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Legislative Council

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Panel on Financial Affairs

Minutes of special meeting
held on Friday, 17 December 2004 at 8:30 am
in the Chamber of the Legislative Council Building

Members present	:	Hon Bernard CHAN, JP (Chairman) Hon Ronny TONG Ka-wah, SC (Deputy Chairman) Hon James TIEN Pei-chun, GBS, JP Hon Albert HO Chun-yan Hon LEE Cheuk-yan Dr Hon David LI Kwok-po, GBS, JP Hon James TO Kun-sun Hon CHAN Kam-lam, JP Hon SIN Chung-kai, JP Hon Emily LAU Wai-hing, JP Hon Abraham SHEK Lai-him, JP Hon Jeffrey LAM Kin-fung, SBS, JP Hon Andrew LEUNG Kwan-yuen, SBS, JP Hon WONG Ting-kwong, BBS Hon CHIM Pui-chung Hon Albert Jinghan CHENG Hon TAM Heung-man
Public officers attending	:	**Agenda Item I** Mr CHOI Yiu-kwan, JP Executive Director, Banking Supervision Department Hong Kong Monetary Authority

Mrs Millie NG
Principal Assistant Secretary for Financial Services and the Treasury (Financial Services) 5

Agenda Item II

Mrs Clarie LO
Acting Permanent Secretary for Financial Services and the Treasury (Financial Services)

Agenda Item III

Ms Edna WONG
Principal Assistant Secretary for Financial Services and the Treasury (Financial Services) 2

Attendance by invitation : **Agenda Item I**

Industrial and Commercial Bank of China (Asia) Limited

Mr ZHU Qi
Chief Executive

Mr Stanley WONG
Alternate Chief Executive

Mr Lawrence TANG
Chief Financial Officer

Mr Bill PANG
Assistant General Manager

Mr Wilfred KONG
Head of Legal & Compliance

Belgian Bank

Mr Clarence CHEUNG
General Manager, Commercial Banking

Freshfields Bruckhaus Deringer

Mr Robert ASHWORTH
Partner

Mr David McManus
Registered Foreign Lawyer (Scotland)

PricewaterhouseCoopers

Mr Shane KNOWLER
Director

Agenda Item II

Securities and Futures Commission

Mrs Alexa LAM
Executive Director
Intermediaries and Investment Products

Mr Stephen PO
Senior Director
Intermediaries and Investment Products

Agenda Item III

Securities and Futures Commission

Mr Mark DICKENS
Executive Director
Supervision of Markets

Mr Keith LUI
Senior Director
Supervision of Markets Division

Mrs Irene TANG
Associate Director
Supervision of Markets Division

Clerk in attendance : Miss Salumi CHAN
Chief Council Secretary (1)5

Staff in attendance : Ms Pauline NG
Assistant Secretary General 1

Ms Connie SZETO
Senior Council Secretary (1)4

Ms May LEUNG
Legislative Assistant

Action

I. Briefing on the draft Industrial and Commercial Bank of China (Asia) Limited (Merger) Bill

(LC Paper No. CB(1)458/04-05(01) — Information note (including the draft Bill) provided by Dr Hon David LI)

Briefing on the draft Bill

At the invitation of the Chairman, Dr David LI gave a brief introduction on the draft Industrial and Commercial Bank of China (Asia) Limited (ICBC (Asia)) (Merger) Bill (the Bill). Dr LI pointed out that he would introduce the Bill into the Legislative Council (LegCo) as a Member's Bill. The Bill provided for the merger of the Hong Kong Branch of Belgian Bank (BBHK) with ICBC (Asia). The need for the merger arose from ICBC (Asia)'s acquisition of all the outstanding shares of BBHK. With effect from 30 April 2004, BBHK and its subsidiaries were members of the ICBC (Asia) Group. Dr LI further pointed out that the increase in bank mergers in recent years resulting from the intense competition in the local banking industry had strengthened the industry, provided new job opportunities, and improved services to customers. He took the opportunity to thank Members for their support for the previous bank merger bills.

2. Upon the Chairman's invitation, Mr ZHU Qi, Chief Executive, ICBC (Asia) briefed members on the draft Bill. He highlighted the following points:

(a) The purpose of the Bill was to transfer the undertakings of BBHK to ICBC (Asia). ICBC (Asia) was an authorized institution (AI) regulated by the Hong Kong Monetary Authority (HKMA) and incorporated in

Hong Kong. BBHK was an AI regulated by HKMA. It was a branch office of Belgian Bank, a company incorporated in Belgium.

