LegCo Financial Affairs Panel

Review of the Level and Funding of the Investor Compensation Fund, Broker Defaults since 1998 and the Operation of the Investor Compensation Arrangements

PURPOSE

This paper outlines the main points of the Consultation Paper entitled "Review of the Level and Funding of the Investor Compensation Fund, Broker Defaults since 1998 and the Operation of the Investor Compensation Arrangements" which the Securities and Futures Commission ("SFC") proposes to issue (copy at **Annex**).

BACKGROUND

2. The Investor Compensation Fund ("ICF") was established on 1 April 2003 under the Securities and Futures Ordinance (Cap. 571) 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 Hong Kong Exchanges and Clearing Ltd., based on the principles of user pay and providing compensation for all retail investors who trade through intermediaries licensed by or registered with the SFC.

3. The ICF is mainly funded by transfers of the balances in the two old compensation funds (i.e. the Unified Exchange Compensation Fund ("UECF") and the Commodity Exchange Compensation Fund) and by investor compensation levies of 0.002% on securities transactions executed on the Stock Exchange of Hong Kong Ltd. and $0.5 ($0.1 for smaller size contracts) per contract on futures transactions executed on the Hong Kong Futures Exchange Ltd.

4. 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 UECF 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[1], the Administration undertook to keep the levy under review in light of the operations of the ICF.

5. The SFC has conducted a review on the level and funding of the ICF and intends to consult the market and the public on the proposals put forward in the attached Consultation Paper. In conducting the review, the SFC has also taken the opportunity to review the major broker defaults since 1998 and examine some suggestions identified through its discussions with certain liquidators which might help improve the existing procedures in handling broker defaults.

6. The current review of the ICF focuses on the following objectives:

- maintain the ICF at a level that is appropriate to the risks of broker failure;
- maintain the level of investor compensation that does not engender too high moral hazard; and
- expedite the liquidation process so that time and costs are minimized in order to conserve as much as possible resources for investor compensation.

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7. In prior public papers on the new compensation arrangements, the SFC explained its policy that the ICF assets should not exceed a prudent base amount of assets with annual investment income sufficient to cover estimated expenditure plus any likely future expansion of ICF coverage. Such a level would have a reasonable probability of being "self-funding" for the future without the need for a levy on the market. If the ICF appears as if it will reach the self-funding level, consideration should be given to suspending any levy that might be in effect.

8. As of the end of October 2004, the total assets that were available to the ICF were about $1.36 billion. At the current level of market turnover, the ICF assets would reach $1.4 billion in about two to three months' time. With an

[1] Legislative Committee Brief on the Securities and Futures Ordinance (Cap. 571) of 13 December 2002 (Ref: SUB 38/26/3 (2002)).

asset size of $1.4 billion and estimated annual expenditure of $60 million including the estimated annual compensation payments, the ICF would become self-funding if an expected investment rate of return of 4.3% can be achieved in the long run. We believe that rate of return can be achieved.

9. In order not to accumulate amounts beyond what is necessary for the ICF and to reduce the burden on investors, the Consultation Paper proposes to introduce an automatic levy triggering mechanism with the following key features:

- The current investor compensation levies will be imposed 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.

- The current investor compensation levies will be suspended if the net asset value of the ICF exceeds $1.4 billion.

- A month-end net asset value of the ICF which is certified through an audit by the auditors of the ICF will be used for the purposes of applying the levy triggering mechanism.

- 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 notice of any changes to the prevailing levy arrangements including the date of implementation of such changes.

- 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 one month after the date of the issue of the SFC's notice.

Level of compensation coverage

10. The Consultation Paper examines the current $150,000 per investor limit, which was first adopted in 1998. The Consultation Paper measures the similarity of coverage in terms of the average number of investors whose claims are paid in full by the ICF, the average allowed amount of compensation per claimant as a measure of average account size, and considers other relevant factors such as inflation and the level of the Hang Seng Index. The Consultation Paper concludes that the $150,000 per investor limit, which

provides a similar level of coverage (i.e. 76% of claimants paid in full) to that in and since 1998, should be maintained.

Review of broker defaults since 1998 and key court decisions

11. The Consultation Paper provides a summary of the main facts and results of a number of broker defaults since 1998 as well as the key decisions made by the courts in order to facilitate better understanding by the public and the market of the status of these cases and the complex legal issues relating to broker defaults.

Discussions with liquidators and banks

12. In conducting the review, the SFC had discussions with a number of liquidators and banks involved in the liquidations of broker defaults to examine three suggestions which might help improve the existing procedures in handling broker defaults (i.e. for the ICF to advance funds to liquidators for the purpose of facilitating the return of clients' shares pledged by a broker to a bank as security for a loan; to give power to liquidators to sell securities and distribute money; and use of ICF funds to pay for an administrator). However, after careful consideration of the suggestions, the Consultation Paper concludes that they should not be pursued because the suggestions would introduce additional financial exposure to the ICF, involve alterations to the existing individual proprietary rights of investors in securities held by brokers and have implications for the current law dealing with trust property and insolvency.

13. As a considerable body of precedent and experience has been accumulated in administration of broker liquidations, the Consultation Paper concludes that further development of the law in this area should be left to the common law. The SFC will continue to monitor overseas developments in this area.

PUBLIC CONSULTATION

14. The SFC plans to issue the Consultation Paper in the early part of 2005 and, subject to the results of the public consultation, will work with the Administration to put in place the necessary legislative amendments to implement the proposals.

Securities and Futures Commission
10 December 2004

Annex

Review of the Level and Funding of the Investor Compensation Fund, Broker Defaults since 1998 and the Operation of the Investor Compensation Arrangements

Securities and Futures Commission
December 2004

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I. Executive summary

1.1 This paper is a review by the SFC's Supervision of Markets Division (Division) of various matters concerning the Investor Compensation Fund (ICF) and the investor compensation arrangement. The paper -

(a) examines the operation of the compensation arrangement under the Securities and Futures Ordinance (SFO) since 1 April 2003 and suggests policies for the size of the ICF and the related levy triggering mechanism;

(b) concludes that the $150,000 per investor limit of compensation has maintained a consistent level of coverage since 1998;

(c) reviews the circumstances of 6 broker defaults since 1998, including various court decisions concerning the ownership and distribution of client assets; and

(d) discusses three suggestions identified through our discussions with liquidators which might help improve the existing procedures in handling broker defaults.

Level and funding of the Investor Compensation Fund

1.2 In prior public papers on the new compensation arrangement, the SFC explained its policy that ICF assets should not exceed a prudent base amount of assets with annual investment income sufficient to cover estimated expenditure plus any likely future expansion of ICF coverage. Such a level would have a reasonable probability of being "self-funding" for the future without the need for a levy on the market. If the ICF appears as if it will reach the self-funding level, consideration should be given to suspending any levy that might be in effect.

1.3 The assets available to the ICF amounted to almost $1.36 billion as of the end of October 2004. This level exceeds the minimum prudent level of $1 billion as determined by the risk model. In order not to accumulate amounts beyond what is necessary for the ICF and to lower the burden on investors, we propose to suspend the current investor compensation levies as soon as practicable once the net asset value of the ICF exceeds $1.4 billion.

1.4 With a net asset size of $1.4 billion and estimated annual expenditure of about $60 million, in order to achieve the goal of maintaining the ICF in a self-funding status, the ICF needs to be able to obtain an expected investment rate of return of about 4.3% in the long run.

1.5 For the future, we propose to introduce an automatic levy triggering mechanism containing the following key features:

- The current investor compensation levies will be imposed if the net asset value of the ICF falls below $1 billion.
- The current investor compensation levies will be suspended if the net asset value of the ICF exceeds $1.4 billion.
- A month-end net asset value of the ICF which is certified through an audit by the auditors of the ICF will be used for the purposes of applying the levy triggering mechanism.
- 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 notice of any changes to the prevailing levy arrangements including the date of implementation of such changes.
- 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 one month after the date of the issue of the SFC's notice.

Level of compensation coverage

1.6 The paper examines the current $150,000 per investor limit. The SFC has previously recommended the policy that the per investor limit should be maintained at a similar level of coverage to that provided in 1998 when the $150,000 per investor level was first adopted. We measure the similarity of coverage in terms of the average number of investors whose claims are paid in full by the ICF, the average allowed amount of compensation per claimant as a measure of average account size, and by considering other relevant factors such as inflation and the level of the Hang Seng Index and conclude that the $150,000 limit provides a similar level of coverage to that in and since 1998.

Review of broker defaults since 1998 and key court decisions

1.7 The broker defaults since 1998, including CA Pacific Securities Ltd, were larger and more complicated than previously experienced. They raised new issues, which added to the time and expense of dealing with the defaults and winding up proceedings under the Companies Ordinance. On the positive side, there are now precedents for handling

future cases, in particular concerning clients' proprietary rights in shares and the allocation and distribution or sale of clients' shares. To understand these new issues, their complexities and how they had been addressed by the courts, we provide a summary of the main facts and results of each of the 6 broker defaults since 1998 as well as the key decisions made by the courts.

