

## **LEGISLATIVE COUNCIL BRIEF**

### **Securities and Futures Ordinance (Cap. 571)**

#### **SECURITIES AND FUTURES (INVESTOR COMPENSATION - CLAIMS) RULES**

##### **INTRODUCTION**

Pursuant to section 244(2) of the Securities and Futures Ordinance (Cap. 571) (the SFO), the Securities and Futures Commission (the SFC) has made the Securities and Futures (Investor Compensation - Claims) Rules (the Claims Rules) at the **Annex**.

##### **BACKGROUND**

###### **The SFO**

2. The SFO was enacted in March 2002. It consolidates and modernizes ten existing ordinances governing the securities and futures markets into a composite piece of legislation to keep the regulatory regime on a par with international standards and practices. For effective regulation, the SFO provides flexibility in addressing changing market practices and global conditions by empowering the Chief Executive in Council, the Financial Secretary, the Chief Justice and the SFC to prescribe detailed and technical requirements as necessary by way of subsidiary legislation, to supplement the regulatory framework laid down under the primary legislation.

3. On 22 February 2002, the House Committee of the Legislative Council established the Subcommittee on Draft Subsidiary Legislation to be made under the Securities and Futures Ordinance (the Subcommittee) to study the subsidiary legislation necessary for commencing the SFO. From March 2002 to October 2002, the Subcommittee held 12 meetings and considered a total of 37 sets of draft subsidiary legislation, including the vires to make them.

## **THE PROPOSALS**

### **Major policy considerations**

4. Parts III and XII of the SFO make provisions for the legal framework for the operation of the new investor compensation arrangements, the establishment of a new investor compensation fund (ICF) and the establishment of an investor compensation company. The Claims Rules supplement Part XII and the circumstances in which a person is entitled to claim compensation, the manner in which a claim for compensation is to be made, the information to be supplied to the SFC to enable the claim to be determined and the persons who are not entitled to make a claim.

5. The Claims Rules should be read in conjunction with two other Rules and two Orders that have been made by the Chief Executive in Council and published in the Gazette on 13 December 2002 -

- (a) the Securities and Futures (Investor Compensation – Levy) Rules
- (b) the Securities and Futures (Investor Compensation – Compensation Limits) Rules;
- (c) the Securities and Futures (Transfer of Functions – Investor Compensation Company) Order; and
- (d) the Securities and Futures Ordinance (Amendment of Schedule 8) Order 2002.

In this Brief these Rules and Orders are referred to as the Compensation Levy Rules, the Compensation Limits Rules, the Transfer Order and the Schedule 8 Order.

### *The existing compensation arrangements*

6. Part X of the Securities Ordinance (Cap. 333) (the SO) has provided for a compensation fund for securities market investors since 1974. The fund originally applied to a default by a member of any of the four stock exchanges in operation until 1986. Since the unification of those exchanges in 1986, the Unified Exchange Compensation Fund (the UECF) has replaced the original fund and has applied to a default by any member of the Stock Exchange of Hong Kong Limited (the Stock Exchange).

7. Another fund, known as the Futures Exchange Compensation Fund (FECF), has been established under Part VIII of the Commodities Trading Ordinance (Cap. 250) providing investors compensation for defaults by futures exchange participants. Further limited compensation is provided for investors under the Dealers' Deposit Scheme established under section 52 of the SO.

8. The compensation ceilings for the UECF and the FECF are respectively \$8 million per stockbroker and \$2 million per futures broker.

*The new compensation arrangements*

9. Under Part XII of the SFO, the SFC will establish a new investor compensation fund (ICF). The ICF will replace the existing UECF, the FECF and the Dealers' Deposit Scheme.

10. The new arrangements will significantly enhance the compensation available to investors. They will cover defaults by all -

- (a) securities and futures dealers; and
- (b) margin financiers,

who receive and hold client securities and/or money whether or not they are exchange participants in relation to all products traded on markets operated by Hong Kong Exchanges and Clearing Limited (the HKEx). Coverage will also be extended to retail investors who deal through registered institutions. Institutional investors will be excluded from claiming compensation. The circumstances under which claims can be made are set out in the Claims Rules and are described in greater detail below.