(b) The main reason for the merger was to consolidate the complementary business of the two banks with a view to creating a stronger and more competitive bank in the increasingly consolidated Hong Kong banking market and gaining the advantages of economies of scale and reduction in operating costs. After the merger, the total assets of ICBC (Asia) would increase to $95.9 billion and rank sixth among banks listed in Hong Kong. The capital adequacy ratio of ICBC (Asia) would stand at 18%. As at 1 December 2004, there were a total of 1 286 permanent staff employed by ICBC (Asia) Group (with 595 employed by ICBC (Asia) and 691 by BBHK).

(c) The proposed merger would benefit customers and staff of the two banks and the overall economy of Hong Kong. It would grant customers access to a wider branch network and an increased range of products. Moreover, ICBC (Asia) planned to enlarge its branch network in Hong Kong from the current 42 branches (including 20 branches of ICBC (Asia) and 22 branches of BBHK) to up to 60 branches in the medium to long term following the merger.

(d) The proposed merger by way of a Member's Bill would cause minimum impact on current customers of the two banks and was the most efficient process to achieve the merger. Existing customers of BBHK had been informed of the proposed merger and indicated their support.

(*Post-meeting note:* The speech delivered by Mr ZHU Qi was circulated to members vide LC Paper No. CB(1)569/04-05 on 21 December 2004.)

3. Upon the Chairman's invitation, <u>the Principal Assistant Secretary for Financial Services and the Treasury (Financial Services) 5</u> and <u>the Executive Director, Banking Supervision Department, HKMA (ED(BSD)/HKMA)</u> advised that it was the Government's policy to support consolidation of the banking sector. The Administration had previously supported bank mergers where reasonable proposals were submitted for consolidation subject to the overriding aims of improving the overall competitiveness of the banking sector, promoting the stability of the banking system and providing an appropriate degree of protection to depositors in the merged institutions and to depositors generally. In line with this policy, the Administration and HKMA were in support of the Bill.

Discussion

Impact on the competitiveness of the banking sector

4. While expressing support for the Bill in principle, Mr CHIM Pui-chung expressed concern that the increased consolidation of the banking sector might make small local banks less competitive in the market. He also pointed out that HKMA's policy to facilitate foreign banks' operations in Hong Kong had intensified the competition faced by small and medium sized local banks. He urged HKMA to protect the interests of local banks.

5. In response, ED(BSD)/HKMA advised that bank mergers were commercial decisions. He re-iterated that it was the Administration's policy to support bank mergers subject to the overriding aims mentioned in paragraph 3 above. As regards concern about competition from foreign banks, ED(BSD)/HKMA advised that currently there were over 100 foreign banks and about 25 local banks operating in Hong Kong. The presence of a large number of foreign banks had reinforced Hong Kong's position as a prominent international financial centre. While the majority of the foreign banks provided banking services to the corporate sector, local banks had developed market niche in the retail banking sector. As foreign and local banks had different focuses in terms of business and customers, the presence of a large number of foreign banks in Hong Kong had not caused excessive competition with the local banks. Nevertheless, ED(BSD)/HKMA said that he would take into account Mr CHIM Pui-chung's view in implementing banking policy in future.

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6. Mr Ronny TONG expressed concern that after the merger, ICBC (Asia) might have a dominant share in the market thus affecting the overall competitiveness of the banking sector. In response, Mr ZHU Qi, Chief Executive, ICBC (Asia) said that ICBC (Asia)'s business only amounted to less than 5% of the market share. Hence, it was not envisaged that the merger would have impact on the competitiveness of the banking sector.

Impact on staff and customers

7. Mr WONG Ting-kwong and Mr Jeffery LAM expressed support for the Bill in principle. They were however concerned about possible staff redundancies arising from the merger. In reply, Mr ZHU Qi, Chief Executive, ICBC (Asia) confirmed that ICBC (Asia) had no plan to lay off staff as a result of the merger. While the harmonization and integration process associated with the merger would likely lead to a surplus of employees in certain areas, ICBC (Asia) would re-deploy these employees to other areas which had shortage in personnel and would provide suitable training to help them acquire the necessary skills for the new jobs.

8. Regarding consultation with customers on the merger, Mr ZHU Qi, Chief Executive, ICBC (Asia) advised that the senior management of ICBC (Asia) and

BBHK had visited Belgian Bank's larger customers to inform them of the merger. The customers were generally comfortable with the merger and some welcomed the move with an expectation that the combined organization would be able to provide them with better banking support in the Mainland. Other customers had been informed about the merger through daily interaction in branches, business meetings, visits, and mass media reports. The feedbacks received had been very positive and encouraging.

Discrepancies between the English and Chinese versions of the draft Bill

9. Mr SIN Chung-kai enquired why clause 8(1)(b) and (c) of the Chinese version of the draft Bill referred to the "Wing Hang Group". Members noted that there were discrepancies between the English and Chinese versions of the draft Bill regarding the above subclauses. Dr David LI and representatives of the merger entities undertook to look into the matter and take action to rectify the discrepancies.