Power for the ICF to advance funds to redeem pledged shares

1.8 We examined the suggestion that the ICF should be able in appropriate cases to advance funds for the purpose of facilitating the return of client's shares pledged by a broker as security for a loan. Because the suggestion would involve additional expense to the ICF, increase moral hazard and entail an alteration of the existing proprietary rights of clients, we recommend that it should not be further pursued.

Power for liquidators to sell securities and distribute money

1.9 Some liquidators suggested that significant administrative costs in administering clients securities could be saved if they were allowed to sell clients' securities as soon as possible on receipt and to distribute money rather than shares to the clients after the ownership of the securities has been ascertained. The major issue of this suggestion is that it is inconsistent with the case law which has established that clients normally have individually proprietary rights in securities. The adoption would have implications for the current law dealing with trust property and insolvency which may be regarded as going beyond securities law. As a considerable body of precedent and experience has been accumulated in administration of the broker liquidations since C.A. Pacific, we consider that further development of the law in this area should be left to the common law. In addition, there is currently no overseas experience in adopting this approach. As such, we recommend this suggestion not be further pursued, but that the SFC continue to monitor the development of the law in other major jurisdictions.

Use of ICF funds to pay for an administrator

1.10 We also consider whether ICF funds should be made available to pay for an administrator who is charged with protecting and returning client assets. The suggestion would increase additional exposure to the ICF and also go against the case law that the costs of administrators should be paid out from the trust property they administer. We recommend not to pursue this suggestion further. However, the SFC should where practicable strive to appoint an administrator at an early stage to protect client assets and return shares to clients. Where investors suffer losses

by virtue of the costs of the administrator, the ICF should compensate those losses in accordance with the $150,000 per investor limit.

Other matters

1.11 To provide better protection to investors, the SFC should continue to concentrate on measures, such as its recent proposals for limits on pledging client securities, to reduce the risks of pooling of margin clients securities and to ensure that brokers maintain up to date contracts with clients that clarify their rights and obligations, and continue in its investor education programme to emphasize increasing investor understanding of the risks, as well as the benefits, of margin financing arrangements.

II. Level and funding of the Investor Compensation Fund

Background

2.1 1998 saw a number of broker defaults, including CA Pacific, that were much larger than experienced previously. A special compensation arrangement of up to $150,000 per claimant was provided and since then approximately $525 million has been paid to over 7,218 claimants. The SFC and Stock Exchange contributed $600 million ($300 million each) of their own funds to top up the compensation arrangement. Appendix 1 shows the compensation fund default history.

2.2 The SFO (Cap. 571) created the ICF as of 1 April 2003. Today, rules made by the Chief Executive in Council under SFO section 244(1) provide funds for ICF via levies on trading at the Stock and Futures Exchanges. A levy of 0.002% of trade value payable by both buyers and sellers applies at the Stock Exchange. At the Futures Exchange, the levy is $0.5 per futures contract payable by buyers and sellers or $0.1 for small-size contracts. ICF funding has also come from a transfer of surplus assets in the two old compensation funds (i.e. the Unified Exchange Compensation Fund (UECF) and the Commodity Exchange Compensation Fund) and will include investment income.

2.3 The background to the current situation is described in the SFC's consultation paper in March 2001 on Proposed New Investor Compensation Arrangements detailing the main objectives of the new compensation arrangements and the new arrangements to apply under the SFO. The main objectives of the new compensation arrangements included:

- to enhance the existing investor compensation arrangements and increase investor confidence whilst keeping costs commensurate with benefits. Also, to avoid creating moral hazards.

- to provide a secure per investor level of compensation for retail investors under a formal and transparent structure that is easy to understand.

- to protect and leverage existing compensation fund assets while minimising any additional costs to the industry.

- to employ market- based commercial risk management mechanisms and incentives within the arrangements.

2.4 The 2001 Paper also analyzed the funding needs of the new ICF, using a model prepared by actuarial experts, and concluded that it would likely be underfunded and should be built up to a prudent level of $1 billion. It also proposed to start the funding before enactment of the SFO.

2.5 In 2001, rules were passed to increase the SFC's own levy under the SFC Ordinance by 0.002% on the basis that this amount be paid by the SFC into the compensation fund. 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 SFO as mentioned. The Administration undertook to keep the levy under review in the light of the operations of the ICF.

2.6 Our current review of the ICF focuses on the following objectives:

- maintain the ICF at a level that is appropriate to the risks of broker failure;

- maintain the level of investor compensation that does not engender too high moral hazard; and

- expedite the liquidation process so that time and costs are minimized in order to conserve as much as possible resources for investor compensation.

Policy for the size of the ICF

2.7 In prior public papers on the new compensation arrangement, the SFC explained its policy that ICF assets should not exceed a prudent base amount of assets with annual investment income sufficient to cover estimated expenditure plus any likely future expansion of ICF coverage. Such a level would have a reasonable probability of being "self-funding"

for the future without the need for a levy on the market. If the ICF appeared as if it might reach this level, consideration should be given to suspending any levies. The self-funding level is dynamic and will change with, among other things, ICF investment income and estimated annual losses. If investment income rises, the level will decrease and the level will increase if investment income falls. Similarly, the level will rise if estimated losses rise and fall if they fall.

2.8 The risk model prepared by actuarial experts mentioned in the SFC's 2001 Report has since been updated and enhanced. The model simulates the status of the ICF over time based on inputs including income, market turnover, estimated annual losses and other expenditure, recoveries, etc. An important input for the model is the estimated annual loss due to paying compensation claims. The estimated annual loss is a combination of the real-life average historical loss (adjusted for changes in the Hang Seng Index) and estimations of losses in areas where losses have not actually occurred, such as loss from a bank default or by a non-exchange participant dealer. Since 2001, the estimated annual loss has fallen to about $55 million from about $70 million. The main reason for the fall is the lower than expected losses from 1999 to now as reflected in Appendix 1.

2.9 As of the end of October 2004, the net asset value of the ICF was about $1.314 billion and that of the Unified Exchange Compensation Fund was about $90 million of which $46 million is available to be transferred to the ICF with the remaining balance to cover the outstanding liabilities for default cases occurred before 1 April 2003. If we include the assets of $46 million from the Unified Exchange Compensation Fund, the total assets available to the ICF would amount to $1.36 billion.

2.10 Based on our recent experience, the net asset value of the ICF has increased by about $17 million each month mainly due to the inflow of levy income and investment income. At this rate, we expect that the net asset value of the ICF would reach $1.4 billion in about two to three month's time. Our current estimated annual expenditure of the ICF is about $60 million comprising estimated annual compensation payment of $55 million and estimated annual operating cost of the Investor Compensation Fund of $5 million. With a net asset size of $1.4 billion and estimated annual expenditure of $60 million, if we could achieve an investment rate of return of about 4.3% on the assets of the ICF, the estimated annual investment income would be able to cover the estimated annual expenditure. In other words, under the circumstances, the ICF would become self-funding and there would be no need for the continuation of the imposition of the current levies.

2.11 It should be noted that, based on our estimate, the Unified Exchange Compensation Fund could be expected to receive in the coming years potential inflow of about $56 million. This amount represents the net replenishments of about $26 million to the Fund by the Stock Exchange of Hong Kong under the compensation reimbursement arrangements of the pre-SFO compensation regime and further recovery of about $30 million from the liquidators of the C.A. Pacific resulting from proceeds of corporate actions and residual assets available to creditors. However, at this stage, we do not know when these moneys will be available as many factors affect their availability, such as the need to resolve all the outstanding default cases and court directions sought by the liquidators. As a result, we do not include this contingent amount in our analysis.

Levy triggering mechanism

2.12 In the SFC's 2001 Report, we recommended that the assets of the ICF should be built up to the level of $1 billion which was the prudent level which the ICF should maintain in order to cover its potential obligations in the event of default by intermediaries. Based on our recent updating of the risk model, we believe that the ICF should continue to target the $1 billion level as the minimum prudent amount it should maintain.

2.13 In order not to accumulate amounts beyond what is necessary for the ICF and to lower the burden on investors, we propose to suspend the current investor compensation levies as soon as practicable once the net asset value of the ICF exceeds $1.4 billion.

2.14 For the future, we propose to introduce an automatic levy triggering mechanism under which the current compensation levies would be imposed on the markets if the net assets of the ICF fall below the $1 billion level and they would be suspended if the net assets of the ICF exceed the $1.4 billion level. This is illustrated in Appendix 2.

2.15 During the past 16 years, the total amount of compensation paid by the Unified Exchange Compensation Fund was $568 million with two large default cases (i.e. C.A. Pacific Securities Ltd and Chark Fung Securities Company Ltd) accounting for 76% of the total amount. In our view, the buffer of $400 million provided by the difference between the self-funding level of $1.4 billion and the minimum prudent level of $1 billion for reimposition of the levies will provide a reasonable level of contingency to enable the ICF to cope with potential default cases based on historical loss data. In addition, under section 237 of the SFO, with the consent of the Financial Secretary, the SFC may borrow money for the purpose of the ICF. This provision provides the ICF with an additional back up funding source to meet any unexpected large funding need which may be caused by extreme catastrophic losses.

