

LEGISLATIVE COUNCIL BRIEF

Securities and Futures Ordinance (Cap. 571)

SECURITIES AND FUTURES (INSURANCE) RULES

INTRODUCTION

Pursuant to section 116(5) of the Securities and Futures Ordinance (Cap. 571) (SFO), the Securities and Futures Commission (SFC) has made the Securities and Futures (Insurance) Rules (the Rules) at the **Annex**.

BACKGROUND

The SFO

2. The SFO was enacted in March 2002. It consolidates and modernizes ten existing ordinances governing the securities and futures markets into a composite piece of legislation to keep the regulatory regime on a par with international standards and practices. For effective regulation, the SFO provides flexibility in addressing changing market practices and global conditions by empowering the Chief Executive in Council, the Financial Secretary, the Chief Justice and the SFC to prescribe detailed and technical requirements as necessary by way of subsidiary legislation, to supplement the regulatory framework laid down under the primary legislation.

3. On 22 February 2002, the House Committee of the Legislative Council established the Subcommittee on Draft Subsidiary Legislation to be made under the SFO (the Subcommittee) to study the subsidiary legislation necessary for commencing the SFO. From March 2002 to January 2003, the Subcommittee held 12 meetings and considered a total of 37 sets of draft subsidiary legislation, including the *vires* to make them.

THE PROPOSALS

Major policy considerations

Requirement to take out insurance

4. The Rules supplement the regulatory regime in Part V of the SFO which requires persons who carry on business in a regulated activity¹ to be licensed or registered. In order to cushion licensed corporations against losses arising from infidelity events such as fraud and theft committed by their employees, section 116 of the SFO obliges the SFC to refuse to grant a licence unless the relevant applicant is insured or has deposited with it a security deposit in accordance with the rules made under that section. Compliance with the Rules is a licence condition as specified under section 118.

5. Currently, the Stock Exchange of Hong Kong Limited (SEHK) requires its participants to take out insurance under a master Brokers' Fidelity Insurance Scheme (BFI Scheme) whereas securities dealers who are not accredited to a SEHK participant are required under the Securities Ordinance (Cap.333) to maintain with the SFC a deposit of \$50,000. As for commodity dealers, they are required under the Commodities Trading Ordinance (Cap.250) to pay a deposit of \$100,000 for contribution to the Futures Exchange Compensation Fund if they are participants of the Hong Kong Futures Exchange Limited or to maintain a deposit of the same amount with the SFC if they are not. Taking into consideration various factors including the compensation level, compliance costs and effectiveness in maintaining overall financial stability, the SFC has decided to achieve the protection through requiring insurance coverage instead of maintenance of security deposit, and accordingly made the Rules.

The insurance requirements and their application

6. The Rules require all corporations licensed for dealing in securities, dealing in futures contracts and providing securities margin financing (relevant regulated activities) to take out insurance against specified risks if the SFC has approved a master insurance policy in respect of such activities (paragraphs 9 and 10 below), unless they are not exchange participants and are subject to a licence condition that they shall not hold client assets. The insured amount is \$15 million for the risks specified, with a deductible of not more than \$3 million, in respect of each relevant regulated activity. If a single master insurance policy is arranged for all relevant regulated activities, a corporation licensed for two or more of such activities is required to take out insurance for an insured amount of \$25 million.

¹ There are nine types of regulated activities and they are listed in Part 1 of Schedule 5 to the SFO.

7. Relevant licensed corporations which are exchange participants are required to take out insurance under the approved master insurance policy whereas others may take out insurance with an independent insurer that fulfills the conditions specified in the Rules. This is to ensure the viability of arranging master insurance policies such that all relevant licensed corporations can secure the requisite insurance coverage at an affordable price. The SFC and the Industry Working Group (IWG)² (paragraph 14 below) both take the view that it is inappropriate to prescribe in the Rules the basis of premium allocation under the master insurance policy because the circumstances in relation to premium allocation will change from time to time. Instead, a more flexible approach through industry consensus will be adopted in determining the basis of premium allocation. In that regard, the IWG has generally agreed that the basis should largely be modeled on the existing BFI Scheme arranged by SEHK.

8. The insurance requirements aim to indemnify an insured licensed corporation against financial losses caused by the specified risks, thus alleviating the adverse impact on its financial position and reducing the likelihood that it may go into liquidation if a more severe loss is being encountered. This would help maintain stability of the financial market as a whole and contribute to enhancing confidence in the market. As for investors, the insurance requirements would reduce the possibility that they would be affected as a result of such financial losses.