> (*Post-meeting note:* The revised Chinese version of the draft Bill provided by the merger entities was circulated to members vide LC Paper No. CB(1)544/04-05(01) on 20 December 2004.)

II. Progress of public consultation on proposed measures to address risks arising from securities margin financing

(LC Paper No. CB(1)458/04-05(02) — Paper provided by the Securities and Futures Commission

LC Paper No. CB(1)458/04-05(03) — Background brief prepared by the Legislative Council Secretariat)

Briefing by the Securities and Futures Commission

10. At the invitation of the Chairman, Mrs Alexa LAM, Executive Director, Intermediaries and Investment Products of the Securities and Futures Commission (SFC) gave a power-point presentation on the background of the measures proposed by SFC to address risks arising from securities margin financing (SMF), major responses received on the recent public consultation on such measures, and the way forward. She highlighted the following points:

(a) SFC's Working Group on the Review of the Financial Regulatory Framework for Licensed Corporations (Working Group) was formed in 2002 in response to the call made by the Panel on Financial Affairs (the FA Panel) for more effective measures to manage risks in the securities industry, in particular risks arising from pooling and repledging of margin clients' collateral. In March 2004, SFC reported to the FA Panel on the recommendations made by the Working Group. In September 2004, SFC published a consultation paper to consult the public and the market on the proposed measures. The consultation period ended on 31 October 2004.

(b) The problem of pooling and re-pledging of clients' collateral still existed in the securities industry. Margin clients, who had not borrowed or had borrowed very little, could have all their shares re-pledged by their broker. If the broker failed, these clients would suffer from losses. No other major financial markets allowed re-pledging of non-borrowing margin clients' collateral. The Mainland completely disallowed re-pledging of clients' stocks.

(c) The Working Group had proposed two principal measures to address the problem. Firstly, to impose a limit on the amount of clients' collateral that a SMF provider could re-pledge to secure its borrowing. The limit should be set within the range of 130% to 150% of the total amount of margin loans lent by a SMF provider. Secondly, to increase the haircut percentage rates on clients' collateral prescribed in the Financial Resources Rules (FRR) to encourage SMF providers to adhere to prudent lending ratios. If a SMF provider wished to lend more, it would need to finance the additional amount with its own capital. The objectives of these measures were to improve fairness and protection for investors, protect Hong Kong's reputation as a premier financial centre, enhance investor confidence in brokers, and keep cost burden to industry to a minimum.

(d) During the public consultation on the proposed measures, SFC received 24 written submissions, 17 of which were from industry respondents.

- All respondents generally accepted the rationale that the proposed reforms would enhance investor protection. Those who supported the measures recognized the necessity for better investor protection and the resulting benefit for the whole industry.
- Public opinion, based on commentaries in the media, was supportive of the need for reform.
- On the proposal of imposing a re-pledging limit, two brokerage associations and some brokers expressed support while others either had reservation about or disagreed with the proposal. A broker (which was one of the existing 89 SMF firms that re-pledged clients' collateral, and had a sizeable margin financing business) preferred complete segregation to the re-pledging limit. The Consumer Council (CC) and Hong Kong Bar Association also advocated complete segregation of borrowing and non-borrowing margin clients' collateral to protect investors. However, some industry respondents argued that existing brokerage firms would be impacted by the proposal, and suggested a wider re-pledging limit ranging from 180% to 300%. A few industry respondents did not agree with the mechanism at all. They pointed out that pooling

was a long-established common practice of the securities industry, and the proposal would increase their costs and affect their profitability and business.

- As regards the proposal on increasing FRR haircut percentages, some respondents supported the proposed percentage rates, while others suggested modest increase or preferred no change at all. CC suggested bringing the percentage rates in line with the average rates adopted by banks and the industry (i.e. higher rates than those proposed by the Working Group).

(e) SFC had conducted impact analysis of the proposed measures which revealed that seven firms might be impacted more significantly by the 130% re-pledging limit and the proposed FRR haircuts. These firms re-pledged about $3.5 billion clients' collateral in aggregate to banks and served 42 000 clients. It would have great impact on clients and the market if they were to collapse. SFC had started dialogue with these firms. With strong turnover and profitability, these firms were generally positive about compliance with the new requirements. SFC would continue discussions with them to ensure that they would take appropriate steps to meet the new requirements.

(f) SFC expected that market turnover in 2004 would break the all-time high record in 1997. Total margin loans and total re-pledged collateral value had increased by 20% and 27% respectively within the period from June 2003 to September 2004. There was evidence that the problem of concept stock bubbles had re-surfaced. SFC considered it necessary to introduce the reform measures to plug the loophole before any possible market overheating.

(g) On the way forward, SFC would continue dialogue with the industry to identify the most suitable measures for reducing risks and give the industry a reasonable transitional period for accommodating changes to the existing practice. Once measures were decided upon, SFC would revise the rules and submit them to the Department of Justice for comments. SFC planned to finalize the proposals and issue rule amendments in 2005.