2.16 The imposition of levies raises transaction costs in the markets and requires market participants to adjust their systems to pay and collect the levies. We consider that the buffer which is 40% above the minimum prudent level would also help to avoid this until it is necessary and also to avoid more frequent than necessary changes to the levies.

2.17 Barring any unexpected catastrophic losses, in order to achieve the goal of maintaining the ICF in a self-funding status, the ICF needs to be able to obtain an expected investment rate of return of about 4.3% in the long run. To this end, we will work closely with the investment advisers which manage the assets of the ICF to devise an investment policy which is appropriate to achieve the long term investment objective of the ICF.

2.18 From an operational standpoint, the activation of the levy triggering mechanism depends very much on whether the net asset value of the ICF has exceeded the upper limit of $1.4 billion which would trigger the suspension of the levies or fallen below the lower limit of $1 billion which would trigger the imposition of the levies.

2.19 To ensure that accurate and reliable data would be used, we propose that the net asset value figure and the related financial statements of the ICF must first be audited by the auditors of the ICF before they could be relied upon for the purposes of activating the levy triggering mechanism. At present, the SFC publishes the financial statements of the ICF each quarter. The information would continue to help the public understand and keep track of the financial position of the ICF.

2.20 In addition, we also consider that the market and the public should be given a reasonable period of time to prepare for themselves before the implementation of any change to the then prevailing levy arrangements. It is also more appropriate to allow a longer period in the case where the imposition of levies is required.

2.21 In sum, the proposed automatic levy triggering mechanism contains the following key features:

- The current investor compensation levies will be imposed if the net asset value of the ICF falls below $1 billion.

- The current investor compensation levies will be suspended if the net asset value of the ICF exceeds $1.4 billion.

- A month-end net asset value of the ICF which is certified through an audit by the auditors of the ICF will be used for the purposes of applying the levy triggering mechanism.

- 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 notice of any changes to the prevailing levy arrangements including the date of implementation of such changes.

- 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 one month after the date of the issue of the SFC's notice.

III. Assessment of the consistency of compensation coverage with the $150,000 per investor limit

3.1 The SFC has previously recommended the policy that the per investor limit should be maintained at a similar level of coverage to that provided in 1998 when the $150,000 per investor level was first adopted. We refer to several related factors to assess the consistency of compensation fund coverage. They include the percentage of claimants whose losses are paid in full from the compensation fund and the average allowed claim for compensation.

3.2 Appendix 1 shows the accumulated percentage of claimants paid in full to be 76%. Since the CA Pacific default in 1998 when we introduced the $150,000 per claimant arrangement, this factor has remained steady overall, although individual defaults obviously vary. For example, the percentage for Win Successful was 68%, for Ying Kit 66%, and for Lawsons 87%. Separately, we simulated a default by the largest retail broker licensed with the SFC with roughly 28,300 client accounts. The $150,000 limit would have paid 76% of claimants in full.

3.3 We also consider the average allowed claim, which measures the investor's loss before compensation. The average allowed claim per investor before compensation is about $204,000, and Appendix 1 shows the corresponding numbers for Win Successful at $345,848, Ying Kit at $238,124, and Lawsons at $74,458. Overall, the average is not rising. If the paid-in-full factor falls or the average claim size rises materially, the level of coverage may be in decline and this would be a signal that the compensation limit should be reviewed to maintain consistent coverage levels. We also consider any inflation in Hong Kong and significant changes in the level of the Hang Seng Index, neither of

which has been significant in the last few years. Consequently, there is no need to adjust the $150,000 per claimant level under the policy. Appendix 3 provides Hong Kong market statistics since the SFC's 2001 paper.

IV. Review of various broker defaults since 1998 and summary of court decisions

4.1 The broker defaults since 1998, including CA Pacific Securities Ltd, were larger and more complicated than previously experienced. They raised new issues, which added to the time and expense of dealing with the defaults and winding up proceedings under the Companies Ordinance. On the positive side, there are now precedents for handling future cases, in particular concerning clients' proprietary rights in shares and the allocation and distribution or sale of clients' shares. To understand these new issues, their complexities and how they have been addressed by the court, we consider that it would be useful to provide a summary of the main facts and results of each of the 6 broker defaults since 1998 as well as the key decisions made by the courts.

CA Pacific Securities Ltd. (CAPS) / CA Pacific Finance Ltd. (CAPF)

4.2 CAPS "voluntarily" suspended operations on 19 January 1998, and provisional liquidators were appointed over both firms on 20 January 1998 on petitions from the SFC and another creditor. Also on 20 January CAPS defaulted to the clearing house in the amount of $38.5 million.

4.3 In broad terms, as of 19 January 1998, clients' claims for securities were valued at $1.4 billion and the firms had pledged $1 billion in shares with banks against outstanding loans of $450 million.

4.4 CAPF assets included 3 loans totaling $423 million the repayment of which appeared doubtful. One of them was a deposit of $252 million relating to a property purchase, which was not completed and the loan not secured. The two others totaling $171 million were secured by Leading Spirit/LS Conrowa shares, which were suspended and of no practical value at the time. The affairs of the 2 firms (CAPS and CAPF) were inseparable and a major asset of CAPS was a receivable of $71 million from CAPF, which was doubtful.

4.5 The Stock Exchange allowed compensation claims totaling $983 million. The UECF has paid $300 million to 3,933 claimants. Claimants received the amount of their allowed claims or $150,000, whichever was less. The UECF has so far recovered about $128 million in the

liquidation. It expects to recover further amounts of about $30 million in relation to corporate actions and residual assets available to the UECF being the largest unsecured creditor in the liquidation. On this basis, it is estimated that the UECF will have made net payments to investors of about $140 million.

Summary of Court decisions

4.6 Whether securities are held on trust for clients will depend on the intention of the parties. The logical starting point for any examination is the client agreement. On the particular facts, it was held that clients have proprietary interests in shares bought for them by the broker. The nature of the proprietary interest is individual rather than a tenancy-in-common of the entire pool of securities. Where there is a shortfall of securities, the approach taken by the court is to examine how the shortfall arose and determine whether an intention in dealing with the trust assets can be ascertained and, if so, whether it is practical to apply an allocation rule based on the intention. In the absence of any such intention or if it is impractical to apply the rule based on the intention, the court will consider what is the most fair and just rule to apply. On these particular facts, where there is a shortfall in a line of stock, cash clients have priority over margin clients and clients of each class share pari passu within the class. Clients' recovery of shares is subject to payment of the liquidators' related costs and expenses, any debts they owe, and the SFC's rights of subrogation.

4.7 Liquidators must write to clients setting out clients' share entitlements and the liquidators' processing fee (in this case 14% of the value of the client's shares held in 1998). Clients must pay the processing fee and any debts they owe first to get shares back. The client may opt to return the received compensation amount to the UECF and get back all the allocated shares or simply indicate to receive the portion of shares in pari passu with the UECF according to the subrogation ratio. If clients did not pay the fee within 60 days of the notice of share distribution the liquidator must send a reminder and if no payment is made within 60 days after that, the clients were deemed to have instructed the liquidators to sell the shares and pay any net proceeds to the clients.

4.8 Miscellaneous Court orders include authorizing the liquidators to sell warrants before expiry dates, provisions for taxation of legal costs classification between margin and cash clients and an independent assessment of liquidators' costs.

Forluxe Securities Ltd. (FS)

4.9 On 4 May 1998, prior to a scheduled routine SFC inspection of the firm on 5 May 1998, the owners of FS and of its money lender Forluxe Finance Limited failed to show up at the office and employees called the police. On 7 May 1998, the SFC issued a restriction notice and liquidators were appointed the same day.

4.10 As of 31 December 1999, the companies held shares worth $19 million compared to client claims for shares of $65 million. Some shares were pledged to lenders for loans to the owners of FS who were unable to repay the loans. Lenders closed out the loans due to default (e.g. $12 million in shares pledged to a finance company and $5.2 million in shares pledged to a bank).

4.11 The Stock Exchange allowed compensation claims totaling $57 million. The UECF paid about $31.1 million to 430 claimants. After exercising its subrogated rights and its rights as a large creditor in the liquidation, it expects to recover about $2 million, making the net payment about $29 million.

4.12 The liquidators obtained final judgments against the owners of FS in 1999 for sums totaling $39 million. The liquidators do not expect to receive any significant sums in execution of the judgments.

Summary of Court decisions

4.13 Clients have individual proprietary rights in shares, because the client agreement points to the intention that the shares would be held in trust for clients. The clients' rights are generally the same as in CAPS. However, cash clients do not have priority over margin clients, because the books and records were so bad it was virtually impossible to identify cash versus margin clients and further the clients' losses were due to misappropriation by the owners of FS rather than the CAPS situation where shares were pledged and lost when lenders sold the share collateral.

4.14 Concerning the share distribution, the Court ordered that the costs of dealing with the trust property were to be paid out of each line of stock proportionally to the total cost. Shares were then to be allocated to clients pari passu by line of stock and liquidators were to deduct any debts owed plus amounts to pay the SFC for its subrogated rights. After that, shares were to be distributed to clients in board lots; any shares less than a board lot could be sold by the liquidators and proceeds distributed ratably.

