

## **LEGISLATIVE COUNCIL BRIEF**

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

### **SECURITIES AND FUTURES (INVESTOR COMPENSATION – LEVY) (AMENDMENT) RULES 2005**

#### **INTRODUCTION**

At the meeting of the Executive Council on 28 June 2005, the Council ADVISED and the Chief Executive ORDERED that under section 244(1) of the Securities and Futures Ordinance (Cap. 571) (SFO), the Securities and Futures (Investor Compensation – Levy) (Amendment) Rules 2005, at Annex, should be made to provide for the automatic levy triggering and suspension mechanism.

#### **JUSTIFICATIONS**

2. The assets of the Investor Compensation Fund (ICF) should not exceed a prudent amount with annual investment income sufficient to cover its estimated expenditure. As at end May 2005, the net asset value of the ICF was \$1.49 billion. With an asset size of \$1.4 billion and estimated annual expenditure of \$60 million including the estimated annual compensation payments, the Securities and Futures Commission (SFC), which is responsible for administering the ICF, estimated that the ICF would become self-funding if an expected investment rate of return of 4.3% could be achieved in the long run. The SFC considers that this rate of return could be achieved.

#### **THE PROPOSAL**

3. It is proposed that an automatic levy triggering and suspension mechanism should be incorporated in the Securities and Futures (Investor Compensation – Levy) Rules (Cap. 571 AB) (Levy Rules), as follows -

- (a) no person is required to pay investor compensation levies if the net asset value of the ICF exceeds \$1.4 billion;

- (b) the current investor compensation levies will be payable again if the net asset value of the ICF falls below \$1 billion, which is the minimum prudent level which the ICF should maintain in order to cover its potential obligations;
- (c) a month-end net asset value of the ICF which is certified through an audit by the auditors appointed by the SFC will be used for the purposes of applying the levy triggering mechanism;
- (d) the SFC is responsible for implementing and monitoring the operations of the levy triggering mechanism as well as informing the public and the market by way of a Gazette notice of any changes to the prevailing levy arrangements including the date of implementation of such changes; and
- (e) for imposition of levies, the implementation date is set at at least two months after the date of the issue of the SFC's notice. For suspension of levies, the implementation date is set at at least one month after the date of the issue of the SFC's notice.

## **THE AMENDMENT RULES**

4. The Amendment Rules (Annex) seek to amend the Securities and Futures (Investor Compensation – Levy) Rules by adding a new Part 5 to the Levy Rules. The new Part 5 requires the SFC to publish, under certain circumstances, in the Gazette an exemption notice and a termination of exemption notice, both of which are not subsidiary legislation.

5 **Clause 2** of the Amendment Rules adds a number of new defined terms to the Levy Rules for the purposes of the new Part 5.

6 **Clause 3** of the Amendment Rules provides that the levy payable in respect of sale and purchase of securities should be subject to the new Part 5.

7 **Clause 4** of the Amendment Rules provides that the levy payable in respect of sale and purchase of futures contracts should be subject to the new Part 5.

8 **Clause 5** of the Amendment Rules provides that the Exchange Company (that is, the Stock Exchange Company and the Futures Exchange Company) is not required to furnish a report under section 20(1) of the Levy Rules in respect of any 12-month period ending on 31 March in a year if there is no transaction concerning any levy during that period.

9 **Clause 6** of the Amendment Rules provides the new Part 5, which sets out the following –

- (a) the SFC shall appoint an auditor to audit the accounts of the ICF if the net asset value of the fund exceeds or falls below a certain level;
- (b) the SFC shall publish an exemption notice if the net asset value of the compensation fund exceeds \$1.4 billion. Levy is not payable in respect of a sale and purchase of securities or futures contracts taking place at any time –
  - (i) on or after the date specified in the exemption notice (the date shall not be earlier than one month after its publication); and
  - (ii) before the date specified in a termination of exemption notice.
- (c) the SFC shall publish a termination of exemption notice if the net asset value of the compensation fund falls below \$1 billion. The termination of exemption notice shall specify a termination date for the exemption notice. As a result of the termination, levy is again payable in respect of a sale and purchase of securities or futures contracts taking place at any time from the date specified in the notice (the date shall not be earlier than two months after its publication).