(*Post-meeting note:* The presentation material was issued to members vide LC Paper No. CB(1)569/04-05(02) on 21 December 2004.)

11. Upon invitation by the Chairman, <u>the Acting Permanent Secretary for Financial Services and the Treasury (Financial Services) (Acting PS/FST(FS))</u> said that it was the Administration's policy to ensure that the overall regulatory framework for managing financial risks of the brokerage industry would enhance investor protection, conducive to long term development of the industry, and reinforce Hong Kong's position as an international financial centre. The

Administration considered that SFC's proposed measures were a step forward in the right direction and supported SFC's decision to engage in close dialogue with the industry to work out the final measures and details.

Discussion

Measures to regulate SMF activities

12. Mr SIN Chung-kai pointed out that following the collapse of C.A. Pacific in 1998, the Government and SFC had undertaken to implement a series of measures to step up regulation of SMF activities. He enquired about the progress made so far.

13. In response, Mrs Alexa LAM advised that the Securities (Margin Financing) (Amendment) Ordinance was enacted in 2000 to put all SMF providers including unregulated finance companies under the regulatory framework of SFC. At that time, SFC had proposed implementing segregation of borrowing and non-borrowing margin clients' collateral, but given the grave concern expressed by small and medium-sized SMF providers about the possible negative impact of the proposal on their business, SFC had finally agreed to review the matter after two years. In May 2002, SFC introduced two new financial requirements under the FRR to manage margin financing risks, namely, the 65% gearing ratio adjustment and the illiquid collateral haircut. During consultation on these new measures, the securities industry and some LegCo Members requested SFC to examine issues related to the regulatory capital requirements of securities firms and the practice of pooling and re-pledging of clients' collateral. SFC therefore established the Working Group to take forward the task.

14. Mr Albert HO expressed concern about the losses suffered by margin clients of C.A. Pacific. He pointed out that these clients had lost all their collateral deposited with the firm and were not eligible for compensation under the Investor Compensation Fund (ICF). Moreover, they were required by the liquidator of C.A. Pacific through court order to re-pay the outstanding margin loans they owed to the firm. Mr HO was of the view that clients' outstanding margin loans and their claims for losses of collateral could be off-set. However, the liquidator had taken a different view. Mr HO urged SFC to look into the matter with a view to enhancing the protection for investors. In this connection, Mr Ronny TONG remarked that whether margin clients were required to re-pay their outstanding margin loans owed to the firm would depend on the terms of the margin contracts they had entered into with the firm. Moreover, margin clients might consider taking legal action against C. A. Pacific for breach of trust.

15. In reply, Mrs Alexa LAM said that SFC was aware that some margin clients of C.A. Pacific were not eligible for compensation under the ICF. She explained that SFC had considered different proposals to help these clients including the suggestion raised by Mr Albert HO. However, as the matter was very complex involving the general law relating to liquidation of companies, it was necessary to consider related

issues in a prudent manner. Mrs LAM also pointed out that SFC had reviewed the operation of the investor compensation arrangements, the details of which would be discussed under Agenda Item III of this meeting. Representatives of SFC would be pleased to discuss related issues with members under that item.

Impact of the proposed measures on the securities industry

16. Mr CHAN Kam-lam said that LegCo Members of the Democratic Alliance for Betterment of Hong Kong were in support of SFC's proposed measures. He however expressed concern about the impact of the measures on the small SMF providers. In particular, he was concerned that the small firms might become less competitive vis-à-vis the large brokerage firms and banks. He enquired about the measures to be taken by SFC to help small SMF providers.

17. On the impact of the proposed measures on SMF providers, Mrs Alexa LAM re-iterated that according to SFC's analysis, only seven firms might be impacted more significantly by the two proposed measures. SFC had already started discussion with these firms to help them resolve possible compliance problems. In general, these firms were confident about complying with the new requirements. Moreover, SFC would work out with the industry on the most suitable transitional period to allow firms to make proper preparation for and adapt to the changes. Mrs LAM stressed that SFC recognized the need to give smaller firms leeway to continue their business. Depending on the level of protection afforded by the new measures, SFC would consider the need for relaxing certain existing financial resources requirements.

18. As regards the concern about competition faced by small SMF providers, Mrs Alexa LAM emphasized that the proposed measures were expected to help small firms. She said that some investors had pointed out that the C.A. Pacific incident and other broker failures in recent years had eroded their confidence in brokers and prompted them to trade securities through large banks. The new measures would help small firms to re-establish their credibility and image. As small firms had competitive advantages of flexible operation and good quality service, they should be able to attract more business.