4.15 The Court ordered that the SFC's subrogated rights to clients' shares were proportional to the loss of each client compared to the amount paid by the SFC. This means higher recoveries for clients and has since been codified in the SFO.

Chark Fung Securities Company Ltd. (CF)

4.16 On 26 May 1998, following an investigation into the Ming Fung group, the SFC petitioned to wind up all 4 group companies (CF the securities dealer, KFS a money lender, a futures dealer Winton Commence Ltd. who defaulted to the futures compensation fund, and a leveraged forex trader). The provisional liquidators were appointed the same day.

4.17 As of 26 May 1998, CF and KFS records showed clients' claims for shares of $290 million versus shares on hand of only $44 million, leaving a shortfall after other adjustments of $257 million. About $11 million of the $44 million in shares had been pledged to a bank with an outstanding loan of $8.9 million, which was closed out by the bank in late May.

4.18 The Stock Exchange allowed compensation claims in the amount of $229 million. The UECF paid 1,941 claimants a total of about $129 million. After exercising its subrogated rights and its rights as a large creditor in the liquidation, it expects to recover about $22 million, making the net payment about $107 million.

4.19 The liquidators noted that the reason for the shortfall in CF appeared to have been large-scale misappropriation of clients' shares by the management of CF and KFS. The liquidators believed the major shareholder owed $44 million to KFS and that the companies had advanced considerable sums to his wife and related companies, which had not been repaid.

<u>Summary of Court decisions</u>

4.20 Clients have individual proprietary interests in shares purchased for them by CF in the form of separate trusts. Where there is a shortfall in a line of stock it is to be allocated pari passu to clients with verified claims on that stock. Cash clients do not have priority over margin clients, because the clients' losses were due to misappropriation by management rather than the sale of shares by lenders.

4.21 Liquidators must send allocation statements to each client not paid in full by the UECF (1611 of 1941 clients were paid in full) setting out client share entitlements and return options as follows – the return of shares subject to SFC's subrogation rights; to have shares sold and net

proceeds paid to the client; and to repay the SFC to extinguish its subrogation rights. All options were subject to payment of liquidators' processing fee, debts owed to CF, expenses of distribution, etc. Clients were given 30 days to reply, followed by a reminder if they did not reply, and if there was no response within 30 days of that they were deemed to elect a sale of their shares.

4.22 Miscellaneous Court orders include the rounding down of all fractional share entitlements, and the set off of proceeds of warrant sales and dividends against the liquidators' processing fee to avoid issuing many small cheques.

Win Successful Securities Ltd. (WS)

4.23 On 21 January 2000, the SFC learned of a default by WS in paying a client the proceeds of a sale of shares. On initial investigation it was obvious clients' shares were missing and the SFC issued a restriction notice on 24 January 2000. On 28 January 2000, SFC sought appointment of provisional liquidators and a winding up followed.

4.24 290 active clients initially claimed about $120 million in shares, but WS held only about $2 million in shares. The clients' shares were missing rather than pledged to banks. WS books and records were a mess (2 sets of books), which made it very difficult to analyze transaction history and verify clients' claims to shares.

4.25 The Stock Exchange allowed compensation claims of $98.6 million. The UECF paid out about $26 million to 285 claimants. After exercising its subrogated rights and its rights as a large creditor in the liquidation, it expects to recover about $0.1 million, making the net payment about $25.9 million.

4.26 The liquidators discovered unauthorized trading and systematic misappropriation from 1997. The trading continually lost money until nearly the whole portfolio of clients' shares was gone by January 2000. It had gone on for such a period of time that it was impossible to trace the true ownership of the few remaining shares.

Summary of Court decisions

4.27 Liquidators asked for and were granted authority to sell all shares and distribute proceeds to the clients less costs of sale and liquidators' various expenses of maintaining the portfolio and costs of making the Court application. Distribution was ordered based on each client's claim to shares as a proportion of the total value of all claims to shares (i.e. not by each line of stock) and subject to SFC's right of subrogation.

It appears that cash clients were not preferred over margin clients. The liquidators explained that any attempt to allocate and distribute the remaining shares to the 290 clients would result in costs greater than the share value. Claims for cash were determined to be unsecured creditor claims.

Lam Kwan Kit trading as Ying Kit Stock Company (YK)

4.28 In October 2001, the SFC noticed unusual movements in YK's Financial Resources Rules (FRR) reports. It also discovered discrepancies between clients records and those of YK. Indeed, it was discovered that numerous clients deposited money into the personal account of its sole proprietor, Mr Lam Kwan Kit, instead of into the company account.

4.29 On 23 January 2002, the SFC served a restriction notice prohibiting YK from continuing business and Mr Lam from dealing with his and YK's assets. On 6 February 2002, the SFC obtained a Court Order appointing Administrators over the property of YK and Mr Lam under section 144 of the Securities Ordinance (now section 213 of the SFO).

4.30 A total of 280 claims against the UECF from YK clients amounting to about $237 million were received by the Stock Exchange. By March 2003, the Administrators had returned shares to 107 clients who were also claimants against the UECF. As a result, the number of valid claims against the UECF was reduced to 173 claims for $186 million. As of September 2004, a total of $15 million had been paid from the compensation fund to 158 claimants and work was continuing on the outstanding claims.

Summary of Court decisions

4.31 On 31 August 2002, the Court ordered that -

- the Administrators should within 14 days fix a date before which any persons claiming to be entitled to any shares held by YK must prove their entitlements or be excluded from the benefit of the share distribution;

- the Administrators should give notice in writing in newspapers and to the clients who had made a compensation claim;

- the Administrators should examine every claim lodged with them and the grounds of the claim, and in writing admit or reject it, in whole or in part, or require further evidence in support of it; and

- the Administrators' remuneration and any fees incurred should be paid out of the assets beneficially owned by YK in priority to all other costs.

4.32 The Administrators issued the notice calling for claims against shares held by Ying Kit on 10 September 2002 with claims required to be submitted on or before 25 September 2002. As of end of 2002, the Administrators had admitted claims from 285 claimants concerning 1252 lines of stock. In July 2003, the Administrators informed the SFC that the Court had granted a bankruptcy order and the Official Receiver had been appointed as Bankruptcy Trustee. The Administrators have returned all the shares that could be located to the clients.

Lawsons Securities Co. (LS)

4.33 In May 2002, the SFC discovered during an inspection that LS might have committed breaches of its obligations to clients. A firm of accountants was requested to start circularisation of account balances of all clients and to do an internal control review. On 30 May 2002, they advised there was a shortfall of about $18 million worth of shares in LS's client account with the clearing house. The shortfall eventually proved to be more than $24 million compared to shares held by LS of only $2 million.

4.34 LS suspended trading "voluntarily" on 31 May 2002. On 7 June 2002, the SFC issued a restriction notice on LS to preserve the assets and protect the interests of the clients and the public. Administrators were appointed in July 2002 and Trustees in Bankruptcy were appointed in April 2003.

4.35 The Stock Exchange allowed compensation claims in the amount of $18.8 million. The UECF paid $13.2 million to 253 claimants. After exercising its subrogated rights and its rights as a large creditor in the liquidation, it expects to recover about $3 million, making the net payment about $10.2 million.

V. Suggestions to improve the handling of broker defaults

5.1 In our recent discussions with liquidators involved in these broker default cases, it was suggested that the SFC should explore the following three suggestions which might help improve the existing procedures in handling broker defaults:

- to expedite the liquidation process by empowering the ICF to advance funds to an administrator or liquidator to facilitate the return of shares pledged with banks by a defaulting broker;

- to specify in the law that liquidators have the discretion to return money instead of shares to investors to reduce the costs of, and enhance the efficiency of, managing a liquidation;

- for the ICF to pay for an administrator appointed by the court at the request of the SFC to protect, administer and return client assets.

5.2 In evaluating the suggestions, we have set out the following objectives in guiding our assessment:

- whether a suggestion would provide benefits to investors in preserving their proprietary rights in securities and minimising their losses due to broker defaults;

- whether a suggestion could make the liquidation process more cost-effective;

- whether a suggestion would cause undue financial exposure to the ICF and breach of the principle of a per investor compensation limit of $150,000;

- whether a suggestion would create new legal issues and uncertainties.

We understand that some of these objectives may conflict with one another and that we need to make a value judgment about a particular suggestion after weighing all the factors.

A. Power for the ICF to advance funds to redeem pledged shares

5.3 The suggestion was made that the ICF be able in appropriate cases to advance funds for the purpose of facilitating the return of clients' shares pledged by a broker as security for a loan. To understand why such a power might be useful, it is helpful to examine what happened under the current law. A margin financier or broker would normally have the power to pledge the stocks of clients, including clients who have not borrowed from the margin financier, with a bank to secure a loan to the margin financier, who would then on-lend the money to his borrowing clients. In order to allow for market risk, the lending bank would normally insist that the value of the shares pledged be much higher than the value of the loan and that the shares be highly liquid and of first-rate companies. The result quite often was that the shares of the more conservative clients ended up being pledged by the margin financier to

secure loans whose proceeds were on-lent to purchasers of more speculative stocks that the bank would not accept as collateral. If the broker then went into default on the loan from the bank, the bank had the power to sell sufficient of the shares pledged with it to cover the loan and return the residue of the shares to the margin financier or broker. If it exercised this power the result was that some clients of the broker - those who owned the stocks sold by the bank - faced a shortfall, whereas other clients of the broker did not. There was often a mismatch between the clients who faced such a shortfall and those who borrowed from the broker.

