For discussion on 27 April 2001

Paper No. 11/01

Bills Committee on
Securities and Futures Bill and Banking (Amendment) Bill 2000

Securities and Futures Bill
Part XII and Schedule 9

INTRODUCTION

This paper outlines the major elements of Part XII of and the relevant provisions in Schedule 9 to the Securities and Futures Bill (the "SF Bill"). Part XII provides the legal framework for the new investor compensation arrangements. The provisions in Schedule 9 relating to Part XII deal with the transitional arrangements after the repeal of the legislation governing the existing investor compensation arrangements. Part XII should be read together with Division 5 of Part III of the SF Bill which empowers the Securities and Futures Commission (the "SFC") to recognize an investor compensation company ("ICC") or companies to manage and administer the whole or a part of the new compensation fund[1].

2. The SFC released on 7 March 2001 a paper entitled "Proposed New Investor Compensation Arrangements" (the "Consultation Paper") for public consultation till 6 April 2001, a copy of which has been provided to each member of the Bills Committee separately. We are now considering the comments received and will report on the preliminary results of the consultation at the Bills Committee meeting on Part XII of the SF Bill.

3. At the Annex is a table comparing the provisions under Part XII of the SF Bill with those under the Securities Ordinance (the "SO") and the Commodities Trading Ordinance (the "CTO") on investor compensation.

POLICY OBJECTIVES

4. The objective of the new compensation arrangements is 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 (the "HKEx"), based on the principles of user pays and equal treatment for all retail investors irrespective of the intermediary through whom they trade.

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[1] Please refer to Paper No.3/01 on Part III of the SF Bill discussed on 19 January 2001.

PROPOSED NEW ARRANGEMENTS

5. Part XII of the SF Bill prescribes the broad legal framework for the Chief Executive in Council (the "CE in Council") and the SFC *(clause 236)* to make rules for implementation of the new compensation arrangements.

A new single investor compensation fund

6. A new single investor compensation fund (the "new fund") would be established to replace the Unified Exchange Compensation Fund (the "UECF"), the Futures Exchange Compensation Fund (the "FECF") and the Dealers' Deposit Schemes *(clause 229)*. The new fund would eliminate existing requirements for exchange participant dealers to make deposits to the compensation funds and for other dealers to the Dealers' Deposit Scheme. The arrangements would also remove the existing requirement for the Stock Exchange of Hong Kong (the "SEHK") to replenish compensation amounts paid out. The UECF, the FECF and the Dealers' Deposit Scheme would eventually be dissolved *(clauses 72 to 74 of Schedule 9)*. Subject to the clearance of all outstanding obligations, the deposits would be refunded to the two exchanges and the dealers concerned *(clauses 72(8), 73(8) and 74(9) of Schedule 9).*

Funding

7. Clause 230 prescribes in broad terms the money constituting the new fund, as supplemented by the rules to be made by the CE in Council under clause 236(1)(a).

8. Initial funding for the new fund would come from a transfer of assets in the UECF and the FECF, but with sufficient amounts reserved in those funds to cover outstanding liabilities *(clauses 72(2), 72(8)(b), 73(2), 73(8)(b) and 74(11) of Schedule 9)*. The initial funding from this source is approximately \$655.8 million, which is sensitive to possible intervening default cases. In order to provide reasonable protection to investors, the SFC recommends that the new fund should build its reserves to a level of \$1 billion[2] as quickly as possible. This can be achieved effectively by increasing the existing transaction levy on securities transactions in the SEHK by 0.002 percentage point and having the SFC pay this additional amount of levy into the existing UECF for transfer to the new fund when formed. Meanwhile, the existing \$0.5 levy for each side of a contract executed on the Hong Kong Futures Exchange (the "HKFE") is proposed to continue for eventual transfer to the new fund. As announced by the Financial Secretary in his Budget Speech in March 2001, the proposed increase of 0.002 percentage point in the levy on securities transactions is to last until such time as the new fund accumulated to \$1 billion. The legislative amendments for effecting the increase, together with the proposed reduction of stamp duty on securities transactions from 0.225% to 0.2%, are included in the Revenue

[2] Please refer to Part IV of the Consultation Paper for the detailed risk assessment mechanism that underlies the proposed reserve level of \$1 billion.

