

## **LEGISLATIVE COUNCIL BRIEF**

Securities Ordinance (Chapter 333)

### **SECURITIES (AMENDMENT) BILL 1998**

#### **INTRODUCTION**

At the meeting of the Executive Council on 21 July 1998, the Council ADVISED and the Chief Executive ORDERED that the Securities (Amendment) Bill 1998, at Annex A, should be introduced into the Legislative Council.

#### **BACKGROUND AND ARGUMENT**

##### **The Unified Exchange Compensation Fund**

2. Part X of the Securities Ordinance (Chapter 333) (“the Ordinance”) provides that the Securities and Futures Commission (SFC) shall establish and maintain a compensation fund, to be known as the Unified Exchange Compensation Fund (UECF). The Ordinance further provides that any person who has suffered pecuniary loss as a result of a “default” on the part of a broker member of the Stock Exchange of Hong Kong (SEHK) is entitled to claim compensation against the UECF.

3. Under these provisions, SEHK is responsible for determining whether or not a default on the part of one of its broker members has or has not in fact occurred and, if it has, whether or not the claims for compensation made by any person including clients of the broker concerned are proper. SEHK will notify the SFC of the allowance or partial allowance of a claim, so that the SFC will effect payment from the UECF.

4. Section 109(3) of the Ordinance imposes a compensation limit of \$8 million in respect of all claims against any defaulting broker allowed by the SEHK or the Court<sup>1</sup>. If the total of all allowed claims for compensation exceeds that limit, section 120(2) provides that the \$8 million should be apportioned amongst the allowed claims on an equitable basis. This normally implies a pro

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<sup>1</sup> The Ordinance provides that the Court may make order in respect of claims against the UECF.

rata distribution according to the sizes of the claims. The Ordinance further provides that on payment of such compensation, whether in full or in part, these claims will be considered absolutely discharged. Due to the need for apportionment in such circumstances, payments from the UECF cannot be determined and effected until the completion of processing and determination of all claims, which usually takes a long time.

5. Under section 118 of the Ordinance, on making a compensation to a claimant, the SFC is subrogated up to that amount to all of that claimant's rights and remedies against the defaulting broker under, for instance, the process of liquidation. Money recovered by the SFC in such process may be recycled to meet any allowed claims which have not been fully compensated hitherto. Such further payments will be apportioned among outstanding claims in the same manner as described in paragraph 4 above. In effect, the maximum net payment from the UECF is limited to \$8 million per default case, although the total amount received by claimants through this recycling process may, in some cases, eventually turn out to be more, depending, for instance in part on the final outcome of the related liquidation process.

6. The UECF currently has a reserve of about \$490 million, of which about \$15 million came from contribution of \$50,000 each from SEHK members as required under the law, and another \$354 million came from surplus from transaction levy income of the SEHK between 1991 and 1994. Under section 107 of the Ordinance, the SFC may require the SEHK to replenish the UECF for the compensation made.

### **The Collapse of C.A. Pacific Group**

7. The C.A. Pacific Group, which comprised, inter alia, a finance company (C.A. Pacific Finance) and a securities dealing company (C.A. Pacific Securities, which was a member of the SEHK), collapsed due to financial and liquidity problems on 19 January, 1998. In that incident, more than 10,000 investors were affected. Many of them claimed that they had been led to open "margin" accounts with the finance company in circumstances in which they did not fully understand the consequences of opening such accounts. Having considered the market conditions, including fragile investor confidence, prevailing at that time, its potential systemic risk to the market system as well as the size of the possible claims in relation to the company, the Administration together with the SFC and the SEHK jointly announced on 25 January 1998 that a flexible approach would be adopted in relation to the compensation arrangements for clients of C.A. Pacific. Details of the scheme are contained in

the press release following the announcement in January 1998, copied at Annex B.

8. After a statutory period of three months, the submission of claims against UECF was closed on 1 May 1998. A total of 5,212 claims were received by SEHK, with a total claim size of \$2,412 million.