Implementation arrangements

9. If there are insurers in the market that are prepared to offer a master insurance policy in respect of all relevant regulated activities, at a reasonable premium, for all corporations concerned (including both exchange participants and non-exchange participants), the SFC will approve one master insurance policy. Otherwise the SFC will approve separate master insurance policies for each relevant regulated activity and/or category of licensed corporation.

10. From the tender process currently in progress and the deliberations of the IWG, the SFC expects that an approved master insurance policy for exchange participants licensed for dealing in securities would be available upon commencement of the SFO (dovetailing the expiry of the existing BFI scheme³);

² The IWG was convened by the SFC and comprised representatives from the Hong Kong Stockbrokers Association, the Hong Kong Institute of Securities Dealers and the Hong Kong Securities Professionals Association, other market participants, as well as relevant experts in the insurance field.

³ It is intended that the new insurance scheme under the Rules will replace the existing Brokers' Fidelity Insurance (BFI) Scheme.

thereby preserving the scope of application of existing insurance requirements. As for the other categories of corporations (i.e. non-exchange participants licensed for dealing in securities, and corporations licensed for dealing in futures contracts and securities margin financing respectively), they are not required to be insured presently. The SFC is working closely with the industry on a suitable master insurance policy for them. However, the process may take a little longer as there is no claims record readily available for these categories. Among them, the higher risk categories are presently covered by the dealers deposit schemes mentioned in paragraph 5 above. The SFC will retain the dealers deposits until a master insurance policy for them is approved. This is permitted by the transitional arrangements under Schedule 10 to the SFO.

11. The SFC will keep in view future developments and propose amendments to the Rules for updating the insurance requirements and to other regulatory measures as appropriate, so as to maintain a reasonable balance between enhancing investor protection and minimizing compliance burden on the industry.

THE RULES

12. The Rules –

- (a) apply to all licensed corporations (specified licensed corporations), except for licensed corporations that are not exchange participants and are subject to a licence condition that they shall not hold client assets (section 3);
- (b) where the SFC has approved a master insurance policy in respect of a regulated activity –
 - (i) require specified licensed corporations which are exchange participants licensed for that regulated activity (may it be dealing in securities, dealing in futures contracts or both) to take out insurance under that master policy; and
 - (ii) require other specified licensed corporations licensed for that regulated activity to take out insurance either under that master policy or a policy arranged individually with an independent insurer (sections 4 and 5);

- (c) specify the risks in relation to which, and the amounts for which, insurance coverage is required (section 4 and Schedules 1 and 2); and
- (d) provide that the SFC may approve a master insurance policy in respect of a regulated activity (targeting at exchange participants as necessary); and prescribe minimum credit ratings to be possessed by insurers with whom insurance is taken out and maintained (section 5 and Schedule 3).

PUBLIC CONSULTATION

13. The SFC released a consultation document and an exposure draft of the Rules on 26 June 2002 for comment by the public. A total of 9 submissions were received. Respondents generally supported the proposal of implementing a compulsory fidelity insurance scheme, and they also raised some comments on policy and administrative matters.

14. A draft of the Rules was considered by the Subcommittee at its meeting on 18 September 2002. Members of the Subcommittee expressed concerns about the need and practicability of a compulsory insurance scheme to be arranged by the SFC, the possibility of cross-subsidy among corporations licensed for different regulated activities if they are all covered under a single master insurance scheme, as well as the need for drafting the Rules in such a way as to avoid weakening the bargaining position in negotiating an insurance scheme with potential insurers. In the light of Members' concerns, the SFC convened, with the kind assistance of Hon Henry Wu, the IWG with members from the industry and relevant experts in the insurance field. The IWG has been consulted on the insurance requirements and closely involved in the preparation of the tender document inviting interest from insurers for the new insurance scheme.

15. We issued a revised draft of the Rules to the Subcommittee on 24 December for its further consideration. The draft reflects the consensus of the IWG as appropriate. Members of the Subcommittee did not make any further comments. We have made some further refinement in the light of the comments from the Legal Service Division of the Legislative Council.

FINANCIAL AND STAFFING IMPLICATIONS

16. There are no financial or staffing implications for the Government.

COMMENCEMENT DATE

17. The Rules will come into operation on the day appointed for the commencement of the SFO, together with other subsidiary legislation necessary for the commencement. We expect this to take place on 1 April 2003, after completion of the negative vetting procedure through the Legislative Council. The SFC will implement the Rules as set out in paragraphs 9 to 11 above.

