurance is required | 8 |
| Schedule 3 | Insured amounts | 10 |
| Schedule 4 | Credit ratings | 10 |

SECURITIES AND FUTURES (INSURANCE) RULES

(Made by the Securities and Futures Commission under section 116(5)
of the Securities and Futures Ordinance (Cap. 571))

1. Commencement

These Rules shall come into operation on 1 April 2003.

2. Interpretation

(1) In these Rules, unless the context otherwise requires –

“dealing in futures contracts” (期貨合約交易) has the meaning assigned to it by Part 2 of Schedule 5 to the Ordinance;

“dealing in securities” (證券交易) has the meaning assigned to it by Part 2 of Schedule 5 to the Ordinance;

“insurer” (保險人) means a person –

(a) carrying on insurance business in or from Hong Kong under section 6(1) of the Insurance Companies Ordinance (Cap. 41); or

(b) carrying on insurance business in or from any place outside Hong Kong under the law of any place outside Hong Kong;

“premium” (保險費) means the premium that is payable by a specified licensed corporation to the underwriter in respect of a scheme period;

“scheme master policy” (計劃集成保險單) means the policy of insurance issued by the underwriter of a scheme of insurance in respect of a scheme period under which the underwriter provides the insurance referred to in section 4 to a specified licensed corporation;

“scheme of insurance” (保險計劃) means the scheme of insurance referred to in section 6 arranged by the Commission in respect of a scheme period;

“scheme period” (計劃期間) means the period of insurance referred to in a scheme master policy;

“specified amount” (指明款額) means the insured amount per scheme period specified in Schedule 3;

“specified credit rating” (指明信貸評級) means any one of the credit ratings specified in Schedule 4;

“specified licensed corporation” (指明持牌法團) means a corporation that shall comply with these Rules under section 3(1);

“specified risks” (指明風險) means the risks specified in Schedule 2;

“underwriter” (承保人) means one or more insurers with whom the Commission arranges a scheme of insurance in respect of a scheme period.

(2) In these Rules, a reference to a deductible amount, in relation to a policy of insurance under which the insurer is liable for only the part of a loss or claim by a specified licensed corporation that exceeds a certain amount, is a reference to that amount.

3. Application

(1) Subject to subsection (3), a corporation which is granted a licence under section 116(1) of the Ordinance to carry on any regulated activity specified in Schedule 1 shall comply with these Rules.

(2) Notwithstanding subsection (1), these Rules shall have effect in relation to an applicant for the grant of a licence under section 116(1) of the Ordinance to carry on any regulated activity specified in Schedule 1, with necessary modifications.

(3) The corporation referred to in subsection (1) is not obliged to comply with section 4 if it is not an exchange participant and –

- (a) it is granted a licence referred to in that subsection that is subject to a condition that the corporation shall not hold client assets;

- (b) it –
 - (i) is insured in relation to the specified risks for an amount not less than the specified amount by one or more than one insurer that –
 - (A) is not a related corporation of the corporation; and
 - (B) has a specified credit rating when the confirmation referred to in subparagraph (ii) or paragraph (c) or subsection (5) is lodged with the Commission; and
 - (ii) has, not less than 60 days before a scheme period commences, lodged with the Commission a written confirmation from a responsible officer and a legal adviser of the corporation that the corporation is so insured under a policy of insurance when the scheme period commences; or
 - (c) where the corporation is not so insured under paragraph (b)(i), it has, not less than 60 days before a scheme period commences, lodged with the Commission a written confirmation from a responsible officer and a legal adviser of the corporation that it will be so insured under a policy of insurance when the scheme period commences.
- (4) For the purposes of subsection (3)(b)(i) –
- (a) section 1 of Schedule 2 shall be construed as not being subject to section 2 of that Schedule; and
 - (b) the relevant insurance may specify a deductible amount that does not exceed \$3,000,000.

(5) Where a policy of insurance referred to in subsection (3)(b)(ii) or (c) expires before the end of the scheme period referred to in that subsection, and the relevant corporation takes out a new policy of insurance under which it is insured in accordance with subsection (3)(b)(i) immediately after such expiry, the corporation shall, within 7 business days after such expiry, lodge with the Commission a written confirmation from a responsible officer and a legal adviser of the corporation that the corporation is and has since such expiry been so insured.

(6) A confirmation referred to in subsection (3)(b)(ii) or (c) or (5) shall state the commencement and expiry dates of the relevant policy of insurance under which the corporation is, or will be, so insured under subsection (3)(b)(i).

(7) Where –

- (a) a corporation (“first-mentioned corporation”) is an exchange participant, and –
 - (i) is licensed under section 116(1) of the Ordinance for dealing in securities or dealing in futures contracts or both; and
 - (ii) is a related corporation of another corporation (“second-mentioned corporation”) which –
 - (A) is licensed under section 116(1) of the Ordinance for dealing in securities or dealing in futures contracts or both;
 - (B) is not an exchange participant; and
 - (C) is a client of the first-mentioned corporation; and
- (b) the first-mentioned corporation acts as the executing broker for the second-mentioned corporation in respect of the regulated activity in paragraph (a)(ii)(A) that the second-mentioned corporation is licensed to carry on for or on behalf of the second-mentioned corporation’s clients, to

whom the second-mentioned corporation is responsible for the acts of the first-mentioned corporation done in the capacity of being the second-mentioned corporation's executing broker,

then –

- (c) the first-mentioned corporation shall take out and maintain insurance under these Rules that covers the specified risks in relation to both the first-mentioned corporation and second-mentioned corporation in respect of the regulated activity in respect of which the first-mentioned corporation is acting as executing broker for the second-mentioned corporation;
- (d) the specified amount of the insurance under paragraph (c) shall be determined as if the specified licensed corporation is solely the first-mentioned corporation; and
- (e) the second-mentioned corporation shall not be obliged to take out and maintain separate insurance in relation to the specified risks already insured under paragraph (c).

4. Duty to insure against specified risks for specified amounts

(1) Subject to section 3(3) and (7)(e), a specified licensed corporation shall take out and maintain insurance in relation to the specified risks for not less than the specified amount.

(2) The insurance may specify a deductible amount that does not exceed \$3,000,000.

5. Duty to take out and maintain insurance under scheme of insurance

A specified licensed corporation shall take out and maintain insurance referred to in section 4 under a scheme of insurance by –

- (a) paying the premium; and
- (b) complying with the terms and conditions of the scheme master policy,

in respect of each scheme period during which the specified licensed corporation is licensed under section 116(1) of the Ordinance.

6. Commission to arrange scheme of insurance

(1) For the purposes of section 5 and subject to subsection (2), the Commission may arrange with one or more insurers a scheme of insurance under which a specified licensed corporation shall take out and maintain insurance as referred to in section 4 in respect of a scheme period.

(2) The Commission shall not arrange a scheme of insurance in respect of a scheme period with an underwriter unless that underwriter has a specified credit rating on the day the scheme period commences.

7. Powers of Commission in arranging scheme of insurance

(1) Without limiting the generality of section 6, the powers of the Commission in relation to arranging a scheme of insurance under that section includes the power to –

- (a) determine the terms and conditions of the scheme master policy;
- (b) collect the premium from each specified licensed corporation in such manner as the Commission specifies in writing and remit such premiums collected to the underwriter;
- (c) distribute certificates of insurance issued by the underwriter to the relevant specified licensed corporations;
- (d) receive notifications of claims or circumstances likely to give rise to claims under the scheme master policy from

specified licensed corporations and transmit such notifications to the underwriter.

(2) The Commission may engage any person to provide such services as the Commission may consider necessary or desirable to assist it in exercising any part of its powers to arrange a scheme of insurance.

8. No refund of premium

The premium paid by a specified licensed corporation in accordance with these Rules is not refundable.

9. Consent to disclosure of information by Commission for purposes of arranging insurance

(1) A specified licensed corporation shall submit to the Commission (or any person assisting the Commission under section 7(2)) such information about the specified licensed corporation and its business as the Commission may require for the purpose of arranging the scheme of insurance.

(2) A specified licensed corporation shall be regarded as having consented to the disclosure by the Commission (or any person assisting the Commission under section 7(2)) for the purpose of arranging the scheme of insurance to –

- (a) the underwriter; or
- (b) an insurer,

of the information relating to the specified licensed corporation, where that information was obtained by the Commission (or any person assisting the Commission under section 7(2)) from the specified licensed corporation.

10. Commission may amend credit ratings

The Commission may, by notice published in the Gazette, amend Schedule 4.

SCHEDULE 1

[s. 3 & Schs. 2 & 3]

REGULATED ACTIVITIES IN RESPECT OF WHICH
INSURANCE IS REQUIRED

1. Dealing in securities.
2. Dealing in futures contracts.
3. Securities margin financing.

SCHEDULE 2

[ss. 2 & 3]

RISKS IN RELATION TO WHICH INSURANCE IS
REQUIRED

1. Subject to section 2, the risks in relation to which a specified licensed corporation shall take out and maintain insurance are –
 - (a) the risk of loss arising out of the loss of client assets that are received or held by the specified licensed corporation (including client assets that are received or held by an associated entity of the specified licensed corporation) attributable to –
 - (i) fraudulent or dishonest conduct by employees of the specified licensed corporation (or its associated entity or service bureau);
 - (ii) robbery or theft while the client assets are in the custody of the specified licensed corporation (or its associated entity);
 - (iii) forgery or fraudulent alteration of a cheque or other negotiable instrument;
 - (iv) fraudulent use of an information system;

- (v) forged or fraudulent instructions relating to the client assets;
- (b) the risk of loss attributable to –
 - (i) receipt in good faith of counterfeit currency by the specified licensed corporation;
 - (ii) costs and expenses incurred in connection with investigations under the Ordinance or otherwise in relation to the businesses carried on by the specified licensed corporation which constitute any regulated activity specified in Schedule 1;
 - (iii) reasonable fees and expenses incurred by the specified licensed corporation in connection with determining the amount of a loss or claim in respect of which it is insured;
- (c) the risk of loss attributable to negligent conduct by the specified licensed corporation or its employees (or by its associated entity or employees of the associated entity or by its service bureau or employees of the service bureau).

2. The risks specified in section 1 exclude losses which do not arise out of a specified licensed corporation carrying on in Hong Kong any regulated activity specified in Schedule 1.

3. For the purposes of this Schedule –

“employee” (僱員), in relation to a specified licensed corporation, includes an individual who is or has been an employee, officer or licensed representative of the corporation, or who is or has been engaged by the corporation whether under a contract of service or otherwise;

“service bureau” (服務部門), in relation to a specified licensed corporation, means a person to whom the specified licensed corporation has delegated the duty to perform certain functions which are ancillary to the carrying on by the specified licensed corporation of any regulated activity specified in Schedule 1.