9. Pursuant to the announced principles for compensation as contained in Annex B, SFC and SEHK have worked out the detailed arrangements for the scheme, the details of which are contained in another press release at Annex C issued on 10 June.

### **Legislative Amendments**

10. Implementation of the announced compensation arrangements requires legislative amendments to the existing provisions in the Securities Ordinance relating to the UECF. The amendments mainly aim to enable the following -

- (a) the contribution of funds by the SFC from its reserve to the UECF;
- (b) the introduction of a per claimant compensation limit in addition to the \$8 million statutory limit that applies on a defaulting broker basis;
- (c) the making of payments as soon as the claims in question have been verified and allowed, without waiting for the completion of the verification exercise and apportionment for all the claims.

11. In addition, the proposed amendments will also cap the recycling process to the first \$8 million recovered through subrogation rights surrendered to the SFC by the affected claimants and clarify beyond doubt that claims upon the discretionary payment may also be considered absolutely discharged even if they do not receive any further payment under apportionment.

12. The proposed legislative amendments are intended to take effect retrospectively as from 27 January 1998.

## THE BILL

- 13 .The Bill at Annex A amends the Securities Ordinance (Cap. 333) -
- (a) to enable the SFC to inject money into the UECF (clauses 2 and 3);
  - (b) to empower the SEHK to, under certain circumstances, authorise discretionary payments to claimants against the UECF before the normal apportionment procedure takes place (clause 5);
  - (c) to exclude the discretionary payments from the calculation of the statutory compensation limit of \$8 million and to restrict the amount of money recouped by the SFC in exercise of its subrogation rights that may be recycled for compensation (clause 4); and
  - (d) to clarify beyond doubt that the claim of a claimant who has been paid a discretionary sum is absolutely discharged on payment of the \$8 million under the apportionment procedure whether or not he receives any further payment under that procedure (clause 6).
14. The Bill also enables the amended provisions to be applied retrospectively (clause 7).
15. Extract of the relevant provisions of the Securities Ordinance is contained at Annex D for ease of reference.

## LEGISLATIVE TIMETABLE

16. The legislative timetable as approved by the Executive Council is as follows -
- |   |                |
|---|----------------|
| Publication in the Gazette  | 24 July 1998   |
| First Reading and commencement of<br>Second Reading debate                | 29 July 1998   |
| Resumption of Second Reading debate,<br>committee stage and Third Reading | to be notified |

## **BASIC LAW IMPLICATIONS**

17. There are no Basic Law implications.

## **HUMAN RIGHTS IMPLICATIONS**

18. The Department of Justice advises that the proposed legislation is consistent with the human rights provisions of the Basic Law.

## **BINDING EFFECT**

19. There is no express provision to bind the State in the Bill and in the provisions of the Ordinance.

## **FINANCIAL AND STAFFING IMPLICATIONS**

20. The Bill has no direct financial or staffing implications for the Government since the additional capital for the proposed compensation arrangement will come from the SFC and SEHK. Although the Government has undertaken to apply to the Finance Committee of the Legislative Council for a loan to top up the UECF in case it falls below a prudential level, the current resources of the UECF (amounting to about \$500 million and would increase to \$1,100 million with the contributions from SFC and SEHK) is considered sufficient to meet the need for compensation arising from the C. A. Pacific incident and other default cases of securities companies already known, if it is decided that the C. A. Pacific compensation model should be extended to such cases.

## **PUBLIC CONSULTATION**

21. The principles of the compensation arrangements have been widely debated in the public domain. The general views are that the proposed compensation arrangement is acceptable and the amount set at \$150,000 is not unreasonable. Under the special compensation arrangements, no client will receive less than what they would be entitled to under the original compensation mechanism. In fact, smaller claims, which are the majority, would receive significantly more, if not full, recovery out of the new arrangement.

