

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

**Securities and Futures (Insurance) Rules**

**Introduction**

This paper informs Members of –

- (a) the outcome of the Securities and Futures Commission (the SFC)'s further consultation with the industry on the draft Securities and Futures (Insurance) Rules, now revised at the **Annex** (the revised draft Rules); and
- (b) the related implementation arrangements.

**Background**

2. Members considered the earlier draft of the Rules vide Paper No. 24/02 at the Subcommittee meeting on 18 September 2002 and raised a number of concerns, especially in relation to the need and practicability of setting up a compulsory insurance scheme to be arranged by the SFC, the possibility of cross-subsidy among corporations licensed for different types of regulated activity if they are all covered under a single master scheme, as well as the need for drafting the Rules in such a way as to avoid weakening the bargaining position in negotiating an insurance scheme with potential insurers.

3. In the light of Members' concerns, the SFC convened, with the kind assistance of Hon Henry Wu, an industry working group (the IWG) in October 2002 with members from the industry<sup>1</sup> and relevant experts in the insurance field. Taking into account SFC's regulatory concerns and the IWG's views, we set out in Paper No. 39/02 the major features that should be reflected in the draft Rules. The paper was considered by Members at the Subcommittee meeting on 24 October 2002. To recap, we considered that the

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<sup>1</sup> Include representatives from the Hong Kong Stockbrokers Association, the Hong Kong Institute of Securities Dealers and the Hong Kong Securities Professionals Association, as well as other market participants.

draft Rules should –

- (a) empower the SFC to authorize a single master policy of brokers fidelity insurance (BFI) and all licensed corporations which are exchange participants would be obliged to participate in it. Relevant licensed corporations are only required to take out insurance if the SFC has approved a master policy so as to avoid undermining the industry's bargaining position in negotiating a scheme with potential insurers; and
- (b) provide flexibility for adjusting, from time to time, the insurance coverage, the risk coverage and the deductibles as the master policy is renewed regularly<sup>2</sup> subject to commercial negotiations.

4. The revised draft of the Rules (paragraph 6 below) together with the implementation arrangements (paragraphs 7 to 13 below) reflect as appropriate the above features and consensus reached by the IWG on the preliminary result of the tender for a master policy scheme. They take into account the views of the industry as we last reported to Members, that the new arrangements should use the existing BFI scheme (arranged by the Stock Exchange of Hong Kong (SEHK) and expiring on 31 March 2003) as the basis to preserve at least the status quo; and that any gap between the existing BFI scheme and the new insurance arrangements should be avoided.

5. In light of the IWG's consensus to first proceed with the arrangement of an insurance scheme for SEHK participants and to further negotiate with potential insurers on the scheme for other licensed corporations concerned, the SFC has revised the draft Rules to provide for flexibility as to the timing of imposing insurance requirements on different categories of licensed corporations. This was done by way of the SFC approving master policies of insurance in relation to different types of regulated activity separately.

### **Major features of the revised draft Rules**

6. The revised draft Rules at the Annex –

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<sup>2</sup> Past experience of the securities industry shows that such insurance policy will be subject to annual renewal.

- (a) apply to all licensed corporations (specified licensed corporations), except for licensed corporations that are not exchange participants and are subject to a licence condition that they shall not hold client assets (clause 3);
- (b) where the SFC has approved a master policy of insurance in respect of a regulated activity –
  - (i) require a specified licensed corporation which is an exchange participant licensed for that regulated activity (may it be dealing in securities, dealing in futures contracts or both) to take out insurance under that master policy; and
  - (ii) require other specified licensed corporation licensed for that regulated activity to take out insurance either under that master policy or a policy arranged individually with an independent insurer (clauses 4 and 5);
- (c) specify the risks in relation to which, and the amounts for which, insurance coverage is required (clause 4 and Schedules 1 and 2); and
- (d) provide that the SFC may approve a master policy of insurance in respect of a regulated activity (targeting at exchange participants as necessary); and prescribe minimum credit ratings to be possessed by insurers with whom insurance is taken out and maintained (clause 5 and Schedule 3).

## **Implementation arrangements**

### ***Insurance requirements***

7. Based on its assessment of the relevant risks applicable to corporations licensed for different types of regulated activity, the SFC has proposed an insured amount of \$15 million with a deductible of not more than \$3 million for the risks specified, in respect of each regulated activity of dealing in securities, dealing in futures contracts and providing securities margin financing. The above insured amount will apply if the SFC approves separate insurance policies in respect of each type of regulated activity concerned.

8. In the event that a single master policy of insurance is arranged for different regulated activities, an aggregate insured amount of \$25 million will apply with respect to all regulated activities concerned. The SFC intends that as far as possible, only one master policy of insurance is to be arranged for all regulated activities concerned.