(No.3) Bill 2001. The combined effect of the two proposals is that the cost of securities transactions in Hong Kong will be lowered.

9. Were a catastrophe to occur, alternative risk transfer mechanisms, contingent capital in the form of credit facility or support from the Government in the form of guarantee of loan would be possible options for funding.

Expanded coverage of intermediaries

10. The UECF and the FECF cover respectively defaults by the participants of the SEHK and the HKFE. The SFC has proposed in the Consultation Paper to extend the coverage of the new fund to defaults by all persons who are licensed or where applicable, exempted for dealing in securities, futures contracts or providing securities margin financing in relation to products traded on the HKEx (collectively the "covered intermediaries"), irrespective of whether they are participants of the two exchanges. The coverage of the new fund will be stipulated by rules made by the SFC under clause 236(2)(a) after consultation with the Financial Secretary as required in clause 236(3).

Per investor limit

11. The UECF and the FECF have a statutory per broker default compensation limit of $8 million and $2 million respectively, regardless of the size of the losses suffered or the number of investors claiming compensation. The two limits may be exceeded by agreement between the exchanges and the SFC. This per broker limit does not indicate to investors the amount of coverage available to them individually and thus gives an uncertain level of protection. The new arrangement proposed replaces the per broker limit with a limit of compensation per investor. The limit is proposed to be $150,000 initially and would be reviewed as necessary. The per investor compensation level will be stipulated by rules made by the CE in Council under clause 236(1)(b).

Basis for making claims

12. The basis for making compensation claims would largely follow existing arrangements, under which a claim would be made where a person has a cause of action against a covered intermediary in relation to any money, securities or futures contracts entrusted to or received by the covered intermediary or any person employed by it as a result of default by the covered intermediary. Specified institutional investors (for example, a person licensed or exempted under Part V of the SF Bill and any similar person licensed or regulated in another jurisdiction; an authorized institution under the Banking Ordinance and any similar person in another jurisdiction; a recognized exchange controller, a recognized exchange company, a recognized clearing house and any similar person in another jurisdiction, etc) would not be eligible for claiming compensation. This is consistent with provisions under existing arrangements. The arrangements for claiming compensation will be

stipulated in rules made by the SFC under clause 236(2)(a) and (f) after consultation with the Financial Secretary.

Accounts of compensation fund

13. Clause 232 prescribes the requirements as regards the accounts of the new fund. In particular, the SFC may maintain separate accounts in respect of the amounts that are respectively paid into the new fund from the UECF and the FECF and in terms of different sectors of the securities and futures industry. This is to uphold the principle that there should generally be no cross subsidy among different sectors. The SFC is obliged to keep proper accounts and prepare the financial statements of the new fund, and arrange for the auditing. The audited financial statements and the auditors' report are to be submitted to the Financial Secretary and published in the Gazette within four months after the end of each financial year.

Subrogation to the SFC to rights of claimant on payment from the new fund

14. Clause 235 replicates section 118 of the Securities Ordinance[3] and provides that the SFC shall be subrogated to the rights of claimants to the extent which its payment bears to the loss claimed.

Miscellaneous

15. Clause 231 obliges the SFC to deposit all amounts of the new fund, save those pending application in accordance with Part XII, with one or more authorized financial institutions.

16. Clause 233 empowers the SFC to invest any amounts of the new fund that is not immediately required for the various purposes prescribed in Part XII on fixed deposit with an authorized financial institution and in securities in which trustees are authorized by law to invest trust funds. Any return or profit from the investment shall be added to the compensation fund.

17. Clause 234 governs the payments that may be made from the new fund. In addition to the compensation payment, other outflows include all legal and other expenses incurred in relation to a claim, the new fund and the recognized investor compensation company, etc.