19. Noting that the practice of pooling and re-pledging clients' collateral might help lower the service fees paid by clients, Mr Ronny TONG enquired about the impact of SFC's proposed measures on the fees paid by clients. In response, Mrs Alexa LAM advised that among the existing 243 brokerage firms providing SMF service, 154 firms ran the business with their own capital and did not re-pledge clients' collateral to banks while the remaining 89 firms pooled and re-pledged clients' collateral to finance their loans. Investors could choose among various SMF providers. Mrs LAM also pointed out that SMF providers had their own pricing strategy. The fees charged by SMF providers were affected by a number of factors including the relationship between SMF provider and its client, terms of the margin contract, etc. SFC did not envisage that the proposed measures would have impact on the level of fees charged by SMF providers.

Pooling and re-pledging collateral of non-borrowing margin clients

20. Mr Ronny TONG considered that the practice of pooling and re-pledging of non-borrowing clients' collateral, which was unfair to clients and infringed their rights, should be abolished. He urged that the Administration and SFC should work out a concrete timetable for abolishing such a practice and achieving complete segregation of borrowing and non-borrowing margin clients' collateral. Mr SIN Chung-kai shared his view.

21. Mr Andrew LEUNG also supported Mr Ronny TONG's request for a concrete timetable for achieving complete segregation of borrowing and non-borrowing margin clients' collateral. He pointed out that the proposed imposition of a re-pledging limit would not solve the existing problem where SMF providers re-pledged liquid stocks of margin clients to banks. In the event of collapse of these firms, the clients who owned liquid stocks would suffer more losses than those owned third or fourth liner stocks. Mr LEUNG urged that SFC should examine how the interests of margin clients could be protected, and how margin clients' awareness of the risks of the pooling and re-pledging of their collateral could be enhanced.

22. Mr Albert CHENG supported Mr Andrew LEUNG's views. He suggested that margin clients should be properly informed in writing about the potential risks they would be exposed to. In order to enhance protection for cash clients, Mr CHENG further suggested that SFC should encourage cash clients to deposit their shares in investor participant (IP) account at the Central Clearing and Settlement System (CCASS).

23. Ms Emily LAU was of the view that the existing practice of pooling and re-pledging of non-borrowing clients' collateral should not be continued. She urged SFC to expedite action in achieving complete segregation of borrowing and non-borrowing clients' collateral so as to enhance investor protection and enable Hong Kong's regulatory system to meet international standards. She also supported Mr Ronny TONG's request for the Administration and SFC to work out a timetable for achieving this target.

24. Mrs Alexa LAM advised that unless authorized in writing by their clients, SMF providers were not permitted to pool and re-pledge clients' collateral. Under SFC's Code of Conduct for SMF providers, SMF providers were required to clearly explain the content of the margin contract to clients including the implications of pooling and re-pledging of their collateral. Mrs LAM also pointed out that SFC recognized that complete segregation of borrowing and non-borrowing clients' collateral was the best measure to protect the interests of non-borrowing clients. However, given the SMF industry's concern about the difficulty and costs involved for SMF providers to differentiate the collateral of borrowing clients from that of non-borrowing clients, and the need to ensure the viability of business of SMF providers, SFC considered the proposed imposition of a re-pledging limit a feasible interim measure to address the risks concerned because with the proposed re-pledging limit in place at least a portion of clients' collateral would not be re-pledged. Mrs LAM stressed that SFC was fully aware of its primary objective of protecting investors and it remained the goal of SFC to achieve complete segregation of borrowing and non-borrowing margin clients' collateral so as to comply with international standards. She undertook to reflect members' views to the industry.

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25. On members' request for the Administration and SFC to work out a timetable for achieving complete segregation of borrowing and non-borrowing margin clients' collateral, the Acting PS/FST(FS) said that it was also the wish of the Administration and SFC to work out such a timetable. Given that the timetable had to be achievable by the industry, SFC would continue discussion with the industry so as to identify the most suitable model for addressing SMF risks and to work out such a timetable.

26. The Chairman considered that investors should be made aware of the pooling and re-pledging practice of different SMF providers. In this connection, Mr SIN Chung-kai suggested that SFC should explore the feasibility of introducing a categorization system of SMF providers to differentiate SMF providers which pooled and re-pledged clients' collateral from those which had no such practice.

27. Mrs Alexa LAM said that the Working Group had recommended two supplementary measures, namely, to improve the Code of Conduct on disclosure obligations by requiring SMF providers to disclose additional information to their clients such as stating in client's account statement whether the firm had adopted the practice of pooling and re-pledging clients' collateral, and to step up investor education on the risks of the pooling and re-pledging practice. On the suggestion of introducing a categorization system of SMF providers, Mrs LAM said that while SFC was not aware of any similar systems in other jurisdictions, it would look into the suggestion.