11. A "per investor" compensation limit of \$ 150,000 is imposed under the Compensation Limits Rules. These Rules provide that where a claimant claims compensation in respect of loss sustained as a result of a default in relation to -

- (a) securities listed or traded on a recognized stock market; or
- (b) futures contracts traded on a recognized futures market,

the maximum amount of compensation that may be paid to each claimant is \$150,000. This is in line with the on-going policy adopted by existing UECF for awards to claimants in recent years.

12. The arrangements will be administered by the Investor Compensation Company Limited (the ICCL) which is recognized and regulated by the SFC. Under the Transfer Order certain functions of the SFC relating to the management of the ICF are transferred to the ICCL subject to the reservation that these functions are to be performed concurrently with the SFC. The ICCL will receive and determine claims under the Claims Rules, make payments to claimants, and pursue subrogated rights against defaulters. The ICCL is to be classified as a public body under the Prevention of Bribery Ordinance (Cap. 201).

13. Initial funding of the ICF will come from a transfer of assets from the existing compensation funds under sections 74 and 75 of Schedule 10 to the SFO, but with sufficient amounts reserved in those funds to cover outstanding liabilities. The net assets of the UECF and the FECF as of 30 September 2002, were approximately \$800 million and \$100 million respectively .

14. Ongoing funding will be provided under the Compensation Levy Rules which impose a levy on the sale and purchase of securities and futures contracts. This will help ensure that the new ICF will be properly funded on establishment to meet with its obligations. The SFC will keep under review the funding level and the rate of levy in the light of the operational experience of the ICF and prevailing circumstances. With this, the existing requirements for exchange participant dealers to provide deposits for the compensation funds and for other dealers to make deposits to the Dealers' Deposit Schemes would no longer be required.

## **THE CLAIMS RULES**

15. Section 4 of the Claims Rules prescribes the circumstances in which a person is entitled to claim compensation. It provides that where a qualifying client of a specified person sustains a loss as a result of the default committed by the specified person, or an associated person of the specified person, in relation to specified securities or futures contracts, or related assets, he may claim compensation from the compensation fund.

16. The terms "qualifying client", "specified person", "default", "associated person", "specified securities or futures contracts" and "related assets" are all defined in section 2 of the Claims Rules. The interaction of these definitions prescribes the circumstances in which a claim for compensation can be made. Important features of these definitions are explained below -

- (a) a qualifying client is a person for whom the specified person provides a service but certain persons will not be able to claim. The persons who cannot claim are mainly institutional investors who should be able to look after their investments compared to retail investors;
- (b) a specified person covers intermediaries licensed or registered for dealing in securities or futures contracts, and licensed intermediaries and banks providing securities margin financing;
- (c) a default, as adapted from the SO, covers insolvency, bankruptcy or winding up, breach of trust, defalcation, fraud or misfeasance of the specified person, and extended to cover the insolvency, bankruptcy or winding up of an associated person of the specified person. Currently “default”, in relation to an employee of the exchange participant, is limited to a breach of trust, defalcation, fraud or misfeasance;
- (d) an associated person covers an employee of a specified person, a person who is authorized under section 164 of the SFO to hold client assets and such a person’s employee;
- (e) a specified securities or futures contracts are limited to securities or futures contracts listed or traded on the Stock Exchange of Hong Kong or the Hong Kong Futures Exchange which were entrusted to the intermediary in default, or its associated person, and to which the qualifying client was entitled; and
- (f) related assets cover money or other property entrusted to the intermediary in default by the qualifying client relating to the purchase, sale or pledge etc. of the securities or futures contracts.

17. Under section 7 of the Claims Rules the SFC will determine whether there has been a default and whether the claimant is entitled to compensation from the ICF. If satisfied, the SFC will determine a provisional amount of compensation.

18. A notice will be issued to a claimant under section 8 of the Rules specifying the amount of compensation payable under the Rules. However, the SFC will not issue a notice of determination specifying a provisional amount of compensation that is less than the compensation claimed unless it has first given the claimant a reasonable opportunity of being heard. If after this, the SFC decides to issue the notice of determination, it will give its reasons in the notice.

19. Under the Amendment of Schedule 8 Order, determinations by the SFC (and or the ICCL) as to whether there has been a default, the date of default, whether a claimant is entitled to compensation or the provisional amount of compensation, are all reviewable by the Securities and Futures Appeals Tribunal (SFAT) on application of the claimant who is dissatisfied with such a decision.