18. The rule-making power of the CE in Council and the SFC under clause 236, save the aforementioned, cover also the manner in which a claim for compensation is to be made, the information or documents required in a claim for

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[3] Section 118 of the Securities Ordinance was interpreted by a High Court Judge in the winding-up of Forluxe Securities in December 2000. The following example was given – A client has entrusted the broker with shares worth $500,000. The broker defaults and the SFC pays the client compensation of $150,000. The client would still have a loss of $350,000. Shares worth of $100,000 are then recovered in a winding-up. The SFC should then take 30% (i.e.150,000/500,000) of the shares recovered and the client 70% (i.e.350,000/500,000).

compensation, the circumstances and manner in which the SFC may call for claims for compensation and determine, deal with and pay a claim for compensation, and the arrangements to be made when a recognized investor compensation company is wound up, etc.

Investor Compensation Company

19. Under clause 80 (in Part III), the SFC may request the CE in Council to transfer to an ICC by way of a transfer order its functions under Part XII other than its rule-making functions under clause 236(2). The request will only be made if the SFC is satisfied that the designated company is willing and able to perform the functions of the SFC in relation to the new fund. The SFC may resume the functions so transferred with an order of the CE in Council.

Transitional arrangements

20. Clauses 72 and 73 of Schedule 9 provide for the continued operation of the UECF and FECF until the new fund is in place. As mentioned in paragraph 8 above, the SFC is empowered to pay from each of the existing two funds into the new fund such sum of money as it considers appropriate having regard to the amounts necessary to meet any likely claims, and the amounts of the deposits to be refunded. A cut off date will be set for further claims to the existing two funds once the new fund is in place. The winding up of the existing two funds and the return of the deposits after outstanding liabilities have been satisfied are also provided for. Lastly, clause 74 deals with the winding up of the Dealers' Deposit Schemes for non-exchange participant dealers in a similar manner.

MARKET COMMENTS

21. The majority of the comments received during the White Bill consultation concern the source of funding of the new fund, the coverage and the level of compensation. Having regard to the comments received, the SFC has prepared the Consultation Paper referred to in Paragraph 2 above and will report on the consultation results at the Bills Committee meeting on Part XII of the SF Bill. This should not however affect consideration of the provisions in Part XII which seek out to set out the framework of the new compensation regime. Results of the consultation will provide a useful basis for the SFC and the Administration to prepare the necessary subsidiary legislation for commencing this Part of the Bill. Other key areas of concern to the market were addressed below.

Cross subsidy

22. We have received a comment that there should be no cross subsidy of compensation among different sectors of the securities and futures industry. We support this principle. As the SFC has proposed in the Consultation Paper, the new

fund should build its reserves to a level of $1 billion, with transfers from both the UECF and the FECF, as well as the levies on transactions at both the stock and futures exchanges. Although a larger portion of the funding is to come from the stock exchange, the application of the $1 billion fund to cover both sectors is still considered fair as the losses in relation to the stock exchange have been much higher by far than the futures exchange. However, if losses turned out to be much higher in relation to the futures exchange, the SFC will propose ways to address the imbalance, such as by a higher levy on transactions at the futures exchange. The SFC has also highlighted in the Consultation Paper that special funding arrangements may be needed in relation to ATS trading that is not done through the exchange facilities to ensure a fair and level playing field.

Ability of the new fund to repay debt

23. Concern was expressed that the new fund may not be able to repay its debts and a statutory borrowing limit, similar to the $1 million limit prescribed in section 101 of the Securities Ordinance, should therefore be set. We consider that the new fund would only be financed through loans on a strictly necessary basis, and generally only where there was a catastrophe. It would be inappropriate and impossible to predetermine a limit on its borrowing capability; as to do so, the new fund might not be able to meet all legitimate claims from investors in exceptional circumstances. With the back up of transaction levy as a source of funding, the new fund should be able to repay its debts over time.

Consultation on the rules to be made

24. We agree to the need for consultation on the rules to be made by the SFC to enable all interested parties to give their views.

INTERNATIONAL COMPARISONS

25. The approach to investor compensation varies internationally. The remaining paragraphs discuss compensation arrangements in the US, Canada, the UK and Australia.

United States Securities Investor Protection Corporation ("SIPC")

26. The SIPC was established by the Securities Investor Protection Act of 1970 to protect securities clients of broker members of the US exchanges and National Association of Securities Dealers. It is regulated by the Securities and Exchange Commission ("SEC"), which, among other things, approves the SIPC rules.