## **LEGISLATIVE TIMETABLE**

10. The legislative timetable is as follows –

Publication in the Gazette	30 June 2005
Tabling at Legislative Council	6 July 2005

## **IMPLICATIONS OF THE PROPOSAL**

### **Financial and Civil Service Implications**

11. There are no financial and civil service implications to the Government as SFC, which is responsible for administering the ICF, is an independent statutory body financed by transaction levies, fees and charges on services rendered to market operators and participants as provided in the SFO.

### **Other implications**

12. The proposal is in conformity with the Basic Law, including the provisions concerning human rights. It does not affect the current binding effect of the existing provisions of the SFO and its subsidiary legislation. The proposed levy triggering and suspension mechanism will slightly reduce the transaction cost to be borne by investors under certain circumstances and thus be conducive to the development of Hong Kong's securities and futures markets. It has no environmental or sustainability implications.

## **PUBLIC CONSULTATION**

13. The Panel on Financial Affairs of the Legislative Council was consulted on 17 December 2004, which had indicated clear support for the proposal. Subsequently, the SFC conducted a six-week public consultation, and the majority of the respondents were supportive of the proposal.

## **PUBLICITY**

14. A press release will be issued today (29 June 2005). A spokesman will be available to handle enquiries.

## **BACKGROUND**

15. At present, the ICF established pursuant to section 236 of the SFO is mainly funded by –

- (a) transfers of the balances in two old compensation funds, i.e. the Unified Exchange Compensation Fund (established under Part X of the repealed Securities Ordinance, Cap. 333) and the Futures Exchange Compensation Fund (established under Part VIII of the repealed Commodities Trading Ordinance, Cap. 250); and
- (b) levies imposed under the Securities and Futures (Investor Compensation – Levy) Rules in respect of securities transactions executed on the Stock Exchange of Hong Kong Limited and futures transactions executed on the Hong Kong Futures Exchange Limited.

16. The ICF was established on 1 April 2003 to replace the old compensation arrangements. The objectives of the compensation arrangements are to provide a secure, cost-effective measure of compensation per retail investor in relation to products traded on the Hong Kong Exchanges and Clearing Limited, based on the principles of user pays and providing compensation for all retail investors who trade through intermediaries licensed by or registered with the SFC.

17. The current investor compensation levies are set at 0.002% on securities transactions executed on the Stock Exchange of Hong Kong Limited and \$0.5 (\$0.1 for smaller size contracts) per side of a contract on futures transactions executed on the Hong Kong Futures Exchange Limited.

18. The 0.002% levy was first introduced in September 2001 as part of the transaction levy collected by the SFC on the basis that the additional amount should be paid by the SFC into the Unified Exchange Compensation Fund for transfer to the ICF when formed. This amount of levy was later imposed by the Securities and Futures (Investor Compensation – Levy) Rules made by the Chief Executive in Council under the Securities and Futures Ordinance, which came into force on 1 April 2003. At the time of the passage of the Securities and Futures (Investor Compensation – Levy) Rules through the Legislative Council in December 2002<sup>1</sup>, the Administration undertook to keep the levy under review in light of the operations of the ICF.

19. In order not to accumulate amounts beyond what is necessary for the ICF and to reduce the burden on investors, it is proposed that an automatic levy triggering and suspension mechanism should be incorporated in the Levy Rules.

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<sup>1</sup> Legislative Council Brief on the Securities and Futures Ordinance (Cap. 571) of 13 December 2002 (Ref: SUB 38/26/3 (2002)).

**ENQUIRIES**

20. Enquiries on this brief should be addressed to Miss Alice Cheung, Principal Assistant Secretary for Financial Services and the Treasury (telephone number: 2528 9161) or Miss Aubrey Fung, Assistant Secretary for Financial Services and the Treasury (telephone number: 2529 2379).

Financial Services Branch  
Financial Services and the Treasury Bureau  
29 June 2005

**SECURITIES AND FUTURES (INVESTOR  
COMPENSATION – LEVY)(AMENDMENT) RULES  
2005**

(Made by the Chief Executive in Council under section 244(1) of the Securities and Futures Ordinance (Cap. 571))

**1. Commencement**

These Rules shall come into operation on a day to be appointed by the Secretary for Financial Services and the Treasury by notice published in the Gazette.

**2. Interpretation**

(1) Section 2 of the Securities and Futures (Investor Compensation – Levy) Rules (Cap. 571 sub. leg. AB) is amended, in the definition of “stock futures contract”, by repealing the full stop and substituting a semicolon.

