For discussion Paper No. 39/02

Subcommittee on Draft Subsidiary Legislation to be made under the Securities and Futures Ordinance

Securities and Futures (Insurance) Rules

Introduction

Members' considered the draft Securities and Futures (Insurance) Rules vide Paper No. 24/02 at the Subcommittee meeting on 18 September 2002. In response to the Hon Henry Wu's comments on the paper, Members advised that the Administration should –

(a) re-consider the draft Rules in further consultation with the market on the need and practicability of setting up a compulsory insurance scheme for licensed corporations to be arranged by the Securities and Futures Commission (SFC); and

(b) consider specifying criteria to be considered for allocating the premium to be borne by licensed corporations if a compulsory insurance scheme was to be set up.

2. This paper seeks to –

(a) clarify SFC's regulatory considerations on the insurance requirements;

(b) brief Members on our latest dialogues with the industry since the above meeting; and

(c) invite Members' views on the possible way forward regarding the draft Rules with a view to addressing latest industry concerns.

Major features of the draft Rules

3. To recap, the draft Rules last considered by Members –

(a) require licensed corporations that are licensed to carry on dealing in securities, dealing in futures contracts or providing securities margin financing, to take out and maintain insurance, subject to certain exceptions for licensed corporations that are not exchange participants;

(b) specify the amounts for which, and the risks in relation to which, insurance coverage is required;

(c) provide that the SFC may arrange a scheme of insurance under which licensed corporations shall take out and maintain the requisite insurance;

(d) provide for the powers of the SFC in arranging the scheme of insurance, including the power to engage persons to assist it; and

(e) require licensed corporations to submit to the SFC information that it requires for the purpose of arranging the scheme of insurance, and for disclosure by it of that information to other persons for that purpose.

Members' concerns

4. Members' major concerns expressed at the last meeting were summarized below –

(a) according to a Member, some industry participants, who were generally content with the draft Rules during the public consultation ended in July 2002, had second thought on the benefits/merits of the proposed compulsory insurance arrangements. Some stock exchange participants were concerned that their position might be worse off than under the existing "Brokers Fidelity Insurance" (BFI) scheme arranged by the Stock Exchange of Hong Kong (SEHK) as the futures brokers, non-participants of the two exchanges and securities margin financiers to be covered under the proposed scheme would be potential sources of uncertainty;

(b) some Members were concerned that stipulating the insurance coverage and mandating the requirement in legislation might weaken the bargaining position in negotiating an insurance scheme, which would make the premium level more uncertain; and

(c) some other Members, however, considered that more details should be written into the draft Rules to ensure that the proposed insurance arrangements could be enforced without difficulty when made.

Regulatory considerations

5. From a regulatory point of view and for investor protection reasons, SFC considers it highly desirable for all licensed corporations which are likely to receive or hold client assets in their business of securities and/or futures dealing (including margin financing) to take out and maintain an insurance policy as an additional layer of protection to insure themselves against the more prominent fidelity risks in their business. As an alternative to insurance cover, SFC would require the licensed corporations to meet with a higher level of capital requirement, for instance, under the Financial Resources Rules (FRR); and/or to further strengthen the new investor compensation scheme, which is premised on the continuation of certain brokers fidelity insurance scheme as at present.

6. SFC advises that in the light of the experience of the current BFI scheme, an insurance scheme would be commercially viable only if the great majority of the licensed corporations concerned participated. The small firms, in particular, would have difficulty in taking out an insurance policy on their own or might only do so by paying a very high premium.

7. SFC also notes that since the BFI scheme was first introduced in 1992, various features of the scheme have undergone modification and adjustments as a result of commercial negotiations between the SEHK and the insurance service providers. The negotiations took into account the benefit of the insurance cover to the licensed corporations, and the costs/affordability of the scheme.

The industry's latest thinking

8. Since the last discussion at the Subcommittee, we have further consulted the industry, through three industry associations[1], on the need and practicability of setting up a compulsory insurance scheme. The SFC has explained to them its regulatory concerns in paragraphs 5 and 6 above.

[1] They are the Hong Kong Stockbrokers Association, the Hong Kong Institute of Securities Dealers and the Hong Kong Securities Professionals Association.

9. In response, these industry associations –

(a) appreciate the merits of an industry-wide insurance scheme, particularly the protection provided to small brokers;

(b) confirm their support for taking forward such a scheme within the remit of the subsidiary legislation, in order to ensure that relevant licensed corporations will be made to participate in any scheme to be made available to the market;

(c) request that the industry should participate in the negotiation with the insurance service providers in designing the details of the scheme, including the specific risks to be covered, the insured amount, the deductible amount, the criteria for determining premium allocation, etc. as they will be the one to pay the premium and benefit from the insurance cover;

(d) ask for flexibility to be provided in the subsidiary legislation in designing the scheme, without having to be subject to rigid statutory constraints, as the scheme would be subject to renewal and modification from time to time to meet latest market needs;

(e) agree to use the existing BFI scheme as the basis for further discussion to preserve at least the status quo;

(f) agree to aim to avoid any gap between the existing BFI scheme and the new insurance arrangements; and

(g) have invited the SFC to convene an industry working group on the Insurance Rules, comprising members including representatives from the three trade associations, the Hon Henry Wu, and relevant experts in this field.

The revised draft Rules

10. To address various concerns raised by Members and the industry, we propose to revise the draft Rules to empower the SFC to authorize a single master policy of brokers fidelity insurance. The Rules will further provide that if such a policy is authorized, all licensed corporations which are exchange participants would be obliged to participate in it. Apart from those exempted, specified licensed corporations which are not exchange participants are still

required to be insured against the specified risks and amount. All licensed corporations concerned would not be required to take out any insurance cover if the SFC does not authorize any master insurance policy. This would avoid undermining the industry's bargaining position in negotiating a scheme with the insurance service providers. This would also allow for the scenario where no such insurance scheme was available in the market, when SFC would have to resort to other alternatives as mentioned in paragraph 5.

11. The Rules would allow the industry flexibility to adjust, from time to time, the insurance coverage, the risk coverage and the deductibles as the master policy is renewed, subject to approval of the SFC. This is necessary in light of the historical pattern of SEHK's BFI scheme over the past ten years. The industry emphasized to us that a lot of the details of the master policy are subject to commercial negotiation and could not be pre-determined in the statute. We shall aim to strike a reasonable balance between providing certainty and flexibility in the revised draft Rules.

Advice sought

12. Subject to Members' views, we shall proceed to amend the draft Rules in accordance with paragraphs 10 and 11, and in consultation with the above-mentioned industry working group (paragraph 9). We aim to submit the revised draft of the Rules in about two weeks' time for Members' consideration. This should not affect our overall timetable for commencing the SFO.

Securities and Futures Commission
Financial Services and the Treasury Bureau
23 October 2002