27. The SIPC protects clients' cash and securities within defined limits if a broker becomes insolvent. Each customer is protected up to US$500,000 inclusive of a US$100,000 limit for cash. The SIPC petitions the courts to place a defaulting

broker into insolvency and to appoint a trustee; sometimes the SIPC itself acts as the trustee. The compensation arrangement and the insolvency effectively are combined in one proceeding. The SIPC works with the trustee to transfer client accounts to solvent brokers. In general, clients share pro-rata in the client property held by the insolvent broker.

28. The SIPC is funded by assessments collected from brokers. As at 31 December 1999, it had net assets of approximately US$1.1 billion. The SIPC has a US$1 billion revolving line of credit with a consortium of banks. It can also borrow from the US Treasury through the SEC if the SEC determines that a loan is necessary to protect customers and maintain confidence in US securities markets. The SIPC must then present a plan for repayment.

Canadian Investor Protection Fund ("CIPF")

29. The CIPF was established in 1969 by the Canadian stock exchanges. In addition to providing investor compensation, it also oversees the work of the exchanges' self-regulatory systems and establishes national standards for financial responsibility and monitoring to contain the risk of providing the compensation arrangement.

30. The CIPF covers clients' losses of securities or funds, within defined limits, that result from broker insolvency. The limits are Canadian $1,000,000 per investor for any combination of cash and securities. It is funded primarily by quarterly assessments of brokers based on their gross revenues and by risk premiums based on brokers' capital deficiencies. As at 30 April 2000, the CIPF had a balance of Canadian $172 million and a bank credit line of Canadian $100 million.

31. The CIPF may petition the courts to appoint a trustee where a broker is insolvent. It works with the trustee to transfer customer accounts from the insolvent broker to a solvent broker. In addition, under the Canadian Bankruptcy and Insolvency Act, customers of the insolvent broker are entitled to share pro rata in all cash and securities held by the broker for customers. Compensation is calculated after the account transfer and pro-rata distribution of customer assets.

United Kingdom Investors Compensation Scheme ("ICS")

32. When the Financial Services and Markets Act ("FSMA") comes into force, a new single Financial Services Compensation Scheme ("FSCS") will be established to cover compensation in respect of investment business, deposits and insurance. The FSCS scheme will be divided into three sub-schemes with respect to each of the three areas. This will create a single point of contact for consumers in the event of a financial services firm being unable to pay claims against it. A new management company, the Financial Services Compensation Scheme Limited has been established by the FSA to manage the new scheme.

33. Each authorized firm will participate in the sub-schemes according to the business it carries on, so a firm may have to participate in more than one sub-scheme. A claimant with different types of claim arising from the same default (for example, a deposit and an investment) will be able to make a claim against more than one sub-scheme, if appropriate.

34. The rules for the new scheme have been drafted and issued for consultation. The draft rules take into account the European Directive on Investor Compensation Schemes (Directive 97/9/EC of 3 March 1997 "ICS Directive"). For the FSCS, the FSA proposes to maintain the level of compensation available to each client of a defaulting firm at £48,000. The ICS Directive requires Member States to ensure that compensation schemes provide for cover of not less than ECU20,000 per investor. The FSCS comfortably exceeds the level prescribed for the ICS. All of the existing exclusions will apply to claims in respect of investment business. This means that claims from large companies, financial institutions, government and municipal authorities and persons connected with the failed firm will continue to be excluded. The FSCS will be funded by levies on the industry and will continue to be funded entirely on a 'pay-as-you-go' basis.

35. The rules for allocation of liabilities will be based on the following principles:

(a) As a general rule, the costs of compensation attaching to a particular default will fall on the contribution group of which the defaulting firm was a member.
(b) The contribution groups will be constructed to reflect the market structure in order to minimise cross-subsidy between firms carrying out dissimilar business activities.
(c) All authorized firms will be required to contribute to the base costs of operating the new scheme.
(d) All other administration costs will be attached to a specific default and will then be met by the firms in the contribution group of which the defaulting firm was a member.
(e) The allocation of liabilities to firms in a particular contribution group will be weighted towards those firms that do business with consumers eligible for compensation, e.g. levies are likely to be based on the amount of protected business conducted by the firm.