Arguments for the suggestion

5.4 Banks normally have an incentive to realize their security quickly by selling shares pledged to them if a broker defaults, because it avoids the risk that the value of the collateral will fall due to market movements and avoids increasing the amount in default as interest accumulates. However, in some cases, there may be such legal or commercial uncertainty or public controversy about the true ownership of the shares pledged with the bank that the bank is reluctant to realize the security. This happened in the CA Pacific case where it was up to 4 years after the default before all of the banks had realized their security and returned the residual shares to the liquidators. This both increased the losses of clients and other creditors because interest accrued on the outstanding loan balance over that time and also delayed the return of shares to investors. In such a scenario it was suggested that it might be useful for the ICF to speed up the process by repaying the loan to the bank and stepping into the bank's shoes as a secured creditor

Arguments against the suggestion

5.5 First, it is necessary to consider the question of unfair preference if a winding-up petition is presented within 6 months of the ICF making an advance to an administrator or to pay off the banks and redeem the shares. Where the loans by the banks are properly secured over the shares, which will normally be the case, the payment to the banks should not constitute an unfair preference. Similarly, to the extent that the advance merely assists the clients to more fully recover shares in which they have property rights, it should not constitute an unfair preference to investors. However, the legal issues are more complex where such clients are margin clients, especially where they have outstanding debts to the firm. We sought senior counsel's advice on how to implement the suggestion without creating a voidable preference. It was suggested that the preferable way to do this would be for the ICF, in exchange for paying the banks the amount of the outstanding loans, to take an assignment from the banks of the pledged shares and the accompanying

debt. The ICF would therefore become a secured creditor of the broker. The ICF could agree through the broker or its liquidators to return the shares to the customers to whom they belonged on the basis that each customer paid a pro rata share of the sums paid by the ICF to obtain the assignment of the shares, less any sum payable for compensation by the ICF to the customers.

5.6 We conducted a preliminary study to assess the overall financial impact on the ICF if it is allowed to advance funds and to be repaid by those who get the benefit i.e. the owners of shares pledged to the banks. The result was that, the ICF will in most cases be worse off than under the existing practice, mainly due to the way losses resulting from shortfalls of shares are treated and allocated. An example from the CAPS case illustrates this point. The lending banks recovered their loans by selling mainly the pledged blue-chip shares which mostly belonged to the major clients. These major clients bore most of the loss as their shares were sold by the banks and there were few shares to be returned to them by the liquidators. In one instance, a client of CAPS who had shares worth $20 million with the broker could only get back assets worth $1 million. If the ICF is allowed to make an advance to cover the bank loan, the repayment to the ICF will be recovered from the sales proceeds of shares collected from those clients whose shares are returned by the banks in proportion to the value of their holdings vis-a-vis the total value of all the redeemed shares. This will lessen the burden on major clients as their blue chip stocks will not be sold by the bank. But, at the same time, it will increase the burden to other smaller clients who will, in turn, claim against the ICF for the reduction in the value of their shares.

5.7 So, compared with the current practice, the suggestion could result in more small clients claiming compensation from the ICF because of the burden which they are required to share in order to get back their shares which they would otherwise have gotten as banks do not normally sell non-blue chip stocks. Since these small clients usually constitute the majority of the clients in a broker default, it is likely that the ICF would be worse off as a whole.

5.8 More importantly, there is a fundamental difference between the loss distribution methods under the current law and under the suggested approach. Under the current law, the amount of loss which an individual investor incurs will depend on how the banks liquidate the collateral. If the bank chooses to sell a particular investor's shares, this investor will suffer most as his shares are sold and lost as far as he is concerned. The suggested approach is based on the principle of proportionate sharing. Hence the amount of the repayment of the loan to the ICF is proportionately shared by all the clients. As the suggested approach will

lead to the reduction of shares to be returned to all investors (as a result of the proportionate repayment of the loan), this affects their proprietary rights in their shares. It is clear that each method produces different sets of winners and losers and that the suggestion involves amendments to the general law of trust and insolvency which go beyond securities legislation.

5.9 Absent the suggested approach, we would expect that lending banks should be more willing than in the CAPS case to exercise their rights to dispose of shares under their loan agreement with the brokers in view of two factors. First, legal uncertainties have been clarified in the various court cases since CA Pacific. Our discussions with liquidators and banks suggested that the delay experienced in the CA Pacific case was unusual and due largely to legal uncertainties that have since been resolved. In both the Chark Fung and Forluxe cases, the banks were quick to close out the loans by selling off the pledged shares and liquidators and banks have advised us that this would be normal practice in order to avoid market risk. Secondly, under the reinforced regulation of margin financing, it is now clear that only the assets of margin clients may be pledged and more guidelines have been provided to brokers to help them better manage their margin financing business. This reduces uncertainties for the banks.

5.10 If the suggestion were adopted, however, the situation might well be different, because it introduces moral hazard for the banks. If the SFC has the power to make such advances, it may well be more attractive for banks not to exercise their power to realize the security but rather to push the SFC into taking over the burden of dealing with client discontent than themselves having to decide which and whose shares to sell. This would transform the role of the SFC from being a simple administrator of a compensation scheme and put it in the position of having to choose between the interests of various shareholders and deciding who the winners and losers should be.

Recommendation

5.11 Because the suggestion would:

- involve additional expense to the ICF;
- increase moral hazard; and
- involve an alteration of the existing proprietary rights of clients

we believe it should not be further pursued.

B. Power for liquidators to sell securities and distribute money

5.12 The case law established at first instance in Hong Kong is that whether clients have proprietary rights in securities held on their behalf by their brokers will depend on the intention of the parties but that clients normally have individual proprietary rights in the securities. Property held on trust for clients does not form part of the broker's assets and is therefore not available to liquidators.

5.13 The court's approach to allocating shares is referred to above. In the absence of any clear intention how to deal with trust assets, the court will consider the most fair and just rule to apply. Court decisions are also relatively consistent in allocating shares in each line of stock pari passu to the clients with verified claims to that stock. An exception is the WS case where the court found that it was virtually impossible to determine which clients owned which stocks and, given the particularly small value of the remaining portfolio, it would be prohibitively expensive to allocate and distribute many small parcels of shares.

5.14 In sum, the courts have held that shares should be allocated and distributed to clients as far as possible based on the principle of individual proprietary rights in shares and the sale of shares and distribution of money are permitted only in exceptional circumstances where it is impractical to apply the usual approach. In our discussions with liquidators, some of them have pointed out that such an approach gives rise to practical difficulties in complex broker default cases.

5.15 Some liquidators involved in broker defaults suggested that significant administrative costs could be saved if they were allowed to sell clients' securities as soon as possible on receipt and to distribute cash rather than shares to the clients after the ownership of the securities has been ascertained. In broker liquidations, the liquidators normally assume custody of clients' securities. As clients have proprietary interests in shares bought for them by the brokers, liquidators have to trace the ownership of the securities before they can return them to the clients. The liquidators would usually set up a stock tracking system to keep track of the movements and activities of the securities. This involves setting up a database to record each line of securities and the quantity, which has to be updated whenever there are changes to the portfolio as a result of cash and scrip dividends, share splits, consolidation, warrant or options expiry and other corporate actions. The liquidators also have to deal with the custodian banks who are appointed to handle the custody of the securities. All the costs associated with administering the portfolio of clients' securities amount to a significant sum. For example, in the CAPS case, about $50 million of the provisional cost of

administering the liquidation of about $120 million was related to administering the portfolio of securities.

Arguments for the suggestion

5.16 The benefits of selling securities and distributing sales proceeds instead of securities include the following:

(a) the costs of maintaining the portfolio prior to distribution can be minimised or eliminated;

(b) the process of distributing cash instead of securities is more straightforward, e.g. by sending a cheque to clients instead of making prior arrangements for the return and receipt of shares; and

(c) this approach could expedite the overall liquidation process by allowing the liquidators to focus on other tasks.

Arguments against the suggestion

5.17 The major issue is that this suggestion is inconsistent with the case law which has established that clients normally have individual proprietary rights in securities. The adoption of the suggestion would deprive the clients of their proprietary rights in shares and remove all the benefits as well as the risks associated with being an owner of the securities. These benefits and risks include the gain and loss as a result of the changes in the market value of the securities, dividends, bonus shares, and other entitlements and distributions which could be made by the listed companies.

5.18 It is difficult to conclude that the suggestion would generally make clients better off. When compared with the current approach, the ultimate results will depend very much on the movements of the market subsequent to the default and the specific performance of the listed companies whose shares are held by the clients. For instance, the clients may lose out if share prices go up after the shares are sold and before the sales proceeds are distributed because they would be unable to buy back the same number of shares with the sales proceeds. In addition, they may also lose out on dividends or bonus issues from the securities that they would have got had their shares not been sold before distribution. In the CAPS case, it took 4 years before the liquidators were ready to distribute the securities. The money received from the corporate actions during the few years before share distribution was substantial at about $90 million.