SCHEDULE 3

[s. 2]

INSURED AMOUNTS

1. Where a specified licensed corporation is licensed under section 116(1) of the Ordinance to carry on one regulated activity specified in Schedule 1, the insured amount per scheme period is \$15,000,000 in respect of all of the specified risks.
2. Where a specified licensed corporation is licensed under section 116(1) of the Ordinance to carry on more than one regulated activity specified in Schedule 1, the insured amount per scheme period is \$25,000,000 in respect of all of the specified risks.

SCHEDULE 4

[ss. 2 & 10]

CREDIT RATINGS

1. A Moody’s Long-Term Insurance Financial Strength rating of “A” or above.
2. A Standard & Poor’s Insurer Financial Strength rating of “A” or above.
3. A Fitch’s Insurer Financial Strength rating of “A” or above.

Chairman,
Securities and Futures Commission

2002

Explanatory Note

These Rules are made by the Securities and Futures Commission under section 116(5) of the Securities and Futures Ordinance (Cap. 571). They require applicants for licences, and corporations to whom the Commission has granted licences under section 116(1) of the Ordinance to carry on certain regulated activities, to take out and maintain insurance in respect of specified risks and for specified amount, under a scheme of insurance arranged by the Commission. They also prescribe the requirements with which those applicants and licensed corporations must comply in relation to such insurance.



SECURITIES AND
FUTURES COMMISSION
證券及期貨事務監察委員會

Annex 2

A Consultation Document on the Securities and Futures (Insurance) Rules

Hong Kong
June 2002

香港
2002年6月

CONSULTATION

This consultation document invites the public to comment on the draft Securities and Futures (Insurance) Rules (“the draft Rules”) which the Securities and Futures Commission (“the SFC”) proposes to make under **section 116(5)** of the Securities and Futures Ordinance (No. 5 of 2002) (“the Ordinance”).

The SFC maintains that the Rules should be easy to use and they have been drafted in a way that would facilitate compliance and enforcement. Industry practitioners are welcome to give suggestions on any specific area of the draft Rules so as to make them more user-friendly.

Introduction

1. Section 116(3)(c) of the Ordinance provides that the SFC shall refuse to grant a licence to carry on a regulated activity unless the applicant satisfies the SFC that it:
 - (i) has lodged and maintains with the SFC such security in accordance with rules made by the SFC; or
 - (ii) is insured in accordance with rules made by the SFC.
2. For the purposes of licensing, the SFC may therefore choose to require an applicant to comply with any security or insurance requirement by making the relevant rules as it sees fit.
3. In an attempt to develop a more protective coverage for both licensees and investors against infidelity events, errors or omissions on the part of the licensees (including their employees), the SFC inclines to go for the proposal of making rules in relation to insurance requirements instead of security. In making the proposal, the SFC has taken into consideration numerous factors including compensation level, administrative costs and effectiveness in maintaining the overall stability of the financial system with respect to each of the two alternatives as well as the new investor compensation arrangements under the Ordinance.
4. Section 116(5) of the Ordinance empowers the SFC to make rules that provide for:
 - (a) insurance coverage for specified amounts to be taken out and maintained by a licensed corporation in relation to specified risks;
 - (b) the terms on which the insurance is to be taken out and maintained;
 - (c) any other matter relating to the insurance.
5. The draft Rules at [Appendix 1](#) thus set out the relevant insurance requirements for the purposes of licensing. In essence, a compulsory fidelity insurance scheme is proposed (“the Proposed Scheme”) and licensed corporations conducting certain regulated activities as specified in the draft Rules would have to participate in the Proposed Scheme as one of the on-going obligations in maintaining their licences granted by the SFC.

6. The SFC has sent copies of this document to all registered firms using the FinNet communication network. In addition, copies of the document can be obtained free of charge at the SFC's office and on the SFC's website at <http://www.hksfc.org.hk>.
7. The public is invited to submit comments before the close of business on **25 July 2002**.

Background

8. The need for a compulsory fidelity insurance for market participants was first mooted by the Securities Review Committee (chaired by Mr. Ian H Davison) in May 1988. That Committee was formed to review the operation and regulation of the Hong Kong securities industry following the market crash in October 1987. Among other things, the Committee recommended implementing a compulsory fidelity insurance coverage for intermediaries that control client assets in order to foster market stability and investor protection.
9. This recommendation was adopted by the Stock Exchange of Hong Kong Limited ("the SEHK"). Since 1992, the SEHK has required its participants to take part in a compulsory Brokers' Fidelity Insurance ("BFI") Scheme which insures them against losses caused by employees' fraud and theft, error and omission, etc.
10. In April 1996, the SFC further put forth the recommendation by making a policy initiative to impose fidelity insurance requirements on dealers which are not Exchange Participants¹. That initiative was generally welcomed by the industry.
11. Against this background, the SFC now proposes to require a uniform insurance policy (with terms and conditions similar to the current BFI Scheme) to be taken out and maintained by all licensed corporations whose businesses are subject to relatively higher fidelity risk. In this connection, it is considered that the insurance requirement is particularly essential for those licensees which are likely to receive or hold client assets in their business of securities and/or futures dealing.

The Proposed Scheme

12. In making the draft Rules, the SFC intends to develop a compulsory and common insurance scheme to cover all licensed corporations concerned. Therefore, upon implementation, the Proposed Scheme would replace the BFI Scheme which is now arranged for SEHK Participants only.

¹ The proposal was made in the SFC's "Consultation Paper on a draft for a composite Securities and Futures Bill" issued for public comments in April 1996.

13. The basic features and coverage of the Proposed Scheme are exhibited as follows.

Licensed Corporations Concerned

14. Participation in the Proposed Scheme as implemented under the draft Rules would be mandatory to all licensed corporations which:

- (a) deal in securities,
- (b) deal in futures contracts, or
- (c) provide securities margin financing.

15. In other words, the draft Rules would concern corporations licensed for Type 1, Type 2 or Type 8 regulated activity as defined under Schedule 5 to the Ordinance.

16. However, to avoid excessive regulatory burden on licensees, a licensed corporation or an applicant to be licensed for the relevant regulated activities may be exempted from the insurance requirements under the following circumstances:

- (a) The company concerned is not an Exchange Participant; **and**
- (b) It is covered by an insurance policy against specified amount and risks (irrespective of whether the policy covers the company only or a group of companies including the company); or
- (c) It is a related company of an Exchange Participant and it has:
 - (i) entered into a client contract with this Exchange Participant being that company's executing broker; and
 - (ii) entered into third party client contracts or bears responsibility in respect of services or activities of the Exchange Participant; or
- (d) It does not handle client assets.

Specified Risks

17. It is proposed that the insurance coverage would be specific to the licensed corporations' businesses in Hong Kong. As such, overseas branches of licensed corporations would not be indemnified for losses that they may incur in relation to their overseas operations.

18. Broadly speaking, the exposures arising from fraudulent acts by employees or other parties, errors and omissions, etc faced by licensed corporations are more or less similar to each other. Therefore, the Proposed Scheme would be established to indemnify all insured licensees against a uniform spectrum of risks. Basically, the risks as specified in Schedule 2 to the draft Rules would be covered and the major risk categories, which are similar to those currently covered by the BFI Scheme, are summarized as follows:

- A. Risk of loss of client assets of the licensed corporation concerned (including client assets that are received or held by its associated entity) attributable to:
- (a) fraudulent or dishonest acts committed by employees of the corporation or its associated entity;
 - (b) robbery or theft while the client assets are in the custody of the corporation or its associated entity;
 - (c) forgery or fraudulent alteration of a cheque or other negotiable instrument;
 - (d) fraudulent use of an information system;
 - (e) forged or fraudulent instructions relating to client assets.
- B. Risk of loss attributable to negligent acts done or omitted to be done by the licensed corporation concerned or its employees (or by its associated entity or employees of its associated entity).

Indemnity Limit

19. Under the Proposed Scheme, each licensee insured would carry an annual amount of insurance coverage of HK\$15 million in aggregate for all sections of the policy combined. This level of indemnity has proven workable for both the insurance market and the Exchange Participants insured under the BFI Scheme.
20. Where a corporation is licensed for more than one type of regulated activities concerned, e.g. both dealing in securities (Type 1) and dealing in futures contracts (Type 2), the indemnity limit would be increased to HK\$25 million in aggregate for all sections combined per licensee in respect of all regulated activities covered by the insurance.
21. In this regard, although it is not feasible to accurately calculate the exact indemnity limit in light of the increased risk profile due to the carrying out of multiple regulated activities, it is generally believed that the common back office and other functions that the same licensee has maintained would infer the aggregated risk profile to be less than doubled. Based on the above rationale and the recommendation of the SFC's advisers, the indemnity limit for multiple regulated activities per licensee would be increased to HK\$25 million instead of HK\$30 million.

Self-insured Amount (Deductible)

22. Each licensed corporation would be responsible for the first HK\$3 million in each and every loss or claim under the Proposed Scheme. This deductible level is in line with the current requirement of minimum liquid capital applicable to most dealers.

Premium Allocation

23. The SFC recognizes that premium allocation would be subject to many and varied views and the basic principle is to apply a fair and consistent allocation amongst the licensees. The SFC has taken advice on this aspect and reviewed how this has been addressed under the existing BFI Scheme.
24. Under the BFI Scheme, a minimum premium of HK\$16,000 is applied to each SEHK Participant and the balance of premium is calculated for each Participant using their last annual turnover figure as an adjustable factor. Under the current policy this results in an average premium per participant of approximately HK\$43,000.
25. As under the current BFI Scheme, the tendering insurers will quote a total annual policy premium in respect of the entire scheme, i.e. one lump sum for all licensees or a “global premium”. This premium will be assessed by normal commercial underwriting of the risks in a competitive environment and will also be driven by the loss history in Hong Kong as well as the continued improvements expected in this sector.
26. Unlike the BFI Scheme, which is a relatively homogenous group of risk in view of a common activity, the Proposed Scheme will have five different groups of activity carrying different risk profiles.
27. As part of the tender process, insurers will be asked to break the global premium down into five amounts with each amount representing their views on the overall risk weighting attaching to that sector.
28. It is proposed that the minimum premium amount for all categories will remain in the region of HK\$16,000 (i.e. base premium) as in the current BFI Scheme. The premium will be allocated amongst the individual licensees in each sector by using the base premium, which will be the same for each licensee in that sector, plus an adjustable factor which will be based on two parameters:

- a. Turnover for the insured activity

This is a standard benchmark used by insurers of these risks to gauge overall business activity and thus is a good indicator of the overall risk. However, for licensees of Type 8 regulated activity (i.e. securities margin financing), an annualized average of their monthly loan balance will be used. The balance of premium due from each licensee (after the base premium from all licensees in that sector is taken from the sector allocation) will be determined by applying the percentage of that firm’s turnover out of the total sector turnover, to the total sector balance of premium.

b. Individual claims weighting

Licensees having claims paid in the past three years will have a small additional loading applied on their premium. However, this will only apply to claims occurring after the commencement of the Proposed Scheme.