9. The basis of premium allocation has not been included in the draft Rules because the SFC and the IWG recognize that the circumstances in relation to premium allocation will change from time to time. It is therefore inappropriate to stipulate such basis in the Rules. Instead, a more flexible approach through industry consensus will be adopted in determining the basis of premium allocation. In that regard, the IWG has generally agreed on the basis of allocation, which is largely modeled on the existing BFI Scheme arranged by the SEHK.

10. The SFC will keep in view future development and propose amendments to the Rules for updating the insurance requirements and to other regulatory measures as appropriate, so as to maintain a reasonable balance between enhancing investor protection and minimizing compliance burden on the industry.

### *Approval of master policy*

11. If there are insurers in the market that are prepared to offer a master policy, at a reasonable premium, for all corporations licensed for dealing in securities, dealing in futures contracts or securities margin financing business, then the SFC will approve one master policy for all categories of licensed corporations concerned (including both exchange participants and non-exchange participants). Otherwise the SFC will approve separate master policies for each relevant type of regulated activity or category of licensed corporations, as the insurance market conditions dictate.

12. From the tender process currently in progress and the deliberations of the IWG, the SFC expects that an approved master policy for exchange participants licensed for dealing in securities would be available upon commencement of the Securities and Futures Ordinance (Cap.571) (the SFO) (dovetailing the expiry of the existing BFI scheme); thereby preserving the scope of application of existing insurance requirements.

13. As for the other categories of corporations (i.e. non-exchange participants licensed for dealing in securities, and corporations licensed for dealing in futures contracts and securities margin financing respectively), they

are not required to be insured presently. The SFC is working closely with the industry on a suitable master policy of insurance for them. However, the process may take a little longer as there is no claims record readily available for these categories. Among them, the higher risk categories are presently covered by the dealers deposit schemes<sup>3</sup> under the Securities Ordinance (Cap. 333) and the Commodities Trading Ordinance (Cap. 250). The SFC will retain the dealers deposits until a master policy for the relevant licensed corporations is approved. This is permitted by the transitional arrangements under Schedule 10 to the SFO.

## **Public Consultation**

14. As mentioned in paragraphs 2 and 3 above, Members considered Paper No.24/02 and Paper No.39/02 respectively at the Subcommittee meetings on 18 September 2002 and 24 October 2002. The IWG (which met several times since October 2002) has been closely involved in the preparation of the tender document inviting interest from insurers for the new insurance scheme, and has been consulted on the revisions to the draft Rules. The IWG is agreeable to the implementation arrangements outlined in paragraphs 7 to 13 above.

## **Way Forward**

15. The SFC will make the Rules under the authority vested in it and publish the Rules so made in the Gazette on 17 January 2003 for tabling before the Legislative Council on 22 January 2003 in the normal manner. The SFC will implement the Rules as set out in paragraphs 7 to 13 above. The intention is that the Rules will come into operation on commencement of the SFO on 1 April 2003.

Securities and Futures Commission  
Financial Services Bureau  
24 December 2002

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<sup>3</sup> Under the Securities Ordinance, each securities dealer who is not accredited to a SEHK participant is required to lodge and maintain with the SFC a deposit of \$50,000. As regards commodity dealers, each commodity dealer firm is required under the Commodities Trading Ordinance to pay a deposit of \$100,000 for contribution to the Futures Exchange Compensation Fund if it is a Futures Exchange participant, or for lodging with the SFC if it is a non-Futures Exchange participant.

**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 the day appointed for the commencement of the Securities and Futures Ordinance (Cap. 571).

**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 in compliance with 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;

“period of insurance” (保險期) means a period during which a policy of insurance approved by the Commission under section 5(1) or (2)(a) or (b) is, or is to be, taken out and maintained;

“specified amount” (指明款額) means the insured amount (if any) specified in Schedule 2 per period of insurance;

“specified credit rating” (指明信貸評級) means any one of the credit ratings specified in Schedule 3;

“specified licensed corporation” (指明持牌法團) means a corporation to which these Rules apply by virtue of section 3(1);

“specified risks” (指明風險) means the risks specified in Schedule 1.

(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) These Rules apply to a corporation that is granted a licence under section 116(1) of the Ordinance to carry on any regulated activity other than such a corporation that –

- (a) is not an exchange participant; and
- (b) is granted a licence under section 116(1) of the Ordinance to carry on any regulated activity subject to a condition that the corporation shall not hold client assets directly or through any of its associated entities.

(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, with necessary modifications.

### **4. Duty of licensed corporations to take out and maintain insurance**

(1) Where the Commission has approved a master policy of insurance under section 5(1) in respect of a period of insurance for a regulated activity, a specified licensed corporation licensed for that regulated activity shall take out and maintain insurance for that regulated activity in relation to the specified risks for not less than the specified amount for that period of insurance under –

- (a) that master policy of insurance approved by the Commission; or

- (b) any other policy of insurance with one or more insurer that –
  - (i) is not a related corporation of the specified licensed corporation; and
  - (ii) has a specified credit rating on the date of commencement of the policy of insurance.