SFC

28. Mr CHIM Pui-chung declared interest that he was a LegCo Member returned from the financial services functional constituency. He pointed out that the C.A. Pacific incident was an individual incident and should not damage investors' confidence in the credibility and image of the brokerage industry. He stressed that the

majority of SMF providers had been conducting their business in a prudent manner and had not pooled and re-pledged clients' collateral to banks. On the proposed measures to address SMF risks, Mr CHIM emphasized the importance for SFC to work out the final model with the brokerage industry in order to strike a proper balance between the interests of the industry and those of investors. He also indicated support for SFC to step up investor education on the risks of SMF activities. Investors should be made aware that SMF providers were not permitted to pool and re-pledge clients' collateral without clients' authorization. With a view to enhancing investor protection, Mr CHIM expressed support for implementation of the IP account system. He called on SFC to consider requiring brokers to transfer clients' shares to IP accounts within 48 hours after the transaction and stressed that the charges by CCASS for the service should be set at a reasonable level. He also pointed out that the objectives of SFC's work were to regulate the securities industry, to ensure a level playing field in the market, to promote development of the market and the financial services industry, and to enhance investor protection.

29. Mrs Alexa LAM shared the view that the majority of SMF providers had been conducting their business in a prudent manner. She re-iterated that the proposed measures were feasible options to address risks of pooling and re-pledging of clients' collateral and aimed to require those small number of imprudent SMF providers to cut down their aggressive re-pledging activities. On the suggestion of IP account, Mrs LAM said that while SFC encouraged cash clients to set up IP accounts, the measure could not address the problem and the risk associated with re-pledging of margin clients' collateral. It was because in margin finance business, a SMF provider would take collateral from its clients into its possession or control. These shares would not be held in the clients' own names and thus could not be kept in their IP accounts.

Conclusion

30. The Chairman requested the Administration and SFC to take into consideration members' views when discussing further with the brokerage industry to finalize the proposed measures. In this connection, Mr SIN Chung-kai suggested and members agreed that the Administration and SFC should be invited to report the progress to the Panel in a year's time. The progress report should cover the proposed concrete timetable for achieving complete segregation of borrowing and non-borrowing margin clients' collateral.

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III. Outcome of review of the levies of the Investor Compensation Fund

(LC Paper No. CB(1)458/04-05(04) — Paper provided by the Securities and Futures Commission

LC Paper No. CB(1)458/04-05(05) — Background brief prepared by the Legislative Council Secretariat)

Briefing by the Securities and Futures Commission

31. Upon invitation by the Chairman, Mr Mark DICKENS, Executive Director, Supervision of Markets, SFC briefed members on SFC's paper which outlined the main points of the proposed consultation paper entitled "Review of the Level and Funding of the Investor Compensation Fund, Broker Defaults since 1998 and the Operation of the Investor Compensation Arrangements" (the Consultation Paper) to be issued by SFC in early 2005. Mr DICKENS highlighted the following points:

(a) The Consultation Paper covered the following two major issues:
- SFC's review of the level and funding of the Investor Compensation Fund (ICF) which was established on 1 April 2003 under the Securities and Futures Ordinance (SFO) (Cap. 571) to replace the Unified Exchange Compensation Fund and the Commodity Exchange Compensation Fund; and
- SFC's review of major broker defaults since 1998 and examination of some suggestions identified to help improve the existing procedures in handling broker defaults through discussions with a number of liquidators and banks.

Review of the ICF

(b) It was SFC's policy that the ICF assets should not exceed a prudent base amount with annual investment income sufficient to cover estimated expenditure plus any likely future expansion of the ICF coverage. Such a level would have a reasonable probability of being "self-funding" for the future without the need for a levy on the market. If the ICF appeared as if it would reach the self-funding level, consideration should be given to suspending any levy that might be in effect.

(c) At the current level of market turnover, the ICF assets were expected to reach $1.4 billion at end of December 2004. SFC's current estimated annual expenditure of the ICF was about $60 million. It was envisaged that the ICF would become self-funding if an expected investment rate of return of 4.3% could be achieved in the long run.

(d) In order not to accumulate amounts beyond what was necessary for the ICF and to reduce the burden on investors, the Consultation Paper proposed to introduce an automatic levy triggering mechanism with details set out in paragraph 9 of SFC's paper. In brief, the current investor compensation levies, i.e. at the rate of 0.002 % on securities transactions executed on the Stock Exchange of Hong Kong and $0.5 ($0.1 for smaller size contracts) per contract on futures transactions executed on the Hong Kong Futures Exchange would be imposed if the net asset value of the ICF fell below $1 billion. The levies would be suspended if the net asset value of the ICF exceeded $1.4 billion. SFC would inform the public and the market by way of a notice of any changes to the prevailing levy arrangements including the date of implementation of such changes. The implementation dates for the imposition and suspension of levies were set at least two months and one month respectively after the date of the issue of SFC's notice.