29. An example illustrating the methodology of premium allocation is set out at Appendix 2.
30. New licensees admitted during the policy period will be charged pro rata of the base premium and any licensees leaving the scheme during the policy period will not be entitled to any premium refund.
31. For the purposes of considering and determining the allocation of insurance premium, the SFC proposes to establish a Standing Committee under section 8(1)(a) of the Ordinance. The Standing Committee would comprise representatives of the industry in respect of each type of the regulated activities concerned and the SFC.

Duties of Disclosures of Licensed Corporations

32. Although the SFC would arrange the Proposed Scheme for the licensees concerned, it would not be a contract party in the insurance policy to be entered into between the insurer(s) and the licensees. For the purposes of the Proposed Scheme, individual licensees would assume their own duties of disclosure to the insurer(s). As a common practice in the insurance market, it is likely that the insurer(s) would require a review of all licensees concerned including a declaration of past claims/losses be they insured or uninsured. As a coordinator, the SFC may facilitate gathering of the required underwriting information from the licensees if necessary.
33. In addition to providing the basic information necessary for the insurer(s) to perform related risk assessment, the licensees concerned would need to ensure that they are complying with their legal duty of disclosure of all relevant material matters. In particular, they must satisfy themselves as to the accuracy and completeness of any information provided. It should be noted that if not all such information is disclosed, the insurer(s) would have the right to avoid the contract from its commencement which may lead to claims not being met.
34. Once the Proposed Scheme is established, each insured licensee would be responsible for reporting claims and potential claims to the insurer(s) as well as to the SFC. Related responsibilities and administrative details would be provided to the licensees in a separate document nearer the scheme inception date.

Benefits of Implementing the Proposed Scheme

Enhanced Protection to Licensed Corporations and Investors

35. The Proposed Scheme aims to provide indemnity protection to licensed corporations against the specified risks at a justifiable cost. In the possible event that an insured licensed corporation suffers from financial losses caused by the specified risks, the Proposed Scheme would indemnify the licensee concerned thus alleviating the adverse impact on its financial position and reducing the likelihood that the corporation may go into liquidation if a more severe loss is being encountered. Obviously, this would help maintain stability of the financial market as a whole and contribute to enhancing confidence of the Hong Kong market.
36. As for investors, the Proposed Scheme would increase the possibility and amount that investors could be compensated by licensed corporations in relation to losses caused by fraudulent acts, errors or omissions, etc.

Benefits of Implementing a Common Scheme

37. In order to ensure an adequate and consistent insurance coverage, the SFC considers that it would be most useful and cost effective to implement a common scheme for all licensees concerned across the industry. It is because, in the first place, a common scheme will relieve licensees of the administrative burden in seeking, assessing and negotiating with different insurance companies which vary in experience and financial position (or ability to meet claim obligations). It will also reduce the administrative burden in checking compliance with insurance requirements.
38. Secondly, with more insured firms participating in a single scheme, there would be an additional benefit of lowering the average insurance premium to be borne by individual licensees since the overall risk to the insurer(s) would be more widely spread.
39. Thirdly, a common scheme could save those licensed corporations operating in a small scale from the difficulty of finding acceptable insurers in arranging their own policies, or incurring unreasonably higher costs for the same insurance coverage that they would have to pay otherwise.
40. According to the advisers' information provided to the SFC, should SEHK Participants need to source their own fidelity insurance coverage rather than participating in the current collective scheme, each of them would be paying considerably more than the current premium level on average. Furthermore, a number of firms would experience considerable difficulty in securing any meaningful insurance protection at all.

International Practice

41. With the assistance of professional insurance advisers, the SFC has reviewed the insurance and capital requirements imposed on dealers in a number of overseas jurisdictions.
42. Generally speaking, it is observed that both capital and insurance requirements act in concert to maintain standard of the financial standing of intermediaries. While the insurance and capital requirements vary considerably from one jurisdiction to another, a number of jurisdictions such as the United States, Australia and Malaysia do have compulsory requirements imposed on dealers to take out insurance policies against fidelity, civil liability and/or professional indemnity risks.

Tender Procedures

43. The SFC, or through its advisers, would arrange a full tender of the Proposed Scheme in the Hong Kong and international insurance market.
44. It is proposed that selection of the successful insurer or a combination of insurers would be determined by the SFC on advice from its Advisory Committee having regard to the following major criteria:
 - (a) Competitiveness of the premium;
 - (b) Extent to which the terms offered could meet the requested program structure and policy coverage;
 - (c) Insurer's reputation and financial soundness (including credit rating);
 - (d) Evaluation of the pros and cons of choosing a single insurer or a co-insurance structure. It is envisaged that it may be better to spread the risk amongst a few key insurers for the long-term interest of the Proposed Scheme;
 - (e) Ability to service the insured licensed corporations efficiently on claims handling (including whether the insurer has business presence in Hong Kong); and
 - (f) Experience of the insurer in underwriting similar class of risk and their length of practice in the Hong Kong market.

Administration of the Proposed Scheme

45. Once the Proposed Scheme has been arranged, an explanatory circular letter and a debit note will be issued to each licensed corporation which needs to take out the insurance policy.

46. In relation to the on-going administration of the Proposed Scheme such as collection of premium and claims handling, the SFC may outsource such functions to professional service providers where appropriate.
47. As mentioned, the licensed corporations concerned would need to participate in the Proposed Scheme and pay their respective insurance premium. Upon payment of the premium, they would receive their insurance certificates.
48. The insured licensees would need to notify the insurer(s) claims/losses or circumstances likely to give rise to a claim/loss in accordance with the requirements and procedures to be set out in the certificate of insurance and the insurance policy. In handling claims, a panel of law firms may likely be appointed to keep the insurer(s) and the SFC apprised of the development and to ensure that the claims are settled as expeditiously as possible.

Other Matters

49. Written comments can be sent:

By mail to: SFC (Insurance Rules)
12/F, Edinburgh Tower, The Landmark
15 Queen's Road Central
Hong Kong

By fax at: 2293 5755

By on-line submission at: <http://www.hksfc.org.hk>

By e-mail to: insurance_rules@hksfc.org.hk

50. Please note that the names of the commentators and the contents of their submissions may be published on the SFC website and in other documents to be published by the SFC. In this regard, please read the Personal Information Collection Statement attached at [Appendix 3](#).
51. You may not wish your name and/or submission to be published by the SFC. If this is the case, please state that you would like your name and/or submission to be withheld from being published when you make your submission.

SECURITIES AND FUTURES (INSURANCE) RULES

(Made by the Securities and Futures Commission
under section 116(5) of the Securities and
Futures Ordinance (5 of 2002))

1. Commencement

These Rules shall come into operation on the day on which
Part V of the Securities and Futures Ordinance (5 of 2002) comes
into operation.

2. Interpretation

In these Rules, unless the context otherwise requires -

"dealing in futures contracts" () has the meaning
assigned to it by Part 2 of Schedule 5 to the Ordinance;

"dealing in securities" () has the meaning assigned to it
by Part 2 of Schedule 5 to the Ordinance;

"insurer" () means a person -

(a) specified in section 6(1) of the Insurance Companies Ordinance (Cap. 41); or

(b) carrying on insurance business and regulated under the law of any place outside Hong Kong;

"person requiring insurance" () means a person referred to in section 3(1);

"premium" () means the premium that is payable by a person requiring insurance to the underwriter in respect of a scheme period;

"scheme of insurance" () means the scheme of insurance referred to in section 6 arranged by the Commission in respect of a scheme period;

"scheme master policy" () means the policy of insurance issued by the underwriter of the scheme of insurance in respect of a scheme period under which the underwriter provides the insurance referred to in section 4 to a person requiring insurance;

"scheme period" () means the period of insurance referred to in a scheme master policy;

"underwriter" () means one or more insurers with whom the Commission arranges a scheme of insurance in respect of a scheme period.

3. Application

(1) Subject to subsections (2) and (3), these Rules apply to -

- (a) an applicant for a licence; and
- (b) a licensed corporation to which a licence is granted,

under section 116(1) of the Ordinance to carry on any regulated activity specified in Schedule 1.

(2) These Rules do not apply to a person referred to in subsection (1) which is not an exchange participant and -

- (a) is insured in relation to the risks specified in Schedule 2 for the amount not less than that specified in Schedule 3 and has given to the Commission -

- (i) a copy of the relevant policy of insurance;
and
- (ii) written confirmation from a responsible officer and its legal advisers that it is insured under that policy of insurance in relation to those risks and for that amount;
or

(b) does not handle client assets.

(3) Where a person referred to in subsection (1) ("A") is -

(a) an exchange participant which is, or seeks to be, licensed under section 116(1) of the Ordinance for dealing in securities or dealing in futures contracts; and

(b) a related corporation of another person requiring insurance ("B") -

(i) which is, or seeks to be, licensed under section 116(1) of the Ordinance for dealing in securities or dealing in futures contracts;

(ii) which is not an exchange participant;

(iii) which is a client of A; and

(iv) for which A acts as executing broker in respect of dealings in securities or futures contracts by B for or on behalf of B's clients, where B is responsible to its clients in respect of the acts of A;

then -

- (c) A shall be required to take out and maintain insurance in accordance with section 5 under which both A and B are insured in relation to the risks specified in Schedule 2 for the amount specified in Schedule 3 that is applicable to A;
- (d) B shall not be required to take out and maintain separate insurance under these Rules; and
- (e) for the purposes of Schedules 2 and 3, the person requiring insurance shall be regarded as including both A and B.

4. Duty to insure against specified risks for specified amount

Subject to section 5, a person requiring insurance shall take out and maintain insurance in relation to the risks specified in Schedule 2 for the amount specified in Schedule 3.

5. Duty to take out and maintain insurance under scheme of insurance

A person requiring insurance shall take out and maintain insurance referred to in section 4 under the scheme of insurance by -

- (a) paying the premium; and
- (b) complying with the terms and conditions of the scheme master policy,

in respect of each scheme period during which the person requiring insurance is, or is to be, licensed under section 116(1) of the Ordinance.