(2) Section 2 is amended by adding –

““exemption notice” (豁免付款公告) means a notice published under section 25(1);

“net asset value” (淨資產值), in relation to the compensation fund, means the balance after deducting the total liabilities of the compensation fund from its total assets and, for the purposes of this definition, net asset value may be a negative figure;

“termination of exemption notice” (終止豁免公告) means a notice published under section 26(1).”.

**3. Application of Part 2**

(1) Section 3 is amended by renumbering it as section 3(1).

(2) Section 3 is amended by adding –

“(2) This Part is subject to the provisions in Part 5.”.

#### 4. Application of Part 3

- (1) Section 8 is amended by renumbering it as section 8(1).
- (2) Section 8 is amended by adding –
  - “(2) This Part is subject to the provisions in Part 5.”.

#### 5. Report

- (1) Section 20(1) is amended by repealing “The” and substituting “Subject to subsection (3), the”.
- (2) Section 20 is amended by adding –
  - “(3) The Exchange Company is not required to furnish a report under subsection (1) in respect of any 12 month period specified in that subsection if –
    - (a) no person is required to pay any levy under these Rules during that period; and
    - (b) no refund, adjustment, collection or remittance of levy was made or has fallen due under these Rules during that period.”.

#### 6. Part 5 added

The following is added –

#### “PART 5

#### NO PAYMENT OF LEVY UNDER EXEMPTION NOTICE

#### 24. Commission to cause financial statement to be audited

- (1) Subject to subsection (3), where the latest unaudited financial statement prepared in respect of the accounts of the compensation fund and made up to (and including) the last day of any month shows that the net asset value of the compensation fund exceeds \$1,400,000,000 as at

that day, the Commission shall as soon as reasonably practicable appoint an auditor to audit, and prepare an auditor's report in respect of, the financial statement and to submit the report to the Commission.

(2) Subject to subsection (4), where the latest unaudited financial statement prepared in respect of the accounts of the compensation fund and made up to (and including) the last day of any month shows that the net asset value of the compensation fund is below \$1,000,000,000 as at that day, the Commission shall as soon as reasonably practicable appoint an auditor to audit, and prepare an auditor's report in respect of, the financial statement and to submit the report to the Commission.

(3) Subsection (1) does not apply if at the date of receiving the latest unaudited financial statement –

- (a) the Commission has published an exemption notice under section 25(1) but has not published a termination of exemption notice relating to it under section 26(1);
- (b) the Commission has received an auditor's report prepared in respect of a previous unaudited financial statement and, as a result, the Commission is required to publish an exemption notice under section 25(1);
- (c) the Commission has appointed an auditor, and is awaiting receipt of an auditor's report to be prepared under subsection (1) in respect of a previous unaudited financial statement; or
- (d) an unaudited financial statement made up to (and including) the last day of the month referred to in subsection (1) is required to be audited, and an auditor's report in respect of the financial

statement is required to be prepared, under section 240 of the Ordinance.

(4) Subsection (2) does not apply if at the date of receiving the latest unaudited financial statement –

- (a) the Commission has not published an exemption notice under section 25(1);
- (b) the Commission has published an exemption notice under section 25(1) and has published a termination of exemption notice relating to it under section 26(1);
- (c) the Commission has received an auditor's report prepared in respect of a previous unaudited financial statement and, as a result, the Commission is required to publish a termination of exemption notice under section 26(1);
- (d) the Commission has appointed an auditor, and is awaiting receipt of an auditor's report to be prepared under subsection (2) in respect of a previous unaudited financial statement; or
- (e) an unaudited financial statement made up to (and including) the last day of the month referred to in subsection (2) is required to be audited, and an auditor's report in respect of the financial statement is required to be prepared, under section 240 of the Ordinance.

**25. Commission to publish exemption notice**

(1) Subject to subsections (3) and (4), where the auditor's report prepared under section 240 of the Ordinance or section 24(1) confirms (whether expressly or impliedly and whether by reference to any

financial statement attached to it or otherwise) that the net asset value of the compensation fund exceeds \$1,400,000,000, the Commission shall by an exemption notice published in the Gazette declare that no person is required to pay any levy under Part 2 or 3 in respect of a sale and purchase of securities or futures contract that takes place at any time –

- (a) on or after the date specified in the exemption notice, which date shall not be earlier than one month after the date of publication of the exemption notice in the Gazette; and
- (b) before the date to be specified by a termination of exemption notice published under section 26(1).