(e) The Consultation Paper concluded that the current $150,000 per investor compensation limit should be maintained. The level provided a similar level of coverage (i.e. 76% of claimants paid in full by the ICF) to that in and since 1998.

Review of broker defaults since 1998 and suggestions to improve the handling of broker defaults

(f) The Consultation Paper provided a summary of the main facts and results of six broker defaults happened since 1998 as well as the key decisions made by the courts in order to facilitate better understanding of the status of these cases and the complex legal issues involved.

(g) SFC had examined three suggestions to help improve the existing procedures in handling broker defaults, namely, for the ICF to advance funds to liquidators for the purpose of facilitating the return of clients' shares pledged by a broker to a bank as security of a loan; to give power to liquidator to sell securities and distribute money; and use of ICF funds to pay for an administrator. The Consultation Paper concluded that these suggestions should not be pursued because they would introduce additional financial exposure to the ICF, alter the existing individual proprietary rights of investors in securities held by brokers, and have implications on the current law dealing with trust property and insolvency. SFC considered that further development of the law in this area should be left to the common law. In this connection, SFC would continue to monitor overseas development in this area. On the appointment and powers of an administrator under the SFO, SFC would strive to appoint an administrator where practicable at an early stage of a liquidation proceeding to protect clients' assets and return shares to clients. However, the costs should not be paid from the ICF assets. The details of the three suggestions, arguments for and against them were given in paragraphs 5.1 to 5.28 of the Consultation Paper.

(h) SFC took the view that more could be done to minimize the risk of brokerage firms and had established an internal working group to examine the complex issues arising from the context of appointing a manager to take over and manage the business of a firm which was considered likely to default on its obligations. SFC would report progress of the review to the Panel in due course.

32. At the Chairman's invitation, the Principal Assistant Secretary for Financial Services and the Treasury (Financial Services)2 (PAS/FST(FS)2) advised that the Administration welcomed the reviews undertaken by SFC and supported the recommendations in the Consultation Paper for enhancing investor protection and confidence in the market. The Administration and SFC welcomed views from Members and the public on the Consultation Paper.

Discussion

Suspension of levies for the ICF

33. Mr CHIM Pui-chung remarked that the proposed suspension of levies for the ICF would be welcomed by the market and investors. He enquired when the proposal would be implemented.

34. In reply, PAS/FST(FS)2 explained that the current levies for the ICF were implemented through the Securities and Futures (Investor Compensation – Levy) Rules made by the Chief Executive in Council under the SFO, which was subject to the negative vetting of the LegCo. Subject to the results of the public consultation, the Administration would work with SFC to put in place the necessary legislative amendments to implement the proposal of suspending the current investor compensation levies. Mr Mark DICKENS supplemented that SFC expected that the proposal would be implemented in the second quarter of 2005.

Review of uses of the ICF

35. Mr CHAN Kam-lam expressed support for the proposal to introduce an automatic levy triggering mechanism in order to increase transparency in the operation of the ICF. He enquired about the bases for arriving at the estimated annual expenditure of $60 million of the ICF. In response, Mr Mark DICKENS advised that the figure comprised two components, namely, the estimated annual compensation payment of $55 million and the estimated annual operating cost of $5 million. The figure was derived from updating the risk model prepared by actuarial experts in SFC's 2001 Report published in relation to the new compensation arrangements. He explained that the model had simulated the status of the ICF over time based on inputs including income, market turnover, estimated annual losses (arising from paying compensation claims) etc. The estimated annual loss was a combination of the real-life average historical loss and estimations of losses in areas where losses had not actually occurred. In respect of actual loss incurred by the ICF, Mr DICKENS said that the amount had fallen significantly below the annual estimated amount of

$55 million since 2001. As regards the annual operating cost, it was envisaged that the cost would be lower than $5 million in the absence of major defaults.

36. Mr CHAN Kam-lam enquired whether SFC would review the uses of the ICF when the Fund had accumulated amounts beyond what was necessary for providing investor compensation. He considered that SFC should explore other uses for the ICF, such as investor education programme.

37. On the current uses of the ICF, Mr Mark DICKENS advised that under the SFO, the Fund could be used for compensation payments, operational expenses and investment purposes. Changes to the purposes of the ICF would require amendments to the SFO. He assured members that SFC would review the ICF should the Fund accumulate substantial assets beyond what was needed for providing investor compensation. SFC might consider other uses for the ICF or raising the current $150,000 per investor compensation limit. SFC would consult the market and the public should it propose to change the current uses of the ICF.

Suggestions to improve the handling of broker defaults

38. Mr Albert HO pointed out that the liquidation of C.A. Pacific had protracted for a long time and involved substantial costs. He requested SFC to clarify why it considered that the three suggestions made by liquidators to help expedite the liquidation process and reduce the costs involved should not be pursued (paragraph 5.1 of the Consultation Paper).