5.19 The pace of a liquidation does not only depend on the difficulties relating to administering the portfolio of securities. It will also depend on the difficulties experienced in the identification and determination of the rights and liabilities between the clients and the defaulted broker and ascertaining the respective rights of clients in relation to each line of stock, especially if there is a shortfall. It is quite possible that while costs could be reduced by converting securities into cash, clients would still experience very substantial delays in being paid.

5.20 We considered two possible ways to achieve the sale of securities and distribution of sales proceeds. The first one is an approach where the liquidators are required to sell all the securities as soon as practicable and distribute the sales proceeds to clients pari passu as if they were co-owners in a common pool in each line of stock. Although this approach may seem to produce the most savings as there would be no need to maintain an extensive database to keep track of the status of the securities, some people may consider such an approach too rigid and inflexible as its application does not take into account the particular facts of a default case (e.g. how well the records and books of the default broker have been kept, whether there is any shortfall in securities and the size etc).

5.21 The second approach was to give a discretion to the liquidators to sell all or part of the securities if they consider that doing so would significantly facilitate the completion of the liquidation process given the particular facts of the default case. But this appeared to be no different to the situation under the common law. As an officer of the court, a liquidator may always seek permission from the court to follow this approach if he can persuade the court it is the most fair and just approach in all the circumstances.

5.22 At present, we are not aware of other major markets which explicitly allow the sale of clients' securities in a broker's liquidation. In the U.S., the liquidators appointed by the Securities Investor Protection Corporation (SIPC) return actual stocks and other securities owned by the clients wherever possible. If necessary, the liquidators can purchase replacement securities in the open market for clients to replace their missing shares provided that the value of the purchases does not exceed the specified compensation limit of US$500,000 per investor. In the UK, the Financial Markets Law Committee has recently issued a consultation paper on the analysis of the need for and nature of legislation relating to property interests in indirectly held investment securities. The paper recommends that unless otherwise agreed, investors in a particular issue of securities held by an intermediary in a common pool have co-proprietary interests in the pool. However, the recommendation has not yet been adopted in the UK and its adoption will involve altering the

legal rights of clients as determined in the cases in the Hong Kong courts. Moreover, the paper does not discuss whether the sale of securities is to be preferred to distributing them by line of stock in the event of the liquidation of an intermediary.

Recommendation

5.23 In view of the various difficult issues relating to suggestion and, in particular, its implications for the current law dealing with trust property and insolvency, we recommend this suggestion not be further pursued but that the SFC to continue to monitor the development of the law in other major jurisdictions.

C. Use of ICF funds to pay for the costs of an administrator

5.24 We considered whether ICF funds should be made available to pay for an administrator who is charged with protecting and returning client assets. Administrators usually take their fees and disbursements out of the trust property and then from realized assets of the broker. If their fees were covered by ICF funds, this would mean higher recoveries for some clients with claims to shares and whose claims may lie against the broker's general assets. A similar result occurs in the U.S. under the Securities Investor Protection Act. It should be noted that this suggestion does not extend to cover the work of an administrator who is subsequently appointed by the court as liquidator under the liquidation or bankruptcy process as the duty of a liquidator is to take care of the interests of creditors, not just the clients of a defaulted broker.

Arguments against the suggestion

5.25 The suggestion would create additional exposure to the ICF. The costs in some of the default cases discussed above were high. As it is difficult to determine how much the ICF should pay to cover the costs of an administrator in a particular case, the uncertainty would create unknown exposure to the ICF. Moreover, the suggestion would also go against the well-established case law that the costs of administrators should be paid out from the trust property they administer. Further, the suggestion involves a derogation from the principle that the ICF does not provide more than $150,000 compensation per investor. To the extent that payment of the cost of the administrator out of trust assets would reduce the value of the shares returned to investors, investors will be compensated by the ICF in any event, but subject to the $150,000 per investor limit.

Appointment and powers of an administrator under the SFO

5.26 The SFC also considered its powers to appoint an administrator under the SFO to assess whether they are adequate to enable the SFC to effectively perform its regulatory functions. The provision dealing with appointment of an administrator is section 213 of the SFO. Although, under the SFO, the SFC is required to apply to the court for the appointment of an administrator, experience has shown that this can be done very quickly and that the courts have given administrators adequate powers to enable them to perform their functions effectively.

5.27 We believe the YK case summarized above demonstrates the benefits in appropriate cases of the appointment of an administrator rather than or prior to initiating a liquidation proceeding. The administrator can be made responsible, among other things, for protecting and returning client property. The administrator in the YK case was able to return shares to 107 clients relatively quickly and without those shares being tied up for a lengthy time in the later bankruptcy proceedings. Because client property is trust property it is not available to creditors in bankruptcy/insolvency proceedings and therefore can be dealt with by an administrator without a later unwinding being possible under the provisions of the relevant law, be it bankruptcy or insolvency. Our discussions with experienced liquidators demonstrated, however, that if a liquidation were subsequently to be commenced, it would normally be cheaper and quicker for the liquidator to also take over the role of administering the trust property under a Berkely Applegate order. This would avoid the duplications involved in having both a liquidator and an administrator dealing with the same claimants (e.g. margin clients who were also debtors) and with the same set of books.

Recommendation

5.28 The SFC should where practicable strive to appoint an administrator at an early stage to protect client assets and return shares to clients. However, the costs of the administrators should not be paid from ICF assets. Where investors suffer loss by virtue of the costs of the administrator, the ICF should compensate those losses in accordance with the $150,000 per investor limit.

Other matters

5.29 Since the collapse of C.A. Pacific in 1998 the SFC has introduced a range of measures to strengthen the regulation of margin financing activities of brokers and to provide better compensation protection to investors in the event of a broker default.

5.30 The per investor compensation coverage of $150,000 which was first introduced in 1998 has now been enacted in the SFO. Under this regime, about 76% of claimants are paid in full. In 2000, the Securities (Margin Financing) (Amendment) Ordinance was introduced whereby all securities margin financing providers ("SMF providers"), including unregulated finance companies, are brought within the regulatory framework administered by the SFC. Various new financial resources requirements have been introduced to manage the business and financial risks relating to brokers' margin financing activities. These include the introduction in May 2002 of the 65% gearing ratio adjustment requirement and an illiquid collateral haircut in order to discourage SMF providers from over reliance on re-pledging client collateral to fund their operations and lending imprudently on illiquid collateral. A recent proposal issued in September 2004 proposes measures to impose a limit on the amount of client collateral that an SMF provider can re-pledge to secure bank loans ("re-pledging limit") on an aggregate basis and new haircut percentages on securities.

5.31 In addition to the above measures, the SFC has also put considerable emphasis in its investor education programme on promoting the understanding of investors about the nature and risks relating to margin trading (e.g. the difference between cash accounts and margin accounts; the operations of margin accounts and the risks of forced sale; the regulation of margin financiers; and the risks relating to the brokers re-pledging the shares in margin accounts). We believe that investor education is a very important part of our overall strategy to provide better protection to investors. The SFC will continue to work with the media, Hong Kong Exchanges and Clearing Limited, investor groups, industry associations and other relevant authorities (e.g. Consumer Council, fellow regulators) to enhance investors' general understanding of the benefits and risks in securities investment and trading.

VI. Conclusion

6.1 The investor compensation fund levy of 0.002% of the value of a stock market transaction, $0.50 per futures contract and $0.10 per mini-futures contract should be suspended as soon as practicable once the ICF exceeds the self-funding level of $1.4 billion.

6.2 Reinstatement of the levies should be activated when the ICF falls below the minimum prudent level of $1 billion.

6.3 The per investor compensation limit should be retained at $150,000 per investor but reviewed if experience shows that the average level of coverage has fallen significantly.

6.4 The SFC should strive where practicable to appoint an administrator at an early stage to a broker in financial difficulties to protect client assets and return shares to clients. The administrator should not be paid out of ICF assets but the ICF should, subject to the normal per investor limit, compensate clients for any losses they incur due to the costs of the administration.

6.5 A considerable body of precedent and experience has been accumulated in administration of the broker liquidations since C.A. Pacific and further development of the law in this area should be left to the common law. The SFC should, however, continue to monitor overseas developments in this area.