## **PUBLIC CONSULTATION**

20. The SFC first released a consultation paper on the concept and general framework of new investor compensation arrangements in September 1998. It outlined the rationale for the new arrangements to enhance investor protection and the objectives and key features of the proposal, including the establishment of an investor compensation company regulated by the SFC. There was broad agreement in principle to the new compensation arrangements and to the setting up of an independent investor compensation company.

21. Taking into account public comments received in the 1998 consultation exercise, the SFC released a more detailed consultation document in March 2001 on the key components of the new investor compensation arrangements. The proposals met with positive response from the public.

22. The SFC issued the final consultation document containing the exposure drafts of the Compensation Levy Rules, the Compensation Limits Rules, the Claims Rules and the Transfer Order on 28 March 2002 for comment by the public. Six submissions were received. The SFC considers that no major changes needed to be made to the substance of the Claims Rules in response to these submissions.

23. A draft of the Claims Rules was considered by the Subcommittee at its meetings on 6 June 2002 and 24 October 2002. The Claims Rules were further refined in the light of comments of the Members of the Subcommittee to better reflect the policy intention and to improve drafting.

## **FINANCIAL AND STAFFING IMPLICATIONS**

24. There are no financial or staffing implications for the Government.

## **COMMENCEMENT DATE**

25. The Claims Rules will come into operation on the day appointed for the commencement of the SFO, together with other subsidiary legislation necessary for the commencement. We expect this to take place shortly, after completion of the negative vetting procedure through the Legislative Council and allowing the industry a reasonable period of time for making necessary adjustments with reference to the subsidiary legislation. We aim to announce the target commencement date by the end of 2002.

## **PUBLICITY**

26. The Claims Rules will be published in the Gazette on 13 December 2002. The SFC will issue a press release on the same day.

## **ENQUIRIES**

27. For any enquiries on this brief, please contact Mr. Gerald Greiner of the Supervision of Markets Department of the SFC at 2840 9304 or Mr. Anthony Wood of the Legal Services Division of the SFC at 2840 9276.

The Securities and Futures Commission  
13 December 2002

## SECURITIES AND FUTURES (INVESTOR COMPENSATION - CLAIMS) RULES

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## **SECURITIES AND FUTURES (INVESTOR COMPENSATION - CLAIMS) RULES**

(Made by the Securities and Futures Commission under section 244(2) of the Securities and Futures Ordinance (Cap. 571), and in relation to rules made under section 244(2)(a) and (f) of that Ordinance after consultation with the Financial Secretary)

### **PART 1**

#### **PRELIMINARY**

##### **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**

In these Rules, unless the context otherwise requires -  
"appointed day" (指定日期) means the date appointed under section 13;  
"associated person" (相聯者), in relation to a specified person,  
means -

- (a) a person employed or otherwise engaged by the specified person;
- (b) a person who may receive or hold client assets of the specified person under section 164 of the Ordinance; or

- (c) an employee of the person referred to in paragraph (b);

"claimant" (申索人) means a qualifying client who makes a claim under section 4;

"default" (違責), in relation to a specified person or an associated person of the specified person, means -

- (a) the insolvency, bankruptcy or winding up of the specified person or associated person of the specified person; or
- (b) any breach of trust, defalcation, fraud or misfeasance committed by the specified person or associated person of the specified person,

which occurs on or after the appointed day;

"qualifying client" (合資格客戶), in relation to a specified person, means a person for whom the specified person provides a service but does not include -

- (a) a licensed corporation;
- (b) an authorized financial institution;
- (c) a recognized exchange company, a recognized exchange controller, or a recognized clearing house;
- (d) a person authorized to provide automated trading services under section 95(2) of the Ordinance;
- (e) an insurer authorized under section 8 of the Insurance Companies Ordinance (Cap. 41);

- (f) a manager or operator of a collective investment scheme authorized under section 104(1) of the Ordinance;
- (g) a manager or operator of an arrangement referred to in paragraph (iii) of the definition of "collective investment scheme" in section 1 of Part 1 of Schedule 1 to the Ordinance;
- (h) a person who is authorized, licensed or exempt by a competent authority in a jurisdiction outside Hong Kong for any activity that in the opinion of the Commission is the same as or similar to any of the activities carried on by a person referred to in paragraphs (a) to (g);
- (i) an associated person of the specified person -
  - (i) which is a corporation; or
  - (ii) who has committed any breach of trust, defalcation, fraud or misfeasance or assisted in the commission of a default by the specified person or any other associated person of the specified person;
- (j) the Government or a government of any place outside Hong Kong; and
- (k) a person in his capacity as a trustee or custodian of a person, scheme or arrangement referred to in paragraphs (a) to (j);