6. Commission to arrange scheme of insurance

For the purposes of section 5, the Commission shall arrange with one or more insurers a scheme of insurance under which a person requiring insurance is entitled to take out and maintain insurance as referred to in section 4 in respect of a scheme period, subject to the person requiring insurance -

- (a) paying the premium; and

- (b) complying with the terms and conditions of the scheme master policy.

7. Role of Commission in arranging scheme of insurance

(1) Without limiting the generality of section 6, the Commission's role in arranging the scheme of insurance may include any of the following matters -

- (a) determining the terms and conditions of the scheme master policy;
- (b) collecting the premium from each person requiring insurance in such manner as the Commission specifies in writing and remitting such premiums collected to the underwriter;
- (c) distributing certificates of insurance issued by the underwriter to persons requiring insurance which have paid the premium;
- (d) receiving notifications of claims or circumstances likely to give rise to claims under the scheme master policy from persons requiring insurance and transmitting such notifications to the underwriter.

(2) The Commission may engage the services of a suitably qualified person to assist it in performing any part of its role in arranging the scheme of insurance.

8. No refund of premium

A premium paid by a person requiring insurance in accordance with these Rules is not refundable.

9. Consent to disclosure of information by the Commission for purposes of arranging insurance

(1) A person requiring insurance shall submit to the Commission (or any person assisting the Commission under section 7(2)) such information about the person requiring insurance and its business as the Commission may require for the purposes of arranging the scheme of insurance.

(2) A person requiring insurance is to be taken as having consented to the disclosure by the Commission (or any person assisting the Commission under section 7(2)) for the purposes of arranging the scheme of insurance to -

- (a) any person assisting the Commission under section 7(2);
- (b) the underwriter; or
- (c) an insurer,

of information relating to the person requiring insurance where that information was obtained by the Commission from the person requiring insurance.

SCHEDULE 1

[s.3(1)]

REGULATED ACTIVITIES IN RESPECT OF WHICH INSURANCE IS REQUIRED

1. Dealing in securities.
2. Dealing in futures contracts.
3. Securities margin financing.

SCHEDULE 2

RISKS IN RELATION TO WHICH INSURANCE IS REQUIRED

The risks in relation to which a person requiring insurance shall take out and maintain insurance are -

1. Subject to paragraph 4, the risk of loss arising out of the loss of client assets of the person requiring insurance (including client assets that are received or held by an associated entity of the person requiring insurance) attributable to -
 - (a) fraudulent or dishonest acts committed by employees of the person requiring insurance (or its associated entity or service bureau);
 - (b) robbery or theft while the client assets are in the custody of the person requiring insurance (or its associated entity);
 - (c) forgery or fraudulent alteration of a cheque or other negotiable instrument;
 - (d) fraudulent use of an information system;
 - (e) forged or fraudulent instructions relating to the client assets.

2. Subject to paragraph 4, the risk of loss attributable to -
 - (a) receipt in good faith of counterfeit currency by the person requiring insurance;
 - (b) costs and expenses incurred in connection with investigations under the Ordinance or otherwise in relation to the businesses carried on by the person requiring insurance which constitute regulated activity specified in Schedule 1;
 - (c) reasonable fees and expenses incurred by the person requiring insurance in connection with determining the amount of a loss or claim in respect of which it is insured.

3. Subject to paragraph 4, the risk of loss attributable to negligent acts done or omitted to be done by the person requiring insurance or its employees (or by its associated entity or employees of the associated entity or by its service bureau or employees of the service bureau).

4. The risks specified in paragraphs 1, 2 and 3 shall exclude -
 - (a) losses attributable to branch offices maintained outside Hong Kong by the person requiring insurance;

(b) losses arising otherwise than in respect of the person requiring insurance carrying on regulated activity specified in Schedule 1.

5. For the purposes of this Schedule -

"employee" () in relation to a person, includes an individual who is or has been an employee, officer or licensed representative of the person, or who is or has been engaged by the person whether under a contract of service or otherwise;

"service bureau" (), in relation to a person requiring insurance ("A"), means a person to whom A has subcontracted the duty to perform certain functions which are ancillary to the carrying on by A of any regulated activity specified in Schedule 1.

SCHEDULE 3

INSURED AMOUNTS

1. Subject to paragraph 3, where a person requiring insurance is licensed, or seeks to be licensed, under section 116(1) of the Ordinance, to conduct one regulated activity specified in Schedule 1, the insured amount per scheme period is \$15,000,000 in respect of all of the risks specified in Schedule 2.

2. Subject to paragraph 3, where a person requiring insurance is licensed, or seeks to be licensed, under section 116(1) of the Ordinance, by the Commission to conduct more than one regulated activity specified in Schedule 1, the insured amount per scheme period is \$25,000,000 in respect of all of the risks specified in Schedule 2.

3. Where, in respect of a scheme period, the underwriter is liable under the scheme master policy for only the part of a loss or claim by a person requiring insurance that exceeds a certain amount, that amount shall not exceed \$3,000,000.

Chairman
Securities and Futures
Commission

2002

Explanatory Note

These Rules are made by the Securities and Futures Commission under section 116(5) of the Securities and Futures Ordinance (5 of 2002). They require applicants for licences, and licensed corporations to whom the Commission has granted licences under section 116(1) of the Ordinance to carry on certain regulated activities, to take out and maintain insurance in respect of specified risks and for specified amounts, under a scheme of insurance arranged by the Commission. They also prescribe the requirements with which those applicants and licensed corporations must comply in relation to such insurance.

Example to illustrate allocation of premium

This example is an illustration of how the proposed allocation mechanism will work in the first year of the Scheme. In subsequent years, the calculation of premium for an individual licensee may also take into account its claim history.

Assuming the global premium is \$35 million¹ and the insurer has allocated this amount amongst the five sectors as follows:

- a. Securities Dealers who are SEHK Participants

Number of dealers: 500

Sector Premium allocated: \$23 million

Total base premium: (500 x \$16,000) = \$8,000,000

Balance allocated on turnover: \$15,000,000

Variable amount: Last annual transaction values

If Firm A had 0.2% of the total sector turnover in the previous financial year, then it will pay an insurance premium of \$46,000 (\$16,000 + \$15 million x 0.2%).

- b. Securities Dealers who are not SEHK Participants

Number of dealers: 200

Sector Premium allocated: \$6.5 million

Total base premium: (200 x \$16,000) = \$3,200,000

Balance allocated on turnover: \$3,300,000

Variable amount: Last annual transaction values

- c. Commodities (Futures Contract) Dealers who are Participants of the Hong Kong Futures Exchange Limited

Number of dealers: 130

Sector Premium allocated: \$4.5 million

Total base premium: (130 x \$16,000) = \$2,080,000

Balance allocated on turnover: \$2,420,000

Variable amount: Number of contracts transacted last year

¹ Please note that this is a hypothetical amount for illustration only.

- d. Commodities (Futures Contract) Dealers who are not Participants of the Hong Kong Futures Exchange Limited

Number of dealers: 20

Sector Premium allocated: \$700,000

Total base premium: (20 x \$16,000) = \$320,000

Balance allocated on turnover: \$380,000

Variable amount: Number of contracts transacted last year

- e. Securities Margin Financiers

Number of financiers: 8

Sector Premium allocated: \$300,000

Total base premium: (8 x \$16,000) = \$128,000

Balance allocated on loan balance: \$172,000

Variable amount: Average monthly loan balance last year

Where a corporation is licensed for more than one type of regulated activity concerned and carries a single indemnity limit of \$25 million for all activities, it will need to pay the equivalent of one base premium and a variable amount. That variable amount is calculated having regard to the last annual securities transaction value and the number of futures contracts transacted by it last year.

Personal Information Collection Statement

1. This Personal Information Collection Statement (“PICS”) is made in accordance with the guidelines issued by the Privacy Commissioner for Personal Data. The PICS sets out the purposes for which your Personal Data¹ will be used following collection, what you are agreeing to with respect to the SFC’s use of your Personal Data and your rights under the Personal Data (Privacy) Ordinance (“PDPO”).

Purpose of Collection

2. The Personal Data provided in your submission to the SFC in response to the Consultation Document on the Proposed Licensing Fee under the Securities and Futures (Fees) Rules (“the Consultation Document”) may be used by the SFC for one or more of the following purposes:
 - to administer the relevant Ordinances, rules, regulations, codes and guidelines made or promulgated pursuant to the powers vested in the SFC
 - for the purposes of performing the SFC’s statutory functions under the relevant Ordinances
 - for research and statistical purposes
 - other purposes permitted by law

Transfer of Personal Data

3. Personal Data may be disclosed by the SFC to the members of the public in Hong Kong and elsewhere, as part of the public consultation on the Consultation Document. The names of persons who submit comments on the Consultation Document together with the whole or part of their submission may be disclosed to members of the public. This will be done by publishing this information on the SFC web site and in documents to be published by the SFC throughout and at the conclusion of the consultation period.

Access to Data

4. You have the right to request access to and correction of your Personal Data in accordance with the provisions of the PDPO. Your right of access includes the right to obtain a copy of your Personal Data provided in your submission on the

¹ Personal Data means personal data as defined in the Personal Data (Privacy) Ordinance, Cap 486 (“PDPO”)

Consultation Document. The SFC has the right to charge a reasonable fee for processing any data access request.

Enquiries

5. Any enquiries regarding the Personal Data provided in your submission on the Consultation Document, or requests for access to Personal Data or correction of Personal Data, should be addressed in writing to:

The Data Privacy Officer
The Securities and Futures Commission
12/F, Edinburgh Tower
The Landmark
15 Queen's Road
Central
Hong Kong

A copy of the Privacy Policy Statement adopted by the SFC is available upon request.



SECURITIES AND
FUTURES COMMISSION
證券及期貨事務監察委員會

Annex 3

Consultation Conclusions on the draft Securities and Futures (Insurance) Rules

Hong Kong
September 2002

香港
2002年9月

Introduction

1. On 26 June 2002, the Securities and Futures Commission (“SFC”) issued a Consultation Document to solicit public comments on the draft Securities and Futures (Insurance) Rules (“the draft Rules”).
2. The consultation period lasted until 25 July 2002.
3. The purpose of this document is to summarize the major comments received during the consultation period and the SFC’s responses.
4. It is advisable to read this document in conjunction with the Consultation Document.

Public Consultation

5. In addition to the public announcement inviting comments, the SFC distributed the Consultation Document to all licensed intermediaries using the FinNet communication network. The Document was also published on the SFC website.
6. The SFC received a total of nine submissions in response to the consultation. One was submitted collectively by a group of five international brokerage firms¹ through their solicitors. Another three were submitted by Hong Kong Stockbrokers Association Limited, the Institute of Securities Dealers Limited and the Securities Law Committee of the Law Society of Hong Kong. These submissions have been posted on the SFC website. The rest were submitted by five respondents who had requested their names and submissions to be withheld from publication.