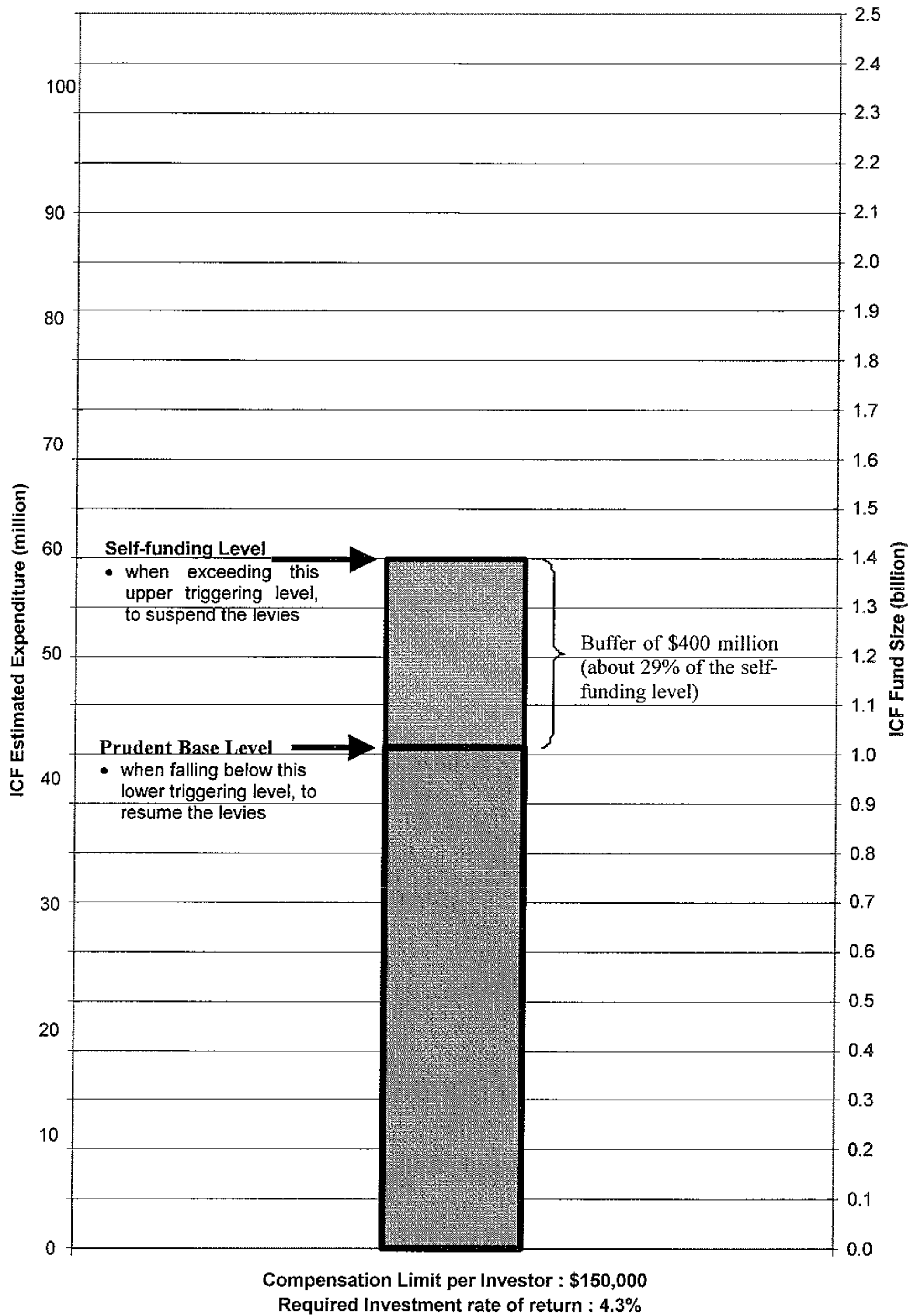
6.6 The SFC should continue to concentrate on measures, such as its recent proposals for limits on pledging client securities, to reduce the risks of pooling of margin clients securities.

6.7 The SFC should continue in its investor education programme to emphasize increasing investor understanding of the risks, as well as the benefits, of margin financing arrangements.

Appendix 1 - Unified Exchange Compensation Fund Claims History as of October 2004

Name of defaulting entities	Year of Default	No. of Claims Allowed	Allowed Amount	Average Allowed Claim	Accumulative Average Allowed Claim	Apportionment	Total Payments	% of clients fully satisfied (without adjustment by price index)	Accumulated % of clients fully satisfied (without adjustment by price index)
Gisella Ma & Co.	1987	6	1,273,000	212,166.67	212,166.67	100%	1,616,584.55	67%	67%
Bonus Securities Co.	1987	117	23,453,000	200,452.99	201,024.39	17%	3,999,997.82	85%	85%
W.H. & Company	1987	1	6,000	6,000.00	199,451.61	100%	9,557.73	100%	85%
Top-Fit Securities Co.	1987	15	6,180,000	412,000.00	222,388.49	32%	2,000,000.00	80%	84%
Myra Kan & Co.	1988	11	889,000	80,818.18	212,006.67	100%	1,097,334.37	91%	85%
Blooming Stock Co.	1990	15	1,036,000	69,066.67	199,012.12	100%	1,257,890.84	93%	85%
Youngs Family Investment	1990	1	211,000	211,000.00	199,084.34	100%	282,171.36	0%	85%
Tri-Pro Stocks & Shares Co.	1991	34	6,327,000	186,088.24	196,875.00	32%	2,000,000.00	74%	83%
HW Securities Co. Ltd.	1992	24	5,295,000	220,625.00	199,419.64	38%	2,000,000.00	71%	82%
Hung Wai Securities Co.	1992	11	898,000	81,636.36	193,906.38	100%	1,060,025.79	82%	82%
Tim Po Securities Co. Ltd	1996	12	3,766,744	313,895.35	199,735.81	47%	3,766,744.24	50%	80%
Wei Xin Securities Ltd.	1996	8	25,808,000	3,226,000.00	294,677.43	31%	8,000,000.00	13%	78%
Cheong Woon Securities Co.	1996	32	10,920,000	341,250.00	299,870.19	73%	8,000,000.00	72%	77%
C.K. Securities Co.	1996	53	8,445,148	159,342.42	277,964.39	77%	8,000,000.00	98%	81%
C.A. Pacific Sec. Ltd	1998	3,933	983,060,400	249,951.79	254,716.83	$150,000.00 per claimant limit	300,904,113.41	73%	73%
Forluxe	1998	430	56,903,947	132,334.76	243,665.95	$150,000.00 per claimant limit	31,063,101.91	78%	74%
Chark Fung Sec. Co. Ltd	1998	2,089	228,517,845	109,391.02	202,722.97	$150,000.00 per claimant limit	129,143,556.30	83%	77%
Foreground Sec. Co. Ltd.	1998	59	25,865,002	438,389.86	301,686.45	$150,000.00 per claimant limit	9,761,459.64	54%	77%
Win Successful Sec. Ltd	2000	285	98,566,751	345,848.25	208,439.16	$150,000.00 per claimant limit	25,977,606.31	68%	76%
Ying Kit	2002	158	37,623,572	238,123.87	209,082.18	$150,000.00 per claimant limit	15,137,003.94	66%	76%
Teil	2002	11	883	80.28	208,767.46	$150,000.00 per claimant limit	883.12	100%	76%
Lawsons	2002	253	18,837,835	74,457.85	204,271.52	$150,000.00 per claimant limit	13,246,438.54	87%	76%
Total		**7,558**	**1,543,884,128**	**204,271.52**			**568,324,469.87**	**76%**	

Appendix 2 - Proposed size of the ICF and the upper and lower levels of the levy triggering mechanism



Compensation Limit per Investor : $150,000
Required Investment rate of return : 4.3%

Appendix 3 - Market environment compared to 2001

1. The Charts in this Appendix update Hong Kong market statistics from the SFC's 2001 Paper to September 2004. In summary, market capitalization and turnover fell in 2002 but rebounded from 2003; larger brokers' market share increased at the expense of smaller brokers in 2002 with a partial reversal of this from later 2003. In derivatives markets, Futures Exchange volume and open interest increased steadily reaching a new high in open interest; stock options turnover rebounded and open interest hit a new high; and derivative warrant capitalization and turnover increased to new highs following restructuring.

Minimum commission abolished

2. A significant event since 2001 was the elimination of fixed minimum brokerage commissions at the Stock and Futures Exchanges, which was delayed a year from 1 April 2002 to 1 April 2003. As noted in the 2001 Paper, non-exchange participants were already competing on commissions and since then as expected there has been increased commission competition among exchange participants. We believe this is good for the market overall, although it may put pressure on some brokers' margins. So far this has not led to increases in broker defaults.

Internet trading

3. The 2001 Paper noted the increasing automation of trading at the Hong Kong Exchanges and the increased use by intermediaries and investors of Internet trading facilities. Since then, however, the growth of Internet trading has not expanded much and certainly not as dramatically as in some overseas markets. Internet trading is estimated to be only about 5% of market turnover. Thus, we did not experience a big increase in the numbers of retail trade volumes and investors that would have been expected with a big increase in Internet trading.

Risk reducing measures

4. The 2001 Paper described various SFC and legislative initiatives that were expected to reduce the risk of broker default. Significantly, in 1998 some brokers conducted margin financing through unlicensed companies that were not subject to financial resources rules requirements. Since then new measures to reduce risk have included margin financing legislation, revised Financial Resources Rules (FRR) requirements, and the new provisions of the SFO. In 2002 we amended the FRR to further address the risks of margin financing. We also amended the annual accounts rules to require auditors to express their

opinion on whether an intermediary has systems of control in place adequate to ensure compliance with client securities and money rules. In September 2004, we proposed additional measures to further reduce the risks of margin financing and "pooling". Whilst we expect these measures will reduce risk, there are still risks in pooling arrangements. As such, we have launched an investor education effort to alert investors to the risks of pooling.