22. Since the proposal itself has already been announced to the public as early as January 1998 and further elaborated in early June, we do not consider it necessary to launch any specific public consultation on the matter.

## **PUBLICITY**

23. A press release has been issued on 22 July 1998 and the Bill will be published in the Gazette on 24 July 1998. A special meeting on 23 July with the LegCo Financial Affairs Panel has also been arranged to brief interested members on the elements of the proposed legislation in advance of the setting up of the Bills Committee after the first reading of the Bill.

### **Financial Services Bureau**

**File Reference: SU B51/98 (IV)**

[leg-bfe]

**A BILL**

**To**

**Amend the Securities Ordinance.**

**Enacted by the Legislative Council.**

**1. Short title**

This Ordinance may be cited as the Securities (Amendment) Ordinance 1998.

**2. Establishment of compensation fund**

Section 99 of the Securities Ordinance (Cap. 333) is amended -

- (a) by renumbering it as section 99(1);
- (b) by adding -

“(2) The Commission may, with the approval of the  
Financial Secretary, pay into the compensation fund from its  
reserves such sum of money as it thinks fit.”.

**3. Money constituting the compensation fund**

Section 101(1) is amended by adding before paragraph (a) -

“(aa) all money paid by the Commission into the fund under section 99(2);”.

**4. Claims against the fund**

Section 109(3) is amended by repealing everything after the semicolon and substituting

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“but for the purposes of this subsection any amount paid -

- (a) from the compensation fund, to the extent that the fund is subsequently reimbursed in respect of any such payment (not being a deposit made under section 107), but only in respect of the first \$8,000,000 so reimbursed; and
- (b) under section 113(5A),

shall be disregarded.”.

## **5. Power of the committee of the Exchange**

### **Company in respect of claims**

Section 113 is amended by adding after subsection (4) -

“(5A) If it appears to the committee of the Exchange Company that the aggregate of all claims arising out of the default of a stockbroker, if allowed, may be in excess of the total amount limited by or under section 109, and the committee -

- (a) having regard to the circumstances of the default, considers it appropriate to do so; and
- (b) after taking into account all ascertained and contingent liabilities of the compensation fund, considers that the assets of the fund so permit,

it may, with the prior approval of the Commission, allow in respect of any claim which has been allowed or partially allowed by the Exchange Company or by an order of the Court under this Part the payment, before the apportionment under section 120(2), of such sum for compensating the claimant as it thinks fit.”.

**6. Provision where fund is insufficient to meet claims  
or where claims exceed total amount payable**

Section 120 is amended -

- (a) in subsection (1), by adding after “equitable” -

“, having regard to the sums already paid, if any, to the claimants  
under section 113(5A)”;

- (b) in subsection (2) -

(i) by repealing “this Part” and substituting “section 109”;

(ii) by adding after “equitable” -

“, having regard to the sums already paid, if any, to  
the claimants under section 113(5A)”;

- (c) by adding -

“(3) For the avoidance of doubt, upon payment under  
subsection (2), the claim of a claimant who has been  
compensated under section 113(5A) and any order of the Court  
relating to the claim shall be absolutely discharged whether or  
not the claimant has received any further payment under the  
apportionment.”.

**7. Transitional**

Sections 109, 113 and 120 of the Securities Ordinance (Cap. 333)(“the principal Ordinance”) as amended by this Ordinance shall also have effect as to claims made in relation to a person specified in a notice published under section 112 of the principal Ordinance on or after 27 January 1998.

### Explanatory Memorandum

The object of this Bill is to amend the Securities Ordinance (Cap. 333) -

- (a) to enable the Securities and Futures Commission to inject money into the Unified Exchange Compensation Fund (“compensation fund”)(clauses 2 and 3);
- (b) to empower the committee of the Exchange Company to, under certain circumstances, authorize payment to claimants against the compensation fund, before the normal apportionment procedure takes place, discretionary sums as compensation (clause 5);
- (c) to exclude the discretionary sums in the calculation of the limit on the total amount payable out of the compensation fund, and to restrict the amount of money recouped by the Securities and Futures Commission in exercise of its subrogation rights that may be paid out for compensation of claimants (clause 4); and
- (d) to expressly provide that the claim of a claimant who has been paid a discretionary sum is absolutely discharged on payment of the total amount under the apportionment procedure even if he is not entitled to any further payment thereunder (clause 6).