39. In response, Mr Mark DICKENS pointed out that the three suggestions had their own drawbacks. The first suggestion, which was for the ICF to advance funds to a liquidator to facilitate the return of shares pledged with banks by a defaulting broker, might introduce moral hazard for banks because banks might shift their burden to SFC and not exercise their power to sell off the pledged shares. This would change the role of SFC as an administrator of a compensation scheme. The second suggestion, which was for empowering liquidators to sell securities and distributing the sale proceeds instead of returning the shares to clients, was inconsistent with the case law which had established that clients normally had individual proprietary rights in securities. The adoption of the suggestion would deprive the clients of their individual proprietary rights in shares, and remove all the benefits as well as the risks associated with being an owner of the securities including gain and loss as a result of changes in the market value of the securities, dividends, bonus shares, etc. As regards the third suggestion, which was for the ICF to pay for an administrator appointed by the court, would create additional financial exposure to the ICF and go against the well-established case law that the costs of administrators should be paid out from the trust property they administered. Mr DICKENS said that the three suggestions would have implications on the general law dealing with trust property and insolvency which went beyond securities legislation and should be considered in a wider context. He added that court decisions relating to previous broker defaults had helped clarify the uncertainties and legal issues regarding ownership of shares as well as the status

and rights of margin and cash clients. These clarifications would benefit and expedite liquidation process of broker default in future. As such, it was SFC's preliminary view that the three suggestions should not be pursued. Nonetheless, SFC maintained an open-mind on the matter. If the results of the public consultation revealed that there was general consensus from the community to introduce the changes, SFC was prepared to re-consider the suggestions.

40. Mr Albert HO enquired whether SFC, having reviewed the six broker defaults since 1998, considered it necessary to introduce legislative amendments concerning clients' proprietary rights in shares. Mr Mark DICKENS advised that the case law in Hong Kong had established that clients had individual proprietary rights in the securities held on their behalf by their brokers. In the six broker defaults since 1998, the courts had held that shares should be allocated and distributed to clients as far as possible based on the principle of individual proprietary rights in shares. SFC however noted that the Financial Markets Law Committee in the United Kingdom (UK) had recently issued a consultation paper on the analysis of the need for and nature of legislation relating to property interests in indirectly held investment securities. The paper recommended that unless otherwise agreed, investors in a particular issue of securities held by an intermediary in a common pool had co-proprietary interests in the pool. SFC would closely monitor the development of the issue in the UK. Should the above mentioned recommendation be adopted, SFC would re-consider its position on whether the existing law in Hong Kong should be changed.

41. Mr Albert HO noted that in a broker's liquidation, the liquidator would assume custody of the broker's assets such as clients' shares and deposit them in a trustee account. He was concerned that management of the account by the liquidator would involve considerable costs. With a view to saving costs, Mr HO suggested that SFC should consider the feasibility of requiring the liquidator to deposit clients' shares in a custodian account held in a bank.

42. In reply, Mr Mark DICKENS explained that the liquidator would keep the clients' shares in a custodian account in a bank. As clients had proprietary interests in the shares, the liquidator had to trace the ownership of the securities before he could return them to the clients by setting up a stock tracking system to keep track of the movements and activities of the securities. This involved the establishment of a database to record the details on lines of securities and their respective quantities. Updating and administration of the share portfolios by the liquidator involved substantial costs. In the wake of the liquidation of C.A. Pacific, the market had developed the necessary software on the securities tracking system. This should help reduce the administrative costs involved. Mr DICKENS further advised that liquidators might consider contracting out the work of administrating the securities tracking system to brokers to lower the costs.

43. Noting that the provisional liquidation cost of C.A. Pacific had amounted to about $120 million, Mr CHIM Pui-chung urged that the Administration or SFC

should consider exerting pressure on the liquidator to expedite the process so that the assets of the broker would not be eaten up by the liquidation cost.

44. In response, Mr Mark DICKENS said that it would be inappropriate for SFC or the Administration to exert pressure on the liquidator of C.A. Pacific as it was a matter for the court, the creditors and the concerned clients to pursue. He assured members that SFC had been monitoring the liquidation process and holding discussions with the liquidator on individual claim cases to work out the best way for compensating the investors. Where appropriate, SFC had also offered advice to resolve problems encountered in the liquidation process. Moreover, in response to complaints by concerned clients, SFC had demanded explanation from the liquidator about decisions made and, where justified, requested for re-consideration of the decisions. Mr DICKENS added that the liquidator of C.A. Pacific had relevant experience in the securities industry and had knowledge about ways to expedite the liquidation process.

IV. Any other business

45. There being no other business, the meeting ended at 10:45 am.

Council Business Division 1
Legislative Council Secretariat
4 March 2005