Summary of Comments and the SFC’s Responses

7. Respondents generally supported the compulsory fidelity insurance scheme (“the Scheme”) proposed under the draft Rules, and they also raised a number of enquiries and comments in relation to policy and administrative matters. A summary of their comments and the SFC’s responses is set out at **Annex 1**.

¹ Goldman Sachs (Asia) L.L.C., J.P. Morgan, Merrill Lynch (Asia Pacific) Limited, Morgan Stanley Dean Witter Asia Limited and Salomon Smith Barney Hong Kong Limited.

Consultation Conclusions

8. Having carefully considered the comments received and consulted with its adviser in the insurance market, the SFC has made amendments to the draft Rules (revised draft Rules at **Annex 2**). Apart from some drafting amendments, the major changes to the draft Rules are summarized as follows:

Section 1: Commencement

9. To coincide with the expiry of the current Brokers' Fidelity Insurance Scheme arranged by the Stock Exchange of Hong Kong Limited for its participants, the SFC has amended the commencement date of the draft Rules to 1 April 2003, which is later than the expected commencement of the principal ordinance.

Section 3: Application

Eligible insurer

10. Some respondents commented that as a matter of quality control, the draft Rules shall set out the minimum requirements or qualifications (in terms of credit rating, capital threshold, etc) in respect of the insurer underwriting the Scheme and of those insurers of group or global policies which the specified licensed corporations (not being exchange participants) may rely upon in seeking exemption from joining the Scheme.
11. The SFC agreed with this comment and has amended the draft Rules to the effect that an insurer concerned shall have a specified credit rating as a minimum standard (sections 3(3)(b)(i) and 6(2) of the revised draft Rules are relevant).
12. The specified credit rating mentioned above is stipulated in Schedule 4 of the revised draft Rules. As proposed, it means:
- (i) a Moody's Long-Term Insurance Financial Strength Rating of "A" or above;
 - (ii) a Standard & Poor's Insurer Financial Strength Rating of "A" or above; or
 - (iii) a Fitch's Insurer Financial Strength Rating of "A" or above.
13. Apart from the requirement on specified credit rating of the insurer, it is now proposed that the insurer of a group or global policy concerned shall not be a related corporation of the licensed corporation which seeks exemption from participating in the Scheme (section 3(3)(b)(i) of the revised draft Rules is relevant). This is to avoid possible risk transfer among group companies.

Lodgment of written confirmation for the purpose of exemption

14. To be more specific as to the timeframe for lodgment of the required written confirmation for the purpose of exemption under section 3(3) of the revised draft Rules, section 3(3)(c) now spells out that the required confirmation shall be lodged with the SFC not less than 60 days before a scheme period commences.
15. In addition, under section 3(5) of the revised draft Rules, where a policy of insurance referred to in section 3(3) expires before the end of the scheme period for which a licensed corporation intends to be exempted from participating in the Scheme, the corporation concerned shall within 7 business days after expiry of the previous policy lodge with the SFC a written confirmation that the corporation is and has since such expiry been so insured under a new policy of insurance.
16. Furthermore, to facilitate administration, a confirmation referred to in sections 3(3)(c) and 3(6) shall state the commencement and expiry dates of the policy of insurance under which the licensed corporation is so insured.

Copy of relevant policy of insurance not required

17. For the purpose of exemption under section 3(3), the initial draft provision (section 3(3)(b)(i)(A)) which requires the corporation to submit to the SFC a copy of the relevant policy of insurance is now removed. This would help reduce the administrative burden in seeking exemption by licensed corporations or licence applicants concerned.

Schedule 2: Specified risks

Specified risks in relation to business carried out in Hong Kong

18. In response to some respondents' enquiries concerning the risk coverage under the Scheme, the SFC would like to clarify that the Scheme is intended to provide insurance coverage specific to a licensed corporation's related regulated activity conducted in Hong Kong. As long as such regulated activity is carried out in Hong Kong forming part of the licensed corporation's business turnover, the insurance coverage shall apply regardless of whether or not the loss is attributable to overseas operations of the licensed corporation. In that regard, section 2 of Schedule 2 of the revised draft Rules has been revised to better reflect this policy intention.
19. On a separate matter, some respondents commented that the provision under section 4 of Schedule 2 (now amended to as section 2 of Schedule 2 in the revised draft) does not appear to be relevant in the context of a group or global policy covering a licensed corporation which intends to seek exemption with reference to that group or global policy. We accepted this comment and have revised the draft Rules by adding section 3(4) which provides that section 2 of Schedule 2 shall not apply to a group

or global policy for the purpose of exemption under section 3(3)(b).

Administrative matters

Standing Committee

20. As proposed in the Consultation Document, the SFC would establish a Standing Committee under section 8(1)(a) of the Securities and Futures Ordinance to consider and determine the allocation of insurance premium. The Standing Committee would comprise representatives of the industry in respect of each type of the regulated activities concerned and the SFC.
21. As noted from the responses received, industry associations are keen to be represented in the Standing Committee. In this connection, the SFC would like to assure that relevant industry associations would be invited to represent in the Committee in due course.
22. Furthermore, the SFC understands that the industry is generally concerned about the cost and other administrative matters such as selection of insurer, monitoring of the insurer's performance as well as handling of claims and complaints from the insured in relation to the Scheme. In that regard, the SFC decided that related administrative matters would be regularly brought before the Standing Committee for information and comments.

Final Note

23. The SFC would like to thank all industry practitioners and interested persons who have made valuable suggestions and comments in response to this consultation.
24. To assist with the administration of the Scheme, the SFC would issue detailed guidelines to the relevant licensed corporations following the finalization of the Scheme.

**Securities and Futures Commission
September 2002**

Summary of comments received on the draft Securities and Futures (Insurance) Rules

| | Section Reference | Details of the Rules | Respondent's Comments | SFC's Response |
|--------------------|-----------------------|--|--|--|
| <i>Application</i> | | | | |
| 1 | s.3(1) and Schedule 1 | The draft Rules apply to corporations which are licensed to carry out Type 1 (dealing in securities), Type 2 (dealing in futures contracts) or Type 8 (securities margin financing) regulated activity under s.116(1) of the Securities and Futures Ordinance ("SFO"). | <p>[Name of respondent withheld as requested]</p> <p>We query as to the reason that the SFC has excluded corporations licensed for Type 3 (leveraged foreign exchange) activity from the Rules. Leveraged foreign exchange is under the same regulatory regime and its associated fidelity risks are the same as that of futures and securities.</p> | <p>A corporation licensed for Type 3 regulated activity (not being an introducing agent) is required to maintain an issued and paid-up capital of not less than HK\$30 million and a liquid capital of not less than HK\$15 million. These requirements are more stringent than those applicable to a corporation licensed for Type 1, Type 2 or Type 8 regulated activity where a minimum paid-up capital of HK\$5 million (HK\$10 million if engaged in securities margin financing) and a minimum liquid capital of HK\$3 million are required.</p> <p>In addition, leveraged foreign exchange traders are generally subject to more statutory restrictions on their business operations. For instance, the gross position of a leveraged foreign exchange trader shall not exceed 60 times its liquid capital.</p> <p>Coupled with our experience of minimal infidelity events occurred in relation to leveraged foreign exchange traders, the SFC decided not to require corporations licensed for Type 3 regulated activity to participate in the proposed Scheme at this stage.</p> |

| | Section Reference | Details of the Rules | Respondent's Comments | SFC's Response |
|-------------------|------------------------|---|---|---|
| <i>Exemptions</i> | | | | |
| 2 | s.3(2) (now s.3(3)) | These Rules do not apply to a corporation which is not an exchange participant upon satisfying certain criteria. | <p>[Linklaters]</p> <p>The exemptions only apply to a licensed corporation that is not an exchange participant. It is unclear why an exchange participant that could be covered by a group or global policy is required to participate in the Scheme. This does not seem to be consistent with the aim to have a single licensing regime in Hong Kong.</p> <p>[Name of respondent withheld as requested]</p> <p>The SFC should apply the same rationale with respect to exchange participants who have insurance equivalent to the Scheme proposed by the Rules. We see that there should be no difference in the risks borne by an exchange participant and a non-exchange participant where they are covered by the same master policy. Thus, there should be provisions in the Rules under which exchange participants can seek exemption.</p> | <p>With a view to maintaining stability of the Hong Kong market and providing licensees which trade Hong Kong securities and/or future contracts with a quality and standardized insurance coverage against the specified risks, the SFC proposed to require all licensed corporations which are participants of the Hong Kong exchanges to participate in the Scheme.</p> <p>In fact, existing securities dealers which are exchange participants are now required to take part in the Brokers' Fidelity Insurance ("BFI") Scheme arranged by the Stock Exchange of Hong Kong Limited regardless of whether or not they are covered by other insurance policies against the same risks.</p> <p>As noted in the Consultation Document (paragraph 12), upon implementation, the new Scheme would replace the BFI Scheme.</p> |
| 3 | s.3(2)(a) (now s.3(3)) | These Rules do not apply to a corporation which is not an exchange participant if it is insured by another insurance policy against the specified risks for an insured amount not less than that specified in Schedule 3. | <p>[The Securities Law Committee of the Law Society of Hong Kong ("SLC")]</p> <p>It is submitted that if exemptions are to be given on the basis of existing group policies, companies which are part of larger groups which are adequately covered by group insurance policies should be exempt from the compulsory insurance regime without further qualification, save as to the amount of the coverage and undertakings to report and provide information to the SFC.</p> | <p>The Commission considers that only those non-exchange participants which are covered by group policies against the specified risks should be exempted from joining the Scheme for reasons stated in item 2 above.</p> |