PUBLICITY

18. The Rules will be published in the Gazette on 17 January 2003. The SFC will issue a press release on the same day.

ENQUIRIES

19. For any enquiries on this brief, please contact Mr. Anthony Wood of the Legal Services Division of the SFC at 2840 9276 or Ms. Lucinda Wong of the Licensing Department of the SFC at 2840 9479.

Securities and Futures Commission
17 January 2003

SECURITIES AND FUTURES (INSURANCE) RULES

(Made by the Securities and Futures Commission under section 116(5)
of the Securities and Futures Ordinance (Cap. 571))

1. Commencement

These Rules shall come into operation on the day appointed for the commencement of the Securities and Futures Ordinance (Cap. 571).

2. Interpretation

(1) In these Rules, unless the context otherwise requires –

“dealing in futures contracts” (期貨合約交易) has the meaning assigned to it by Part 2 of Schedule 5 to the Ordinance;

“dealing in securities” (證券交易) has the meaning assigned to it by Part 2 of Schedule 5 to the Ordinance;

“insurer” (保險人) means a person –

(a) carrying on insurance business in or from Hong Kong in compliance with section 6(1) of the Insurance Companies Ordinance (Cap. 41); or

(b) carrying on insurance business in or from any place outside Hong Kong under the law of that place;

“period of insurance” (保險期) means a period covered by a policy of insurance approved by the Commission under section 5(1) or (2)(a) or (b);

“specified amount” (指明款額) means the insured amount (if any) specified in Schedule 2 per period of insurance;

“specified credit rating” (指明信貸評級) means any one of the credit ratings specified in Schedule 3;

“specified licensed corporation” (指明持牌法團) means a corporation to which these Rules apply by virtue of section 3;

“specified risks” (指明風險) means the risks specified in Schedule 1.

(2) In these Rules, a reference to a deductible amount, in relation to a policy of insurance, means the amount of any loss or claim that an insured must himself bear under that policy and the insurer's liability will only arise when the insured's loss or claim exceeds such amount.

3. Application

These Rules apply to a corporation that is granted a licence under section 116(1) of the Ordinance to carry on any regulated activity other than such a corporation that –

- (a) is not an exchange participant of the Stock Exchange Company or of the Futures Exchange Company; and
- (b) is granted a licence under section 116(1) of the Ordinance to carry on any regulated activity subject to a condition that the corporation shall not hold client assets.

4. Duty of specified licensed corporations to take out and maintain insurance

(1) Where the Commission has approved a master policy of insurance under section 5(1) in respect of a period of insurance for a regulated activity, a specified licensed corporation licensed for that regulated activity shall take out and maintain insurance for that regulated activity in relation to the specified risks for not less than the specified amount during that period of insurance under –

- (a) that master policy of insurance approved by the Commission; or
- (b) any other policy of insurance with one or more insurer that –
 - (i) is not a related corporation of the specified licensed corporation; and
 - (ii) has a specified credit rating on the date of commencement of the policy of insurance.

(2) Where the Commission has approved a master policy of insurance under section 5(2)(a) in respect of a period of insurance for the regulated activity of dealing in securities, a specified licensed corporation that is an exchange participant of the Stock Exchange Company licensed for that regulated activity shall, in addition to an insurance (if any) that it is required to take out and maintain under other provisions of this section, take out and maintain insurance for that regulated activity in relation to the specified risks for not less than the specified amount during that period of insurance under that master policy of insurance.

(3) Where the Commission has approved a master policy of insurance under section 5(2)(b) in respect of a period of insurance for the regulated activity of dealing in futures contracts, a specified licensed corporation that is an exchange participant of the Futures Exchange Company licensed for that regulated activity shall, in addition to an insurance (if any) that it is required to take out and maintain under other provisions of this section, take out and maintain insurance for that regulated activity in relation to the specified risks for not less than the specified amount during that period of insurance under that master policy of insurance.

(4) Each master policy of insurance approved by the Commission under section 5 and the policy of insurance referred to in subsection (1)(b) may specify a deductible amount not exceeding \$3,000,000.

(5) For the avoidance of doubt, a specified licensed corporation shall not be required to take out and maintain insurance in relation to a regulated activity under subsection (1) where that specified licensed corporation is required to take out and maintain insurance for that regulated activity under subsection (2) or (3).

5. Commission may approve master policy of insurance

(1) With the exception of the policies of insurance that may be approved under subsection (2), the Commission may, in respect of any period of insurance, approve one policy of insurance in respect of a regulated activity to be the master policy of insurance for all specified licensed corporations licensed for that regulated activity.