"related assets" (有連繫資產) means money and other property -

- (a) which are entrusted to or received by a specified person or an associated person of the specified person;
- (b) to which a claimant is entitled or in which he has a beneficial interest; and
- (c) which relates to the -
  - (i) purchase;
  - (ii) sale;
  - (iii) holding;
  - (iv) pledge;
  - (v) adjustment;
  - (vi) exercise; or
  - (vii) expiry,

of specified securities or futures contracts;

"securities margin financing" (證券保證金融資) has the same meaning as in Part 2 of Schedule 5 to the Ordinance except that paragraph (v) of the definition of that expression does not apply;

"specified person" (指明人士) means -

- (a) an intermediary licensed or registered for dealing in securities or dealing in futures contracts;
- (b) an intermediary licensed for securities margin financing; or
- (c) an authorized financial institution which provides securities margin financing;

"specified securities or futures contracts" (指明證券或期貨合約)

means any securities or futures contracts listed or traded or to be listed or traded on a recognized stock market or recognized futures market -

(a) which are entrusted to or received by a specified person or an associated person of the specified person; and

(b) to which a claimant is entitled or in which he has a beneficial interest;

"Tribunal" (審裁處) means the Securities and Futures Appeals Tribunal established by section 216 of the Ordinance.

## PART 2

### CLAIMS FOR COMPENSATION

#### **3. Notice inviting claims**

(1) Where the Commission has reason to believe that a specified person or any associated person of the specified person has committed a default, it may publish a notice inviting a qualifying client of the specified person named in the notice who believes he has sustained loss as a result of such default to claim for compensation. Such a notice shall be published in one or more English language newspapers and one or more Chinese language newspapers which are published daily and circulating generally in Hong Kong.

(2) A notice published under subsection (1) shall specify a date, not being earlier than 3 months after publication of the notice, on or before which a claim for compensation may be made under section 4.

#### **4. Making a claim for compensation**

(1) Where a qualifying client of a specified person sustains a loss -

(a) as a result of a default committed on or after the appointed day by -

- (i) the specified person; or
- (ii) an associated person of the specified person;

(b) in relation to -

- (i) specified securities or futures contracts;
- or
- (ii) related assets,

the qualifying client may claim compensation from the compensation fund in respect of such loss.

(2) A claim under subsection (1) may include a claim for the costs reasonably incurred in and incidental to the making and proving of the claim.

(3) A claim under subsection (1) shall be lodged with the Commission -

- (a) if a notice under section 3(1) has been published, on or before the date specified in the notice; or

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

(4) A claim which is not lodged within the time limit provided in subsection (3) is barred, unless the Commission determines otherwise.

#### **5. Submission of claims**

(1) Subject to subsection (2), a claim under section 4(1) shall be -

- (a) lodged in the form specified by the Commission under section 402(1) of the Ordinance for the purposes of this section;
- (b) completed and signed in accordance with such directions and instructions as are included in the form; and
- (c) accompanied by such documents as are specified in the form.

(2) The Commission may accept a claim lodged otherwise than in accordance with subsection (1).

### PART 3

#### PROCESSING OF CLAIMS

#### **6. Commission may require records**

(1) The Commission may, by notice in writing served upon a person, require the person to produce to the Commission originals



or copies of such records as the Commission may reasonably require -

- (a) in connection with a claim for compensation made under section 4(1); or
- (b) for the purpose of assisting -
  - (i) the Commission in the exercise of its rights of subrogation under section 243 of the Ordinance; or
  - (ii) a recognized investor compensation company in the exercise of its rights of subrogation under section 87 of the Ordinance.

(2) A notice under subsection (1) shall specify the records required and the date by which the person served with the notice is to furnish them to the Commission.

#### **7. Determination by Commission**

(1) The Commission shall, in relation to a claim for compensation, determine -

- (a) whether there has been a default by the specified person concerned or any associated person of the specified person;
- (b) the date of the default (if any); and
- (c) whether the claimant is entitled to compensation from the compensation fund.

(2) If the Commission determines that -

- (a) there has been a default by a specified person or any associated person of the specified person; and
- (b) the claimant is entitled to compensation from the compensation fund,

the Commission shall determine a provisional amount of compensation in accordance with subsection (3).