Australian National Guarantee Fund

36. The National Guarantee Fund ("NGF") was established by the Australian Stock Exchange National Guarantee Fund Act of 1987. The NGF is administered by the Securities Exchanges Guarantee Corporation Limited ("SEGC"). The SEGC is a company limited by guarantee and is a subsidiary of the Australian Stock Exchange ("ASX"), but operates independently.

37. The NGF is comprised of assets transferred in 1987 from each of the former State Stock Exchange Fidelity Funds and income derived from investment. The NFG was valued at approximately AU$150 million as at 30 June 2000.

38. Claims can be made on the NGF where a client suffers loss due to, among other things, a broker's insolvency. There is no maximum payable on a per investor basis, but there is an aggregate limit per broker insolvency at 14% of the adjustable "minimum amount" i.e. the amount needed to maintain the NGF at a viable level to meet claims and administrative costs of the SEGC and the NGF. The "minimum amount" is currently set at AU$80 million and the limit on amounts payable presently stands at AU$11.2 million per broker insolvency.

39. If the amount in the NGF falls below the "minimum amount", the SEGC Board has flexibility in managing the financial position of the SEGC and the NGF as appropriate in the circumstances. For example:

(a) with the Minister's approval, reduce the "minimum amount";
(b) take out insurance and loan;
(c) pay claims in installments and in the priority set out in the legislation;
(d) impose a levy on "leviable transactions" (certain sales or purchases of securities that are required to be reported to the ASX under its business rules, or certain guaranteed securities loans); and
(e) impose a levy on a participating exchange.

40. Both types of levy in (d) and (e) may be imposed at the same time. If the SEGC imposes a levy on the ASX, the ASX may impose a levy on its Participating Organisations (i.e. the brokers) to go towards the levy payable to the SEGC.

41. If the amount in the NGF exceeds the "minimum amount", the SEGC may in its discretion pay all or part of the excess to a participating exchange – currently only the ASX. Any money received by the ASX out of NGF funds must be kept in a separate account designated as Security Industry Development Account.

Securities and Futures Commission
Financial Services Bureau
23 April 2001

ANNEX

Comparison table for Part XII

This table includes provisions in the right-hand column that indicate where, in current legislation, the subject matter of the relevant clause of the SF Bill is dealt with.

Legend:

CTO = Commodities Trading Ordinance (Cap. 250)
SO = Securities Ordinance (Cap. 333)

Clause		Derivation
228	Interpretation	New
229	Establishment of compensation fund	SO s.99; CTO s.77
230	Money constituting the compensation fund	SO s.101; CTO s.79
231	Money to be kept in account	SO s.102; CTO s.80
232	Accounts of compensation fund	SO s.103; CTO s.81
233	Investment of moneys	SO s.105; CTO s.83
234	Payments out of the compensation fund	SO s.108; CTO s.86
235	Subrogation of the Commission to rights, etc., of claimant on payment from compensation fund	SO s.118; CTO s.95
236	Rule-making powers	New
Schedule 9		New

Clauses 229, 231, 233 and 235 are a consolidation of the sections listed in the right hand column and follow those provisions quite closely. Clause 230(1) adopts a similar approach to s.79 CTO but includes provision for transfers of money from the existing compensation funds. Clause 230(2) follows s.79(2) CTO but has no borrowing limit. Clause 232 adopts a similar approach to s.81 CTO but is more detailed and provides for the possibility of keeping separate accounts maintained for different parts of the ICF. Clause 234 (1) follows s.86 CTO but sub-clause (1)(a)(iv) and (c) are new. Provision for payment of interest on compensation has been added to (1)(e). Clause 234(2) enables funds to be transferred back to the existing funds if there proves to be a shortfall (because of subsequent claims) – but such transfers are limited to the amount transferred to the new compensation fund from such funds (sub-clause (3)). Sub-clause (4) provides for the return to each exchange of moneys paid into the new fund from the existing funds in the event that the new fund is dissolved. Clause 236 provides for the scope of the compensation arrangements and administration of the new fund to be set out in rules made by the Chief Executive in Council and the SFC. Part XII of Schedule 9 has been explained in paragraph 20 of this paper.