(2) The Commission may, in respect of any period of insurance –

(a) approve one policy of insurance in respect of the regulated activity of dealing in securities to be the master policy of insurance for all specified licensed corporations that are exchange participants of the Stock Exchange Company licensed for that regulated activity; and

(b) approve one policy of insurance in respect of the regulated activity of dealing in futures contracts to be the master policy of insurance for all specified licensed corporations that are exchange participants of the Futures Exchange Company licensed for that regulated activity.

(3) The Commission shall not approve a master policy of insurance under this section unless the insurer of the master policy of insurance (or, if the master policy of insurance is jointly undertaken by more than one insurer, each insurer) has the specified credit rating on the date of the approval.

SCHEDULE 1

[s. 2]

SPECIFIED RISKS

1. The risks in relation to which a specified licensed corporation shall take out and maintain insurance under these Rules are the risks of loss arising out of the loss of client assets that are received or held by the specified licensed corporation (including client assets that are received or held by an associated

entity of the specified licensed corporation) in relation to its carrying on in Hong Kong of a regulated activity, attributable to –

- (a) fraudulent or dishonest conduct by employees of the specified licensed corporation (or its associated entity or service bureau);
- (b) robbery or theft while the client assets are in the custody of the specified licensed corporation (or its associated entity);
- (c) forgery or fraudulent alteration of a cheque or other negotiable instrument;
- (d) fraudulent use of an information system; and
- (e) forged or fraudulent instructions relating to the client assets.

2. For the purposes of this Schedule –

“employee” (僱員), in relation to a specified licensed corporation (or its associated entity or service bureau), includes an individual who is or has been an employee, officer or licensed representative of, or who is or has been engaged whether under a contract of service or otherwise by, the specified licensed corporation (or its associated entity or service bureau);

“service bureau” (服務單位), in relation to a specified licensed corporation, means a person to whom the specified licensed corporation has delegated the duty to perform certain functions that are ancillary to the carrying on by the specified licensed corporation of any regulated activity.

SPECIFIED AMOUNT

PART 1

REGULATED ACTIVITIES CARRIED ON IN HONG KONG

1. Where a specified licensed corporation is licensed to carry on in Hong Kong one regulated activity, the insured amount in respect of a period of insurance for the specified risks arising out of that regulated activity shall be the amount specified in column 2 of Part 2 opposite to that regulated activity which it is licensed to carry on in Hong Kong.

2. Where a specified licensed corporation is licensed to carry on in Hong Kong more than one regulated activity –
 - (a) if it takes out and maintains a single policy of insurance for the specified risks arising out of all those regulated activities, the insured amount in respect of a period of insurance for all those regulated activities which it is licensed to carry on in Hong Kong shall be \$25,000,000;
 - (b) if it takes out and maintains a separate policy of insurance for the specified risks arising out of each of those regulated activities, the insured amount in respect of a period of insurance for each relevant regulated activity shall be the amount specified in column 2 of Part 2 opposite to that relevant regulated activity which it is licensed to carry on in Hong Kong.

3. The insured amount referred to in sections 1 and 2 is the amount of insurance to be maintained in respect of the aggregate of all claims that may be

made during any period of insurance and, subject to those sections, there shall be no limit on the amount of each claim.

PART 2
INSURED AMOUNT

Regulated activity	Insured amount (\$)
1. Dealing in securities	15,000,000
2. Dealing in futures contracts	15,000,000
3. Leveraged foreign exchange trading	Nil
4. Advising on securities	Nil
5. Advising on futures contracts	Nil
6. Advising on corporate finance	Nil
7. Providing automated trading services	Nil
8. Securities margin financing	15,000,000
9. Asset management	Nil

Each of the regulated activities specified in column 1 of this Part shall have the meaning assigned to it by Part 2 of Schedule 5 to the Ordinance.

SCHEDULE 3

[s. 2]

SPECIFIED CREDIT RATINGS

1. A Moody's Investors Service rating of A or above for Long-Term Insurance Financial Strength.

2. A Standard & Poor's Corporation rating of A or above for Insurer Financial Strength.
3. A Fitch Ratings Limited rating of A or above for Insurer Financial Strength.



Andrew Len Tao SHENG
Chairman,
Securities and Futures Commission

14th January, 2003

Explanatory Note

These Rules are made by the Securities and Futures Commission under section 116(5) of the Securities and Futures Ordinance (Cap. 571). They require corporations to which the Commission has granted licences under section 116(1) of the Ordinance to carry on specified regulated activities to take out and maintain insurance in respect of specified risks and for specified amounts. They also deal with other matters relating to the insurance.