(2) Notwithstanding anything in these Rules, where an exemption notice is published in the Gazette, no person shall be required to pay the levy as declared to be not payable by the exemption notice.

(3) No further exemption notice shall be published if a previous exemption notice has been published by the Commission under subsection (1) but a termination of exemption notice relating to it has not been published under section 26(1).

(4) Subject to subsection (5), the Commission may, after consultation with the Financial Secretary, refrain from publishing an exemption notice under subsection (1) if it has reason to believe that the net asset value of the compensation fund will fall below \$1,000,000,000 within 6 months from the date of receiving the auditor's report.

(5) The Commission having refrained from publishing an exemption notice is required to ascertain the net asset value of the compensation fund and if the Commission subsequently reasonably considers that the net asset value of the compensation fund will not fall below \$1,000,000,000 within the 6 month period, it shall proceed to publish the exemption notice.

(6) An exemption notice is not subsidiary legislation.

**26. Commission to publish termination of exemption notice**

(1) Subject to subsection (3), where –

(a) the auditor's report prepared under section 240 of the Ordinance or section 24(2) confirms (whether expressly or impliedly and whether by reference to any financial statement attached to it or otherwise) that the net asset value of the compensation fund is below \$1,000,000,000; and

(b) the Commission has published an exemption notice under section 25(1) but has not published a termination of exemption notice relating to it under this subsection,

the Commission shall by a termination of exemption notice published in the Gazette specify a termination date for the exemption notice, which date shall not be earlier than 2 months after the date of publication of the termination of exemption notice in the Gazette.

(2) The publication of a termination of exemption notice shall not revive the obligation to pay any levy which has been declared to be not payable by the exemption notice relating to it.

(3) Subject to subsection (4), the Commission may, after consultation with the Financial Secretary, refrain from publishing a termination of exemption notice under subsection (1) if it has reason to believe that the net asset value of the compensation fund will exceed \$1,400,000,000 within 6 months from the date of receiving the auditor's report.

(4) The Commission having refrained from publishing a termination of exemption notice is required to ascertain the net asset value

of the compensation fund and if the Commission subsequently reasonably considers that the net asset value of the compensation fund will not exceed \$1,400,000,000 within the 6 month period, it shall proceed to publish the termination of exemption notice.

(5) A termination of exemption notice is not subsidiary legislation.”.

Clerk to the Executive Council

COUNCIL CHAMBER

28 June 2005

### **Explanatory Note**

The object of these Rules is to amend the Securities and Futures (Investor Compensation – Levy) Rules (Cap. 571 sub. leg. AB) (“principal Rules”) in order to add a new Part 5 to the principal Rules. The new Part 5 requires the Securities and Futures Commission (“Commission”) to publish, under certain circumstances, in the Gazette an exemption notice or a termination of exemption notice, both of which are not subsidiary legislation.

2. The amended section 2 adds a number of new defined terms to the principal Rules for the purposes of the new Part 5.
3. The new section 24 requires the Commission to appoint an auditor to audit the accounts of the Investor Compensation Fund (“compensation fund”) if the

net asset value of the compensation fund exceeds or is below a certain level, subject to certain exceptions.

4. The new section 25 provides that an exemption notice shall be published if the net asset value of the compensation fund exceeds \$1,400,000,000. Levy is not payable in respect of a sale and purchase of securities or futures contract taking place at any time on or after the date specified in the exemption notice, which date shall be not earlier than one month after its publication, and before the date specified in a subsequent termination of exemption notice published under the new section 26. The Commission may refrain from publishing an exemption notice after consultation with the Financial Secretary.

5. The new section 26 provides that a termination of exemption notice shall be published if the net asset value of the compensation fund is below \$1,000,000,000. The termination of exemption notice shall specify a termination date for the exemption notice, and, as a result of the specification of the termination date, levy will again be payable in respect of a sale and purchase of securities or futures contract taking place at any time from the date specified in the termination of exemption notice, which date shall be not earlier than 2 months after its publication. The Commission may refrain from publishing a termination of exemption notice after consultation with the Financial Secretary.

6. The new section 20(3) provides that the Exchange Company (that is, the Stock Exchange Company and the Futures Exchange Company) is not required to furnish a report under section 20(1) of the principal Rules in respect of any 12 month period ending on 31 March in a year if there is no transaction concerning any levy during that period.