2. The Bill also enables the committee of the Exchange Company to exercise its power to allow discretionary sums to claimants before apportionment in relation to certain claims made before the enactment of the Bill (clause 7).

Compensation Fund rules and upper limit relaxed

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In the light of the C A Pacific Securities liquidation incident, the Government has agreed to relax the current compensation rules and the upper limit of compensation of the Compensation Fund. Meanwhile, a special task force will be established under the Securities and Futures Commission (SFC) and the Hong Kong Stock Exchange (SEHK) to receive claims.

This was announced today (Sunday) by the Secretary for Financial Services, Mr Rafael Hui, the SFC Chairman, Mr Anthony Neoh, and the SEHK Chairman, Mr H C Lee.

As there might be cases where clients of C A Pacific had been led to open margin account without their consent or under misrepresentation, the authorities considered that a more flexible approach should be adopted in assessing their claims against the Compensation Fund. The principle was that so far as their trading record and account statements had not indicated the use of the margin facility, they would be regarded as cash clients and would be entitled to claim compensation under the Compensation Fund.

Under the current compensation rules, the maximum compensation payable to claimants against any single registered broker was \$8 million. If this rule was to be observed, even if a flexible approach was adopted in assessing claims as outlined above, the compensation that each claimant may receive from the Compensation Fund would likely be very limited.

In view of this, the Government agreed that the upper limit of compensation should be set on a per claimant basis. In other words, each qualified claimant may receive a certain sum of money as compensation and would not be subject to the \$8 million limit. In this case, the compensation that each claimant may receive under the proposed arrangement would be more than what would otherwise be available if the \$8 million ceiling per broker was maintained.

The Fund was established by the Government in 1985 with a view to providing protection for securities investors. The Fund at present has \$480 million.

Mr Hui said: "In order to put investors' hearts at ease, we will increase the Compensation Fund as well as making flexible arrangements. The SEHK and the SFC will each inject \$150 million into the Fund immediately and if necessary, another \$150 million will be injected by each party.

"The Government has also undertaken to apply to the Finance Committee of the Provisional Legislative Council for a loan to top up the Fund when it falls below the prudential level."

Mr Neoh said : "The SFC and SEHK will work closely with the provisional liquidator to verify and assess the claims received. The ceiling of compensation will be determined on completion of the actuarial assessment. However, the amount will certainly be higher than what would otherwise be available if the \$8 million ceiling per broker is maintained."

Mr Lee said: "The SFC and SEHK has set up a special task force to assist C A Pacific Securities clients to register their claims and to apply for claims to the Compensation Fund under existing securities regulations.

"The task force will liaise with the provisional liquidator to obtain a list of the clients and will contact the clients to assist them in filling out the applications for claims. The SEHK will also publish advertisements to notify clients to submit compensation claims.

"A telephone hotline to answer enquiries from C A Pacific Securities clients has been set up by the SEHK. The telephone number is 2840 3729."

The SFC will closely monitor the financial position of the broker-related margin finance companies and to step up its supervision on margin trading activities. Where necessary, appropriate measures will be taken to protect the interests of investors.

Meanwhile, the Government will introduce legislation to bring the margin financing activities under regulation as soon as possible in order to further strengthen the integrity of the securities market and enhance investor protection.