(3) The provisional amount of compensation referred to in subsection (2) shall be determined by the Commission having regard to -

- (a) the market value, as at the date of the default, of the specified securities or futures contracts and of any related assets that the Commission is satisfied the claimant has lost as a result of the default less -
  - (i) any amount that the Commission is satisfied was due from the claimant to the specified person; and
  - (ii) any specified securities, futures contracts or related assets that have been returned to the claimant after the date of the default; and
- (b) any costs that the Commission is satisfied were reasonably incurred by the claimant incidental to the making and proving of his claim for compensation under section 4.

**8. Notice of determination**

(1) Subject to subsection (2), where the Commission makes a determination under section 7, it shall issue a notice of determination to the claimant as soon as practicable thereafter.

(2) The Commission shall not issue a notice of determination specifying a provisional amount of compensation that is less than the compensation claimed unless it has given the claimant a reasonable opportunity of being heard and, where the Commission decides to issue such a notice, it shall give its reasons in the notice of determination.

(3) Where the Commission determines that compensation should be paid to a claimant, it shall specify the following in the notice of determination -

- (a) the name of the person found to be in default;
- (b) the date of the default;
- (c) the provisional amount of compensation as determined under section 7;
- (d) any relevant specified securities or futures contracts or related assets; and
- (e) the amount of compensation payable under these Rules.

**9. Payment of compensation**

(1) Subject to subsection (2) and section 11, the following amounts shall be paid out of the compensation fund -

- (a) any compensation payable to a claimant as specified in the notice of determination under section 8(3)(e);
- (b) any compensation payable following a decision of the Tribunal or the Court of Appeal, under Part XI of the Ordinance; and
- (c) any costs awarded in favour of a claimant by the Tribunal, or the Court of Appeal, following a decision referred to in paragraph (b).

(2) The total amount of compensation payable to a claimant under subsection (1)(a) and (b) shall not exceed the maximum amount of compensation prescribed by rules made under section 244(1) of the Ordinance.

(3) In determining the total amount of compensation to be paid to a claimant under subsection (1)(a) and (b), and in applying the limits on the maximum amount of compensation prescribed by rules made under section 244(1) of the Ordinance, the Commission may aggregate separate claims for compensation by a claimant, or a number of claimants, or parts of those claims, if it is satisfied that the separate claims, or parts of those claims, represent the losses sustained by one person arising out of the same default.

(4) The Commission may pay compensation by instalments if it determines that it is necessary or appropriate to do so.

## PART 4

## MISCELLANEOUS

**10. Financial arrangements**

The Commission may arrange for such insurance, surety, guarantee or other financial arrangements as it considers appropriate to facilitate the administration of the compensation fund.

**11. Provision where the money available to the compensation fund is insufficient to meet claims**

(1) If, at any time, the Commission determines that the amount of money available to the compensation fund is insufficient to pay the total amount of compensation then payable to the claimants, or likely to become so payable -

(a) under these Rules; and

(b) in the circumstances referred to in section 9(1)(b), the amount available to the compensation fund is to be apportioned among the claimants in such manner as the Commission may determine.

(2) In the event that any amounts referred to in section 9(1) remain unpaid because the Commission has determined that an apportionment shall be made under subsection (1), the amounts are to be paid when there is sufficient money available to the compensation fund.

**12. Discharge of claims**

Upon payment of the full amount determined to be payable to a claimant under these Rules, the rights of the claimant against the compensation fund in relation to the claim and the default are absolutely discharged.

**13. Appointed day**

The Commission may by notice published in the Gazette appoint a date as the appointed day for the purposes of these Rules.

  
**Andrew Len Tao SHENG**

Chairman,  
Securities and Futures Commission

31<sup>st</sup> December, 2002

**Explanatory Note**

These Rules are made by the Securities and Futures Commission ("the Commission") under section 244(2) of the Securities and Futures Ordinance (Cap. 571) ("the Ordinance"). They prescribe the persons who may make a claim for compensation from the Investor Compensation Fund established under section 236 of the Ordinance. They also prescribe the manner in which such a claim is to be made and how such a claim will be assessed and paid.

2. These Rules should be read in the light of the Securities and Futures (Transfer of Functions - Investor Compensation Company)

Order (L.N.            of 2002) which transfers certain functions of  
the Commission to a recognized investor compensation company.