| | Section Reference | Details of the Rules | Respondent's Comments | SFC's Response |
|---|----------------------------|---|--|---|
| 4 | s.3(2)(a)(ii) (now s.3(3)) | For the purpose of exemption, the corporation shall submitted a written confirmation from a responsible officer and its legal advisers that it is insured in relation to the specified risks and for that amount. | [Linklaters] It is suggested that the exemption requirement should be to be insured in relation to risks “substantially similar” to those specified in Schedule 2, as it is unlikely that a group or global policy would contain exactly the same risks. | In principle, the group or global policy that a licensed corporation relies upon in order to be exempted from participating in the Scheme shall cover (without limitation) the risks as specified in Schedule 2. The SFC considers that the term “substantially similar” would create ambiguity to the market participants. |
| 5 | s.3(2)(a)(ii) (now s.3(3)) | <i>Ditto</i> | [SLC] The Committee draws the SFC's attention that any law firm providing such written confirmation will only be able to do so on a heavily qualified basis. In particular, the law firm will need to make assumptions as to matters of fact (e.g. due execution, payment of premium etc.) surrounding circumstances (e.g. nothing that would affect the doctrine of <i>uberrima fides</i>), application of overseas law and the other assumptions typically associated with legal opinions. | The SFC trusts that as an independent legal practitioner, a law firm shall exercise professional judgment in forming its views for the purposes of the required written confirmation. This confirmation should be submitted to the SFC as a substantive document in the context of regulatory and compliance functions. |
| 6 | s.3(2)(b) (now s.3(3)) | These Rules do not apply to a corporation which is not an exchange participant if it does not handle client assets. | [Linklaters] The Submitting Group supports the proposal that the draft Rules should not apply to a licensed corporation that does not handle client assets but suggests this is amended to “hold” client assets. | Agreed. The term “hold” is defined in Schedule 1, Part 1 of the SFO. Please refer to s.3(3)(a) of the revised draft Rules. |

| | Section Reference | Details of the Rules | Respondent's Comments | SFC's Response |
|------------------------|---------------------------|---|--|--|
| 7 | s.3(3) | A licensed corporation (which is not an exchange participant) may be exempted from the insurance requirements if it is a related company of an exchange participant and it has entered into a client contract with this exchange participant being the first mentioned corporation's executing broker in respect of dealings in securities or futures contracts conducted by the first mentioned corporation. | <p>[Name of respondent withheld as requested]</p> <p>We would like to obtain clarification on whether an intermediary has to deal exclusively with a designated exchange participant (which should be a related company) in order to enjoy the exemption. If so, there may be practical difficulties because:</p> <p>(a) while we generally deal through our related exchange participant for HK-listed products, we may occasionally deal with other unrelated exchange participants (e.g. in contingency situation or for some special transactions).</p> <p>(b) We deal with overseas brokers directly for overseas products.</p> | <p>In order to be exempted from participating in the Scheme, a licensed corporation (which is not an exchange participant) has to in the ordinary course of business deal with an exchange participant(s) which is a related company requiring to take out and maintain insurance (except for emergency situations where alternative arrangements may be made). In this regard, the scheme master policy taken out by the relevant exchange participant(s) will also cover related losses incurred by that licensed corporation.</p> <p>However, if a licensed corporation effects transactions on behalf of its clients with other brokers which are not its related companies (or overseas brokers) and the licensed corporation holds client assets, this licensed corporation would be required to comply with the insurance requirements even though it is not an exchange participant.</p> |
| Specified risks | | | | |
| 8 | s.1 and s.2 of Schedule 2 | A person requiring insurance shall take out and maintain insurance that covers the loss of client assets of that person (including client assets that are received or held by an associated entity of that person) attributable to fraudulent or dishonest acts committed by employees of that person (or its associated entity or service bureau), etc. | <p>[SLC]</p> <p>With respect to the risks covered, consideration should be given to include risks attributable to fraud, dishonesty etc. by relevant people relating to defective securities (for example, forged share certificates, CCASS eligible securities which are subject to freezing tracing or other equitable remedies which thereby result in the securities ceasing to be "eligible securities of the CCASS Rules, etc).</p> | <p>According to the SFC's adviser on this matter, the scheme master policy will be drafted as widely as the insurance market will permit. Moreover, there would be coverage under the proposed policy wording in respect of liabilities arising from the inability to complete transactions due to counterfeit or forged securities.</p> |

| | Section Reference | Details of the Rules | Respondent's Comments | SFC's Response |
|----|---|---|---|---|
| 9 | s.1 and s.2 of Schedule 2 | <i>ditto</i> | <p>[SLC]</p> <p>The risk of loss is not limited to loss resulting from fraudulent or dishonest acts by licensed corporations, associated entities or their respective employees. There may well be other ways in which fraudulent or dishonest acts can result in loss of client assets.</p> | <p>The risks as specified in Schedule 2 are set out as the minimum requirements in terms of insurance coverage. The SFC notes that in considering the insurance coverage as minimum requirement, one shall also bear in mind the overall cost incurred to the industry.</p> |
| 10 | s.1, s.2 and s.3 of Schedule 2 (Paragraphs 18A and 18B of the Consultation Document) | A person requiring insurance shall take out and maintain insurance that covers the risks arising out of the loss of client assets attributable to [paragraph 18A] fraudulent or dishonest acts committed by employees of the person requiring insurance (or its associated entity or service bureau)... and [paragraph 18B] negligent acts done or omitted to be done by the licensed corporation or its employees (or by its associated entity or employees of its associated entity). | <p>[SLC]</p> <p>A critical distinction between the specified risks in paragraphs 18A and 18B of the Consultation Document is that 18A is risk of loss of assets – which does not cover loss attributable to the diminution in the value of assets due to any of the attributable factors. In contrast, 18B is broader in that it covers loss attributable to negligent acts which, on its face, includes diminution in value.</p> | <p>According to the SFC's adviser on this matter, as an usual insurance market practice, paragraph 18A refers to first party claim and specific perils while paragraph 18B is to provide a broader coverage of legal liability or responsibility.</p> |
| 11 | s.4(a) (now s.2) of Schedule 2 | The risks specified in Schedule 2 shall exclude losses attributable to branch offices maintained outside Hong Kong by the person requiring insurance. | <p>[SLC]</p> <p>While the proposal to limit insurance coverage to licensed corporations' business in Hong Kong is noted and supported, further clarification is needed.</p> <p>(i) If a licensed person takes a client's instruction in Hong Kong and relays it to an overseas broker for execution, is this business being done in Hong Kong in whole or in part?</p> | <p>By receiving a client's instruction in Hong Kong, the transaction concerned is regarded as a business conducted in Hong Kong. The intention is to cover this business against the specified risks.</p> |

| | Section Reference | Details of the Rules | Respondent's Comments | SFC's Response |
|----|---|---|---|---|
| | | | (ii) At which point in the sequential chain of events commencing with a client placing an instruction and ending with the trade being settled and cleared does the transaction cease to be "business in Hong Kong"? This is particularly relevant in the context of licensed corporations which are part of wider groups which collectively take client instructions over the Internet or by email. | If the licensed corporation suffers a loss from a transaction which at some point is supported by or conducted as part of the licensed corporation's operation in Hong Kong and is booked as the turnover of the licensed corporation, the insurance coverage should apply. |
| 12 | s.4(a) (now s.2) of Schedule 2 (Paragraph 17 of the Consultation Document) | The risks specified in Schedule 2 shall exclude losses attributable to branch offices maintained outside Hong Kong by the person requiring insurance. | [SLC] As a technical point, paragraph 17 of the Consultation Document states that the insurance coverage is specific to licensed corporations' businesses in Hong Kong. However, it is phrased differently in the relevant section (s.4(a) (now s.2) of Schedule 2) under the draft Rules, where it states that losses attributable to branch offices maintained overseas will not be covered. This would seem to mean that losses caused to businesses in Hong Kong by fraudulent acts of overseas employees are not covered by the proposed scheme which is different from the intention expressed in the Consultation Document. | Please refer to s.2 of Schedule 2 of the revised draft Rules. |
| 13 | s.4(a) (now s.2) of Schedule 2 | <i>Ditto</i> | [Name of respondent withheld as requested] Although the draft Rules require that the insurance coverage "would be specific to the licensed corporations' businesses in Hong Kong", the draft Rules do not specifically confine the coverage to securities and futures products listed on the Hong Kong Exchanges. Clarification is sought on whether the insurance should cover dealings in overseas products. | The insurance will cover dealings in both Hong Kong and overseas products provided that such dealings are businesses of the licensed corporations conducted in Hong Kong. |

| | Section Reference | Details of the Rules | Respondent's Comments | SFC's Response |
|-------------------------------|-----------------------------|--|--|--|
| 14 | s.4 (now s.2) of Schedule 2 | The risks specified shall exclude (a) losses attributable to branch offices maintained outside Hong Kong, and (b) losses arising otherwise than in respect of the licensed person's regulated activity concerned. | [Linklaters] S.4 (now s.2) of Schedule 2 does not appear relevant in relation to a global or group policy. | Agreed. For the purpose of exemption, a group or global insurance policy that a licensed corporation relies upon is not subject to the exclusion provision under s.4 of Schedule 2 (now revised to as s.2 of Schedule 2). Please refer to s.3(5) of the revised draft Rules. |
| <i>Insured amounts</i> | | | | |
| 15 | s.1 and s.2 of Schedule 3 | Where a licensed corporation undertakes 1 regulated activity requiring insurance, the insured amount is HK\$15 million. If a licensed corporation undertakes more than one regulated activity requiring insurance, the insured amount is HK\$25 million. | [Linklaters] It is suggested that a reduction on the insured amount should be applied on a group basis where regulated activities are conducted through separate licensed corporations that share common back office and other functions. | Having consulted its adviser on this matter, the SFC recognizes that a reduction of the insured amount due to sharing of back office and other functions on a group basis would not be practicable for the proposed Scheme due to considerable variation in business models among different groups. In that regard, whilst some groups share common functions and management staff for all licensed entities, some maintain separate functional units and different management personnel in respect of each licensed entity. Hence, it would require significant administrative work (and costs) to assess and quantify the relevant impacts on each group causing the Scheme more costly to licensed persons. Furthermore, the potential loss in relation to back-office staff is but only one of the areas that could give rise to losses under the scheme master policy. We therefore do not intend to reduce the insured amount lower than the current level of HK\$15 million under the BFI Scheme. |