End/Sunday, January 25, 1998

NNNN

Letter head of Securities & Futures Commission

TO THE BUSINESS EDITOR  
FOR IMMEDIATE RELEASE

10 June 1998

Joint Press Release

### **Compensation Arrangements for CA Pacific Securities Clients**

The Council of the Stock Exchange of Hong Kong (SEHK) today resolved that it would allow a sum of not more than \$150,000 per client towards the compensation of CA Pacific Securities clients, in accordance with the policies announced by the Government, the Securities and Futures Commission (SFC) and the SEHK in January 1998. The resolution requires the SFC's approval, as stipulated in the Securities Ordinance, before it can be proceeded with. (An illustration is at Annex 1)

Section 109 of the Securities Ordinance (SO) states that where a person has a cause of action against a stockbroker in relation to any money, securities or other property entrusted to or received by the stockbroker, in the course of that stockbroking business, that person shall be entitled to claim compensation from the Unified Exchange Compensation Fund in respect of any pecuniary loss suffered by him.

As announced in January, cash clients of CA Pacific Securities will generally be eligible, as will clients of CA Pacific Securities who had signed margin agreements with CA Pacific Finance and had not used the facility under the agreements. In determining whether margin clients had ever used margin facilities, the relevant period to be looked at would be from 1 June 1997 to 19 January 1998, the date of default of CA Pacific Securities, approximately seven months. Clients claiming that they had not used the margin facility have to substantiate their claims by their trading record and account statements.

The Government, the SFC and the SEHK agreed in January to relax the compensation rules and compensation limit in relation to the default of CA Pacific Securities as they had determined that if the usual \$8 million limit were observed, the compensation that each client might receive would likely be very limited. (The press release made by the Government on 25 January is at Annex 2).

According to the books and records of CA Pacific Securities and CA Pacific Finance as provided by the Provisional Liquidators, the two companies had a total of over 11,000 clients (including inactive clients and clients with zero or negative balances) representing holdings of approximately \$1.4 billion of securities valued as at 19 January 1998.

Upon closing of three-month period for submission of claims, 5,212 claims were received by the SEHK. The amount claimed for the value of the securities has been adjusted using the closing price of shares as at 19 January 1998. Together with cash claims, the total amount claimed was approximately \$2.4 billion. As can be seen, there is a large discrepancy between the amounts claimed and the amounts shown in the companies' records.

The SEHK has also received 43 late submission of claims as of 9 June 1998. The SEHK's Compensation Committee on a case-by-case basis will determine admission of these late claims.

The payment level of \$150,000 will, assuming all potentially eligible clients are entertained, represent 81% of claimants being fully paid on the basis of company records (or \$325 million in total payment), or 70% on the basis of claims submitted and adjusted by the share closing price of 19 January 1998 (or \$412 million in total payment).

Upon completion of the initial injection of \$150 million each from the SEHK and the SFC, the Compensation Fund will stand at about \$800 million before the payment of the claims. Further injection into the Compensation Fund has been dealt with in the January announcement (Annex 2).

Under Section 113 of the SO, the SEHK has now begun to process the claims. Each case will be determined in accordance with the evidence provided by the claimant and the records of the companies. It is provided by law that the onus of proof of a claim lies upon the claimant.

The SEHK is proceeding with the processing of claims as quickly as possible, so as to enable the first batch of payments by the Compensation Fund by the autumn of 1998. Claims from cash clients will be processed first.

Upon payment, a client's right to claim under the liquidation process will be subrogated, but only to the extent of the payment, to the SFC as the statutory trustee for the Compensation Fund. Those clients who are not fully compensated through this compensation process are entitled to claim in the liquidation process for any loss over and above what is paid to him by the Compensation Fund. (An illustration is in Point 3 in Annex 1).

As the existing compensation scheme is based upon a ceiling of \$8 million per broker failure and an extension of the ceiling allowed only in individual cases, the scheme as intended to be applied to CA Pacific Securities clients would have to be implemented through a number of minor legislative amendments. These legislative amendments are being drafted by the Government and it is expected they shall be introduced into the Legislative Council in July 1998.