(2) Where the Commission has approved a master policy of insurance under section 5(2)(a) in respect of a period of insurance, a specified licensed corporation that is an exchange participant licensed for the regulated activity of dealing in securities shall, in addition to an insurance (if any) that it is required to take out and maintain under other provisions of this section, take out and maintain insurance in relation to the specified risks for not less than the specified amount under that master policy of insurance for that period of insurance.

(3) Where the Commission has approved a master policy of insurance under section 5(2)(b) in respect of a period of insurance, a specified licensed corporation that is an exchange participant licensed for the regulated activity of dealing in futures contracts shall, in addition to an insurance (if any) that it is required to take out and maintain under other provisions of this section, take out and maintain insurance in relation to the specified risks for not less than the specified amount under that master policy of insurance for that period of insurance.

(4) Each master policy of insurance approved by the Commission under section 5 and the policy of insurance referred to in subsection (1)(b) may specify a deductible amount not exceeding \$3,000,000.

(5) For the avoidance of doubt, a specified licensed corporation shall not be required to take out and maintain insurance in relation to a regulated activity under subsection (1) where that specified licensed corporation is required to take out and maintain insurance for that regulated activity under subsection (2) or (3).



## **5. Commission may approve master policy of insurance**

(1) With the exception of the policies of insurance that may be approved under subsection (2), the Commission may, in respect of any period of insurance, approve one policy of insurance in respect of a regulated activity to be the master policy of insurance for all specified licensed corporations licensed for that regulated activity.

(2) The Commission may, in respect of any period of insurance –

(a) approve one policy of insurance in respect of the regulated activity of dealing in securities to be the master policy of insurance for all specified licensed corporations that are exchange participants licensed for that regulated activity; and

(b) approve one policy of insurance in respect of the regulated activity of dealing in futures contracts to be the master policy of insurance for all specified licensed corporations that are exchange participants licensed for that regulated activity.

(3) The Commission shall not approve a master policy of insurance under this section unless the insurer of the master policy of insurance (or, if the master policy of insurance is jointly undertaken by more than one insurer, each insurer) has the specified credit rating on the date of the approval.

### **SCHEDULE 1**

[s. 2]

### **SPECIFIED RISKS**

(1) The risks in relation to which a specified licensed corporation shall take out and maintain insurance under these Rules, to the extent that those risks arise out of its carrying on in Hong Kong of a regulated activity, are 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 –

- (a) fraudulent or dishonest conduct by employees of the specified licensed corporation (or its associated entity or service bureau);
- (b) robbery or theft while the client assets are in the custody of the specified licensed corporation (or its associated entity);
- (c) forgery or fraudulent alteration of a cheque or other negotiable instrument;
- (d) fraudulent use of an information system; and
- (e) forged or fraudulent instructions relating to the client assets.

(2) For the purposes of this Schedule –

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

“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 that are ancillary to the carrying on by the specified licensed corporation of any regulated activity.

## SCHEDULE 2

[s. 2]

## SPECIFIED AMOUNT

## PART 1

(1) Where a specified licensed corporation is licensed to carry on one regulated activity in Hong Kong, the insured amount in respect of a period of insurance for the specified risks shall be the amount specified in column 2 of Part 2 opposite to the regulated activity for which it is licensed to carry on in Hong Kong.

(2) Where a specified licensed corporation is licensed to carry on in Hong Kong for more than one regulated activity –

- (a) if it takes out and maintains a single policy of insurance for the specified risks arising out of all those regulated activities, the insured amount in respect of all those regulated activities shall be \$25,000,000;
- (b) if it takes out and maintains a separate policy of insurance for the specified risks arising out of each of those regulated activities, the insured amount in respect of each relevant regulated activity shall be the amount specified in column 2 of Part 2 opposite to that relevant regulated activity.

PART 2  
INSURED AMOUNT

	<b>Regulated activity</b>	<b>Insured amount(\$)</b>
1.	Dealing in securities	15,000,000
2.	Dealing in futures contracts	15,000,000
3.	Leveraged foreign exchange trading	Nil
4.	Advising on securities	Nil
5.	Advising on futures contracts	Nil
6.	Advising on corporate finance	Nil
7.	Providing automated trading services	Nil
8.	Securities margin financing	15,000,000
9.	Asset management	Nil

Each of the regulated activities specified in column 1 of this Part shall have the meaning assigned to it by Part 2 of Schedule 5 to the Ordinance.

## SCHEDULE 3

[ss. 2 &amp; 5]

## CREDIT RATINGS

1. A Moody's Investors Service rating of "A" or above for Long-Term Insurance Financial Strength.
2. A Standard & Poor's Corporation rating of "A" or above for Insurer Financial Strength.
3. A Fitch Ratings Limited rating of "A" or above for Insurer Financial Strength.

Chairman,

Securities and Futures Commission

2000

**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 corporations to whom the Commission has granted licences under section 116(1) of the Ordinance to carry on specified regulated activities, to take out and maintain insurance in respect of specified risks and for specified amounts. They also deal with other matters relating to the insurance.