| | Section Reference | Details of the Rules | Respondent's Comments | SFC's Response |
|----------------------------|--------------------------------|--|---|--|
| <i>Level of deductible</i> | | | | |
| 16 | s.3 of Schedule 3 (now s.4(2)) | Where, in respect of a scheme period, the underwriter is liable under the scheme master policy for only the part of a loss or claim by a person requiring insurance that exceeds a certain amount, that amount shall not exceed HK\$3 million. | <p>[Name of respondent withheld as requested]</p> <p>S.3 of Schedule 3 (now s.4(2)) provides that the excess amount should not exceed HK\$3 million. While these limits may be practical in the case of smaller intermediaries, intermediaries which are part of a large financial group, are normally covered by a master insurance policy taken out by the financial group. Such master policy would normally have a deductible in excess of HK\$3 million due to their size and financial standing. We would therefore suggest that the SFC consider including an exception to s.3 (now s.4(2)) of the draft rules to exclude intermediaries where they are subsidiaries of authorized financial institutions ("AFI") which are already covered by the AFI's master insurance policy. This would enable such intermediaries who would have a large deductible amount in excess of HK\$3 million under their master group policy to continue to provide an effective service to the market, while being covered by their master policy.</p> | <p>In the interest of fairness to all licensed corporations, the SFC decided to follow the existing BFI practice of requiring a (self-insured) deductible amount of HK\$3 million. This deductible amount is consistent with the minimum liquid capital required for dealers.</p> <p>The SFC notes that this level of deductible has been increased over time under the BFI Scheme and is a compromise between the maximum loss the smaller licensees could bear without putting too great a financial burden upon them and also being high enough to enable cost-effective insurance coverage to be purchased in the market.</p> <p>Having consulted with its adviser on this matter, the SFC understands that this level of deductible amount is high for most of the (small) intermediaries and reasonable for the others.</p> <p>In maintaining a level playing field across the market, the SFC considers it inappropriate to provide the suggested exception to licensed corporations which are subsidiaries of AFI.</p> |
| 17 | s.3 of Schedule 3 (now s.4(2)) | <i>ditto</i> | <p>[Name of respondent withheld as requested]</p> <p>The SFC should be flexible in determining the amount of deductible for the insured licensee. The deductible level should be varied according to the capital base of the insured licensee. As the insurance premium is influenced by the level of the deductible, where the deductible level is higher, the insurance premium should be lower.</p> | <p>In theory, different levels of deductible could be allowed for different licensees. However, practically speaking, this would create additional monitoring duties (and costs) and would cause significant complications in underwriting the Scheme, particularly when the capital base of a licensee changes over the scheme period.</p> |

| | Section Reference | Details of the Rules | Respondent's Comments | SFC's Response |
|------------------------|-------------------|---|--|---|
| <i>Role of the SFC</i> | | | | |
| 18 | s.7(1) | This Rule sets out the SFC's role in arranging the Scheme. | <p>[Linklaters]</p> <p>The Submitting Group assumes that the SFC will consider and provide for the interaction between the Scheme and any other insurance taken out by the insured. For example, in the event of a claim by an insured, there should be co-operation between the Scheme's insurers and the global insurers in the sharing of claims information and settlement of the claims.</p> | <p>On advice of its adviser on this matter, the SFC understands that the usual insurance market practice may allow for the said interaction between insurers.</p> <p>This matter will be included in the tender document and considered in the tender process when selecting the insurer to underwrite the Scheme.</p> |
| 19 | s.7(1)(d) | The SFC's role in arranging the Scheme may include receiving notifications of claims or circumstances likely to give rise to claims under the Scheme from persons requiring insurance and transmitting such notifications to the underwriter. | <p>[Linklaters]</p> <p>By receiving notifications of claims or circumstances likely to give rise to claims (under s.7(d) of the draft Rules), the SFC will receive information which may result in a potential conflict of interest between the SFC's role as arranger of the Scheme and its regulatory function. The Group assumes that the SFC has considered this and will ensure that steps are taken to keep the two roles separate. If there were no Chinese Walls or other protection, a licensed corporation may be discouraged from submitting a notice of potential claim under its errors and omissions policy if such information were likely to lead to the SFC taking action against the licensed corporation.</p> | <p>The SFC does not see that there is any conflict of interest arising from performing its regulatory role and its role in arranging the Scheme. As in the current BFI arrangement, the SFC has been notified by exchange participants of any claims or circumstances likely to give rise to claims. Upon receipt of such information, the SFC often assesses the implications of those incidents and determines the appropriate follow-up actions to be taken. The SFC considers that both roles are performed with the same view to maintaining stability of the financial market and protecting the investors.</p> |

| | Section Reference | Details of the Rules | Respondent's Comments | SFC's Response |
|----------------------------------|---------------------------|--|---|--|
| <i>Disclosure of information</i> | | | | |
| 20 | s.9(1) | A person requiring insurance shall submit to the SFC (or any person assisting the SFC under s.7(2)) such information about the person requiring insurance and its business as the SFC may require for the purposes of arranging the scheme of insurance. | [The Institute of Securities Dealers Ltd] The requirement that licensed corporation has to fulfill the duties of disclosures may result in the inability of the licensed corporation to apply for claim. Therefore the required disclosures should be simple and straight forward and in a standard form such that the licensed corporations can comply easily. | It is intended that the required disclosure would be simple and straightforward (both in the setup of the Scheme and the on-going claim procedures) but only to the extent that this does not prejudice securing a cost effective scheme. Typically, if insurers do not receive the required information, they may simply either refuse to quote or price terms conservatively (i.e. higher). |
| 21 | s.9(2)(c) (now s.9(2)(b)) | A person requiring insurance is to be taken as having consented to the disclosure by the SFC (or any person assisting the SFC under s.7(2)) for the purposes of arranging the scheme of insurance to an insurer, of information relating to the person requiring insurance where that information was obtained by the SFC from the person requiring insurance. | [Linklaters] (i) It is suggested the reference to insurer in s.9(2)(c) (now s.9(2)(b)) should be deleted as distribution of the information should be limited to persons actually connected with the Scheme. (ii) The Submitting Group would also expect there to be a confidentiality requirement on these persons. (iii) Given the potential impact of such disclosure, we assume that a licensed corporation will be notified of or copied on information provided to the insurer – a licensed corporation would be concerned to ensure that the information presented is accurate and current. | Having consulted with its adviser on this matter, the SFC notes that “the insurer” as referred to in s.9(2)(c) (now s.9(2)(b)) is actually a party connected with the Scheme. Hence, it should not be deleted. These persons would be required to sign relevant confidentiality undertaking. The SFC considers that it would not be practical to notify (or copy) the licensed corporations of all information provided to the insurer. Indeed, this would not be necessary because by virtue of s.9 of the draft Rules, the Commission would only disclose to the relevant persons such information relating to a licensed corporation where that information was obtained by the Commission from that corporation. Moreover, the SFC notes that a licensed corporation generally has a right to access information specific to the corporation as held by the insurer on request made to the insurer. |

| | Section Reference | Details of the Rules | Respondent's Comments | SFC's Response |
|-------------------------|-------------------|----------------------|--|--|
| <i>Level of premium</i> | | | | |
| 22 | - | General comments | <p>[Linklaters]</p> <p>The draft Rules do not apply to a licensed corporation that is a related corporation to an exchange participant where the exchange participant acts as its executing broker in respect of its dealings in securities or futures for or on behalf of its clients, where the licensed corporation is responsible to its clients in respect of the acts of the exchange participant; provided that the exchange participant takes out and maintains insurance under which both the exchange participant and the licensed corporation are insured. It is not clear whether this would result in increased insurance premium for the exchange participant.</p> | <p>This will not result in increased insurance premium for an exchange participant as only one limit is exposed and the premium is intended to be allocated based on the turnover of the exchange participant concerned. Therefore, the turnover would not be double counted.</p> |
| 23 | - | General comments | <p>[The Institute of Securities Dealers Ltd]</p> <p>(i) The Scheme should result in a general reduction of premium due to the spreading of risk over a wider spectrum. As our members are concerned about costs, we would like to suggest that the premium payable on the introduction of the Scheme should not be higher than that of the preceding year.</p> <p>(ii) In addition, we would like to see that the securities dealers sector be well represented in the Standing and Advisory Committee on account that it is the largest. The representatives should be given all relevant information concerning the determination of</p> | <p>Although greater economies of scale may be achieved due to increase in the number of participants in the pool (as compared with BFI), the exact premium level cannot be ascertained until completion of the tender process. Furthermore, it is noted that apart from the number of participants, there are other factors affecting the level of premium such as overall market conditions, claim history and trend as foreseen by the insurer.</p> <p>In arranging the Scheme, industry associations including the Institute of Securities Dealers Ltd and Hong Kong Stockbrokers Association Ltd have already joined the SFC's working group. It is also proposed that representatives of the relevant industry associations would become members of the Standing Committee.</p> |

| | Section Reference | Details of the Rules | Respondent's Comments | SFC's Response |
|-------------------------------------|-------------------|----------------------|---|---|
| | | | premium by the insurer and the allocation to the various sectors. We would like to ensure that the allocation of premium is fair to our members. | <p>As regards the Advisory Committee, it should be noted that the composition of that Committee is stipulated by the legislation in that the majority members shall be appointed by the Chief Executive.</p> <p>However, in addressing the respondent's concern, it is now proposed that the selection of and the rationale behind choosing an insurer will also be tabled before the Standing Committee for comments prior to finalization.</p> |
| 24 | - | General comments | <p>[Name of respondent withheld as requested]</p> <p>To safeguard the insurance cost for exchange participants, the SFC should consider legislative measures to prevent any substantial increase of premium by the insurer due to extraordinary events that may have material impact on the market (e.g. September 11 event).</p> | <p>The SFC reckons that it may not be appropriate to impose legislative measures in relation to the level of premium, which should be determined by commercial forces in the insurance market following the tender procedures.</p> |
| <i>Allocation of premium</i> | | | | |
| 25 | - | General comments | <p>[SLC]</p> <p>While it is noted that a single scheme may well have the benefit of lowering the average insurance premium borne by individual licensees for the reasons stated, it must also be pointed out that licensed corporations which are "good" insurance risks are effectively being required to subsidize those licensed corporations which may be viewed by the insurance provider as being of "higher risk".</p> | <p>After consulting its adviser on this matter, the SFC was given to understand that this situation is inevitable to a certain degree in the context of assessing the overall industry risk and is actually the principle of all insurance regardless of whether or not it is effected under a common scheme.</p> <p>However, all efforts would be made to mitigate this effect. For instance, as proposed in the Consultation Document (paragraph 28b), licensees which have claims paid in the past 3 years will have an additional loading applied on their premium.</p> |