Furthermore, liquidators once appointed by the Court intend in the near future to apply to the Court for directions to determine the respective rights of creditors and whether or not certain claimants are entitled to have their shares to be returned in specie. If shares are ultimately found to be returnable, arrangements will be made for claimants to repay the Compensation Fund and receive their shares back. (See Point 4 in Annex 1).

Claimants whose claims are not allowed or partially allowed may commence proceedings in court to establish their claims against the Compensation Fund. Subject to the merits and financial eligibility test mandated by the Legal Aid Ordinance for individual applicants, such proceedings would generally be eligible for legal aid.

For further information, please contact Henry Law of the SEHK (2840 3862), and Chan Chi Keung (2842 7624) or Bill Weeks (2840 9289) of the SFC.

CC/8PR52

### Examples of Compensation Fund Payments

- Each claimant whose claim is allowed by the Stock Exchange may initially receive the value of the allowed claim up to \$150,000. Remember that the allowed amounts are calculated based on share values at 19 January 1998.

<u>Allowed Claim</u>	<u>Initial Compensation Payment</u>
\$10,000	\$10,000
\$50,000	\$50,000
\$150,000	\$150,000
\$200,000	\$150,000
\$1,000,000	\$150,000
\$10,000,000	\$150,000

- Each claimant is also entitled to receive a pro rata share of the original \$8,000,000 limit under the Securities Ordinance. In other words, no claimant will receive less than what he or she would have received under the original provisions of the Securities Ordinance. However, any such amounts cannot be calculated until all claims have been determined and any appeals have been resolved.

<u>Allowed Claim</u>	<u>Initial Compensation Payment</u>	<u>Pro Rata Share of \$8,000,000*</u>	<u>Additional Compensation Payment</u>
\$10,000,000	\$150,000	\$200,000	\$50,000

\* This amount is for illustration only. The actual pro rata figures will not be available for some time. The ratio is determined by dividing the \$8 million by the total amount of allowed claims, or in this example 0.02 based on hypothetical allowed claims of \$400 million.

3. Apart from the compensation payment, all clients of CA Pacific Securities and CA Pacific Finance are eligible to claim in the liquidation proceeding and to receive a distribution as creditors. The SFC as trustee for the Compensation Fund is subrogated by law to the claimants' rights in the liquidation, but only to the extent of the compensation payment made to each claimant. The example below shows how the process works assuming a 50% distribution in the liquidation (for illustration purposes only). A claimant will not receive less overall by virtue of receiving compensation payments.

<u>Allowed Claim</u>	<u>Assumed Insolvency Distribution (A)</u>	<u>Compensation Payment (B)</u>	<u>Insolvency Distribution Paid to Claimant (A-B)</u>
\$10,000	\$5,000	\$10,000	NA
\$50,000	\$25,000	\$50,000	NA
\$150,000	\$75,000	\$150,000	NA
\$200,000	\$100,000	\$150,000	NA
\$1,000,000	\$500,000	\$150,000	\$350,000
\$10,000,000	\$5,000,000	\$150,000	\$4,850,000

4. There may be cases where a claimant is entitled to a return of securities in the liquidation, and who has already been paid from the Compensation Fund. The principle to apply will be that no claimant will be worse off for having claimed from the Compensation Fund. If the securities have a value greater than the Compensation Fund payment, the claimant may repay the Compensation Fund and receive the return of securities in the liquidation.

<u>Allowed Claim</u>	<u>Compensation Payment</u>	<u>Insolvency Distribution Available</u>
\$75,000 (representing 2,000 shares in ABC valued at 19 Jan. 1998)	\$75,000	2,000 shares in ABC (assume value has risen to \$100,000)

Claimant may receive return of securities upon repayment of \$75,000 to Compensation Fund.

**Press Release by the Hong Kong Special Administrative Region Government on 25  
January 1998**

Compensation Fund Rules and Upper Limit Relaxed

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25 January 1998