| | Section Reference | Details of the Rules | Respondent's Comments | SFC's Response |
|----|-------------------|----------------------|--|--|
| 26 | - | General comments | <p>[Hong Kong Stockbrokers Association Ltd]</p> <p>It is noted that the existing BFI Scheme deals singularly with securities and premium is calculated using annual turnover in dollar terms as a factor. However in the proposed Scheme, the securities dealings in BFI will be merged with futures contracts and the business of margin financing. It is obvious that the added activities are different products involving different risk factors in their nature as well as day-to-day operations. Moreover, margin financing is basically an on-going state of affairs and its nature cannot be readily assessed by using a single factor of turnover as in securities. Therefore, as the question of "fair" premium, we suggest that it should be equitably allocated.</p> | <p>A Standing Committee comprising representatives of the various sectors of the industry will be established to oversee the fair allocation of premium among participating firms.</p> <p>As illustrated in Appendix 2 of the Consultation Document, the insurer will be asked to break the global premium down into 5 amounts with each amount representing its views on the overall risk weighting attaching to that sector.</p> |
| 27 | - | General comments | <p>[Linklaters]</p> <p>(i) It is suggested that turnover may not be the best measure of business risk. Under the current proposal, the larger financial institutions will bear a larger portion of the global premium due to their high market share but this does not mean these institutions have a higher overall risk. In fact, many such institutions have their own insurance policies and internal control systems to mitigate risks. These factors should be considered when allocating the premium.</p> | <p>Turnover is a standard objective benchmark used by insurers of these risks to gauge overall business activity and thus is a good indicator of the overall risk.</p> <p>Moreover, the fact that all licensees concerned will be required to pay a minimum "floor" premium regardless of turnover will act as a counter-balance to this issue.</p> |

| | Section Reference | Details of the Rules | Respondent's Comments | SFC's Response |
|----|-------------------|----------------------|--|--|
| | | | <p>(ii) In Appendix 2 of the Consultation Document, an example is given on how the premium will be allocated. For securities dealers the variable amount is described as "last annual transaction values". What business activities are meant to be covered by that term?</p> <p>(iii) The variable amount for securities margin financiers is described as "average monthly loan balance last year". How is this average to be calculated? Is it simply the average of each month end balance?</p> | <p>It means the turnover of all securities dealing transactions conducted in Hong Kong which represents the insured business under the Scheme.</p> <p>However, to avoid double-counting, in calculating insurance premium borne by a licensed corporation, certain part of its turnover, which are related to the transactions executed through an exchange participant being its related company, can be excluded. The turnover excluded would be taken into account in calculating the insurance premium paid by the exchange participant concerned.</p> <p>This amount comes from the total margin loan balance receivable after deducting any specific provision for bad or doubtful debts. It is currently reported by securities margin financiers in their monthly FRR returns (Table 1 in Form 3).</p> |
| 28 | - | General comments | <p>[Name of respondent withheld as requested]</p> <p>The premium should not be based on the turnover of the insured's activity as turnover is not indicative of the risks undertaken by the insured licensee. It also results in higher premium to be paid by larger brokers which have higher turnover. We suggest that the capital base, the clients' asset base, the deductible level and the risk control system of the insured as criteria in determining premium. These are material factors in evaluating the risk profile of the insured licensee.</p> | <p>Apart from turnover, claim history would also be taken into account in determining the premium paid by individual licensed corporations after commencement of the Scheme. It would provide an objective reflection of the risk control system of the insured.</p> <p>In addition, as noted in item 27(i), the minimum "floor" premium regardless of turnover will act as a counter-balance to this issue.</p> <p>Any changes in criteria or inclusion of qualitative factors in calculating the insurance premium would unnecessarily complicate the Scheme and increase the overall cost as a consequence.</p> |

| | Section Reference | Details of the Rules | Respondent's Comments | SFC's Response |
|----|-------------------|----------------------|---|---|
| 29 | - | General comments | <p>[Linklaters]</p> <p>The Submitting Group would like further information on how the global premium is allocated between the five different sectors. Would the Standing Committee look at other factors, such as the risk management systems and policies of each entity?</p> | <p>The insurer will be asked to give their allocation having regard to the risks associated with each individual sector. The suggested allocation will then be tabled in a Standing Committee meeting for comments.</p> <p>The general risk profile of each sector (rather than individual entity), including the risk management infrastructure, will be factored in.</p> |
| 30 | - | General comments | <p>[Linklaters]</p> <p>(i) Whilst a Standing Committee, comprising members of the financial services industry and the SFC, will be established to consider and determine the allocation of premium, there is no indication in the Consultation Document that the terms and conditions of the Scheme's master policy will be the subject of public consultation, or who, if anyone, other than the SFC will have to approve those terms.</p> <p>(ii) Under s.6 (now s.7) of the draft Rules, the SFC has the ability to determine the terms and conditions of the Scheme's master policy. It is suggested this is also be brought in front of the Standing Committee.</p> <p>(iii) As the Standing Committee is comprised of members of the financial industry and will receive confidential information about other members of the financial industry, the Submitting Group assumes that steps will be taken to ensure that confidentiality is fully respected including subjecting each individual</p> | <p>Terms and conditions of the master policy will not be subject to public consultation. However, as proposed in the Consultation Document (paragraph 44), the SFC, or through its adviser, would arrange a tender of the proposed scheme in the Hong Kong and international insurance market. Selection of the successful insurer or a combination of insurers would be determined by the SFC on advice from its Advisory Committee.</p> <p>The SFC agrees that the selection process shall be run in a transparent manner and the selection of and rationale behind choosing an insurer will be tabled before the Standing Committee for comments prior to finalization.</p> <p>Each member of the Standing Committee will be required to sign a confidentiality undertaking.</p> |

| | Section Reference | Details of the Rules | Respondent's Comments | SFC's Response |
|----------------------------|-------------------|----------------------|--|--|
| | | | member to a confidentiality undertaking. | |
| 31 | - | General comments | <p>[Hong Kong Stockbrokers Association Ltd]</p> <p>We believe we need to be represented in the new Standing Committee on the Scheme. Only by this arrangement that we can efficiently and at first hand communicate to the SFC views of our members and vice versa.</p> | In arranging the proposed insurance scheme, industry associations including the Institute of Securities Dealers Ltd and Hong Kong Stockbrokers Association Ltd have already joined the SFC's working group. It is also intended that representatives of the relevant industry associations would become members of the Standing Committee. |
| 32 | - | General comments | <p>[Name of respondent withheld as requested]</p> <p>(i) We suggest that the Standing Committee becomes involved in other administrative aspects of the Scheme such as monitoring the negotiation and implementation of the Scheme regarding pricing, performance of the insurer, complaints from the insured etc.</p> <p>(ii) To facilitate efficiency, the insured should be able to deal directly with the insurer.</p> | <p>As mentioned in item 30, the selection process will be run in a transparent manner and the Standing Committee will be consulted with before finalization. In addition, the Standing Committee will also be regularly informed in relation to claims and other administrative matters. Details will be provided in its terms of reference.</p> <p>According to the SFC's adviser on this matter, the insured will have to deal through the appointed insurance broker and it is not unusual for tri-partite meetings to be held.</p> |
| <i>Commencement</i> | | | | |
| 33 | - | General comments | <p>[SLC]</p> <p>There are no provisions addressing persons who currently benefit from exempt status during the transitional period from the commencement of the SFO and ending on the date(s) on which they either obtain licensed status or terminate their current activities. Presumably this is intentional?</p> | All licensed corporations including existing exempt persons to be deemed as licensed corporations during the transitional period have to comply with the draft Rules on the proposed commencement date (i.e. 1 April 2003). |

| | Section Reference | Details of the Rules | Respondent's Comments | SFC's Response |
|---|-------------------|----------------------|--|--|
| 34 | - | General comments | <p>[Linklaters]</p> <p>There is no indication as to how this is going to work in practice during the transitional period of Part V of the SFO. The Group would appreciate some guidance as to how the transitional arrangements will work.</p> | <p>Detailed administrative procedures in relation to the Scheme will be issued to the relevant licensed corporations by the end of this year after completion of the tender process.</p> |
| <i>Standing of the insurers underwriting the Scheme</i> | | | | |
| 35 | - | General comments | <p>[Linklaters]</p> <p>There are no provisions relating to the standing of the insurers who will underwrite the Scheme. The definition of "insurer" is wide in the draft Rules. In order to enhance market confidence, the insurers permitted to underwrite the Scheme should be required to satisfy certain criteria, such as meeting a specified credit rating and meeting a minimum capitalization threshold.</p> | <p>Agreed. The draft Rules have been amended to require that the insurer underwriting the Scheme as well as the insurers of the group or global policies covering the specified licensed corporations which intend to be exempted from participating in the Scheme shall have a credit rating specified by the SFC from time to time.</p> <p>In addition, the insurers of the group or global policies shall not be related corporations of the licensed corporations concerned.</p> |
| <i>Alternative to joining the Scheme</i> | | | | |
| 36 | - | General comments | <p>[Linklaters]</p> <p>As an alternative to joining the Scheme, the SFC should permit entities to buy their own insurance based on minimum requirements specified by the SFC, such as self insured limit, risks to be covered, specified insurance companies that are acceptable to the SFC. This is the practice followed in the United States. This avoids sharing of confidential</p> | <p>At the initial stage of implementation, the SFC considers that it would be beneficial to the industry if the majority licensed corporations are to participate in the common Scheme for the sake of better quality control and economies of scale.</p> <p>Upon accumulation of experience for the industry as a whole, the SFC would review the proposed arrangement and consider</p> |

| | Section Reference | Details of the Rules | Respondent's Comments | SFC's Response |
|--|-------------------|----------------------|---|---|
| | | | information with competitors. In the United States, the regulators periodically inspect the policy. | the suggested alternative in due course. |
| <i>Negotiation of terms of the common policy</i> | | | | |
| 37 | - | General comments | <p>[SLC]</p> <p>When negotiating the common policy, the SFC should ensure that it is a term of the policy that default by one licensee should not affect the coverage of other licensees (although the ultimately defaults by licensees will affect the premium payable by all in future years).</p> <p>[Linklaters]</p> <p>The Submitting Group assumes that notwithstanding that licensed corporations are participating in a single insurance policy, that acts of one insured will not affect the policy as it applies to other insured. For example, the failure by one licensed corporation to comply with the terms should not affect the policy vis-à-vis other participants in the Scheme.</p> | <p>Agreed. This issue will be factored into the negotiations with potential insurers and the intention will be to provide for severability for each licensed corporation insured under the scheme master policy.</p> <p>This matter will be included in the tender document for selection of the insurer of the Scheme.</p> |

List of Respondents

| Date of submission | Respondent <Note> |
|--------------------|---|
| 24 July 2002 | The Securities Law Committee of the Law Society of Hong Kong |
| 25 July 2002 | The Institute of Securities Dealers Limited |
| 26 July 2002 | Linklaters (on behalf of Goldman Sachs (Asia) L.L.C., J.P. Morgan, Merrill Lynch (Asia Pacific) Limited, Morgan Stanley Dean Witter Asia Limited, Salomon Smith Barney Hong Kong Limited) |
| 29 July 2002 | Hong Kong Stockbrokers Association Limited |

<Note> Apart from the respondents mentioned above, the SFC also received submissions from another 5 respondents which requested the SFC not to publish their names in relation to this public consultation.