Expanded number of intermediaries

5. As explained in the 2001 Paper, the new compensation arrangements under the ICF extended the scope of covered intermediaries from participants of the Stock and Futures Exchanges to non-exchange participant dealers and to authorized financial institutions such as banks. This involved approximately 400 additional intermediaries. Our risk model assumes that a certain level of defaults and compensation payouts will come from this group. Although this does not mean such defaults will not occur, so far there have not been any defaults from the newly covered intermediaries.

Largest retail broker exposure

6. In the 2001 Paper, the possible size of the exposure of the ICF was estimated by simulating a possible default by the largest retail broker licensed with the SFC. We have updated this analysis to see what would be the impact if the current largest retail broker were to fail. The results suggest that the exposure to the ICF today would be about $1.63 billion, based on the $150,000 per investor compensation limit. Of course, the analysis assumes that all client assets of the failed broker would be missing or misappropriated, which is an extreme and unlikely scenario. However, it should also be noted that if market conditions deteriorate, there could be more than one single broker failure due to contagion and other effects. The above analysis therefore is only an estimation of the exposure under certain assumptions, and not a forecast of what is likely to happen and what the likely exposure would be in the future.

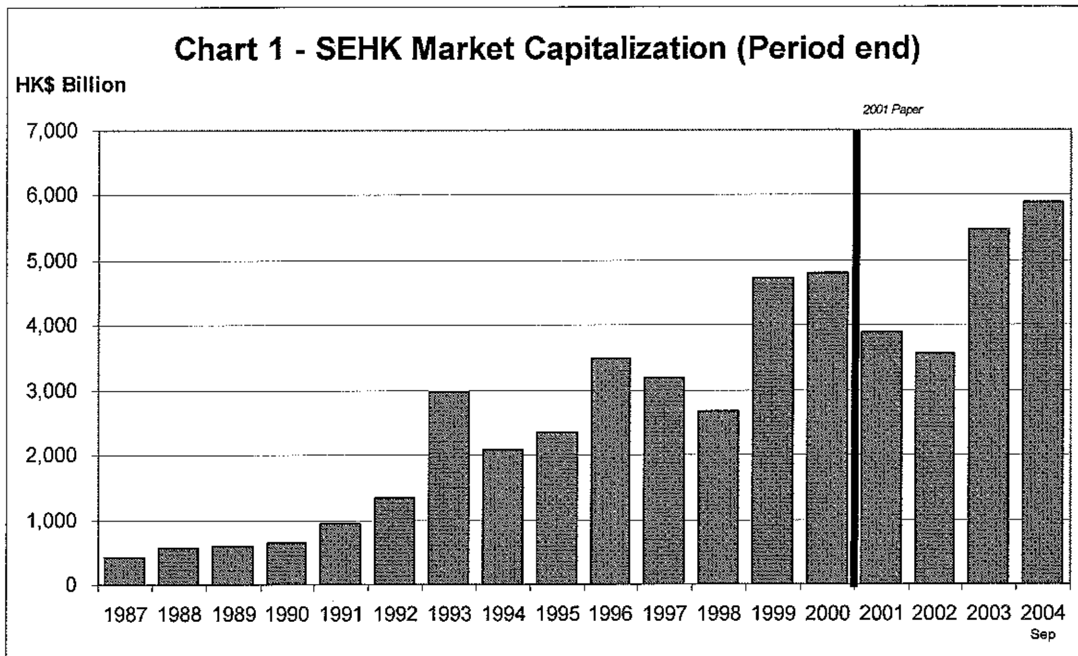


Chart 1 - SEHK Market Capitalization (Period end)
HK$ Billion
2001 Paper
7,000
6,000
5,000
4,000
3,000
2,000
1,000
0
1987 1988 1989 1990 1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002 2003 2004
Sep

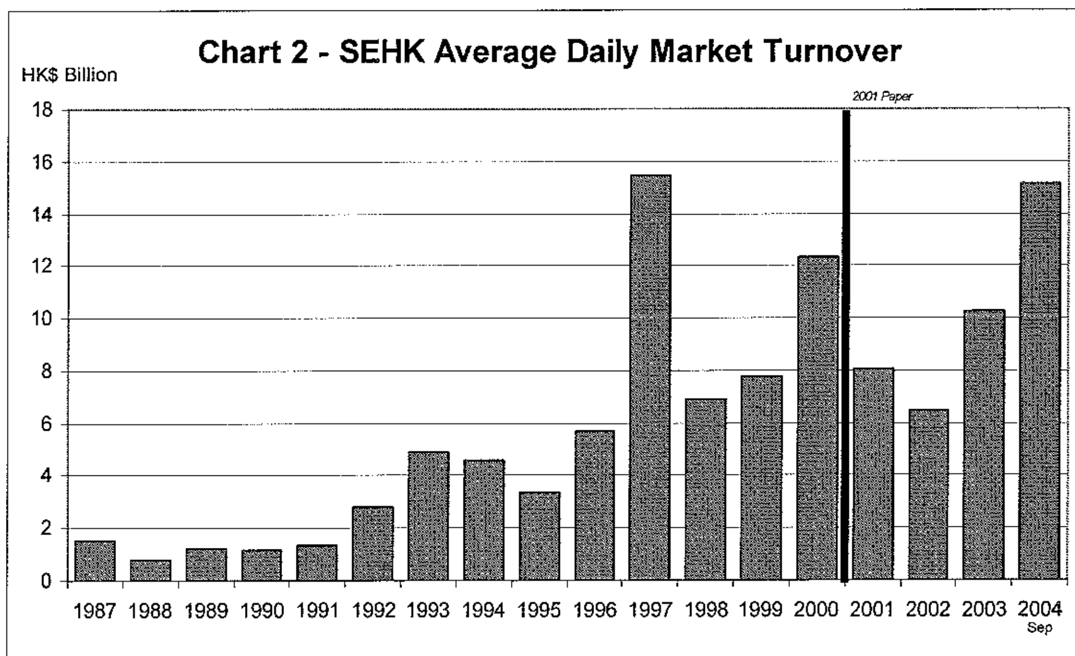


Chart 2 - SEHK Average Daily Market Turnover
HK$ Billion
2001 Paper
18
16
14
12
10
8
6
4
2
0
1987 1988 1989 1990 1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002 2003 2004
Sep

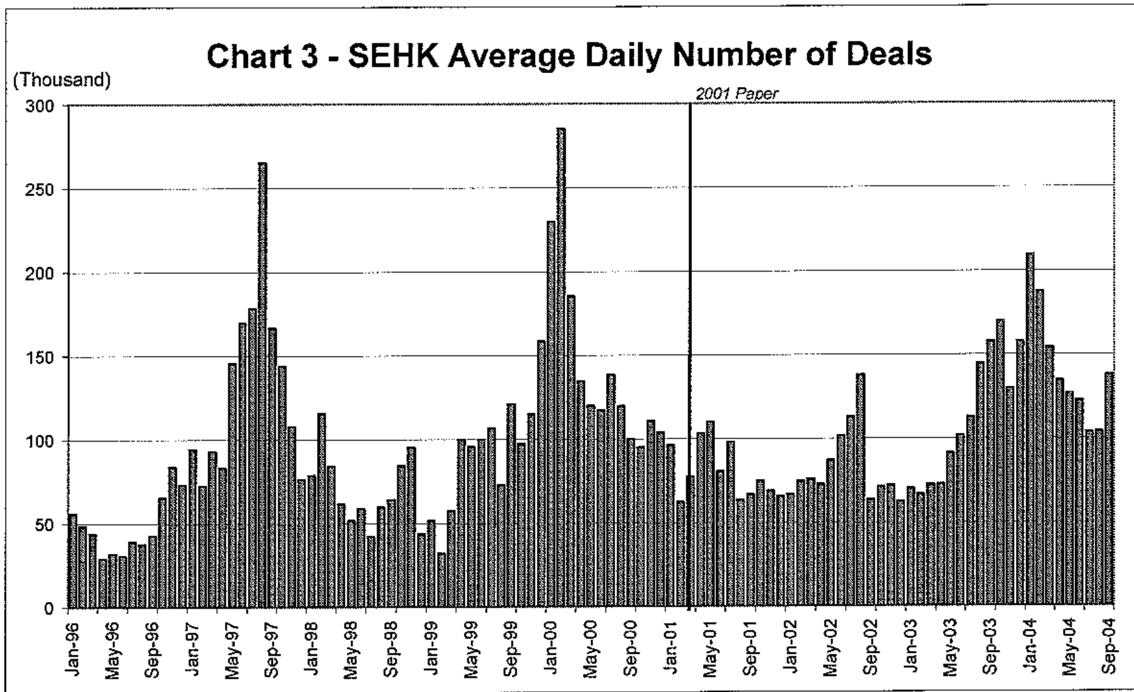


Chart 3 - SEHK Average Daily Number of Deals
(Thousand)
2001 Paper
300
250
200
150
100
50
0
Jan-96
May-96
Sep-96
Jan-97
May-97
Sep-97
Jan-98
May-98
Sep-98
Jan-99
May-99
Sep-99
Jan-00
May-00
Sep-00
Jan-01
May-01
Sep-01
Jan-02
May-02
Sep-02
Jan-03
May-03
Sep-03
Jan-04
May-04
Sep-04

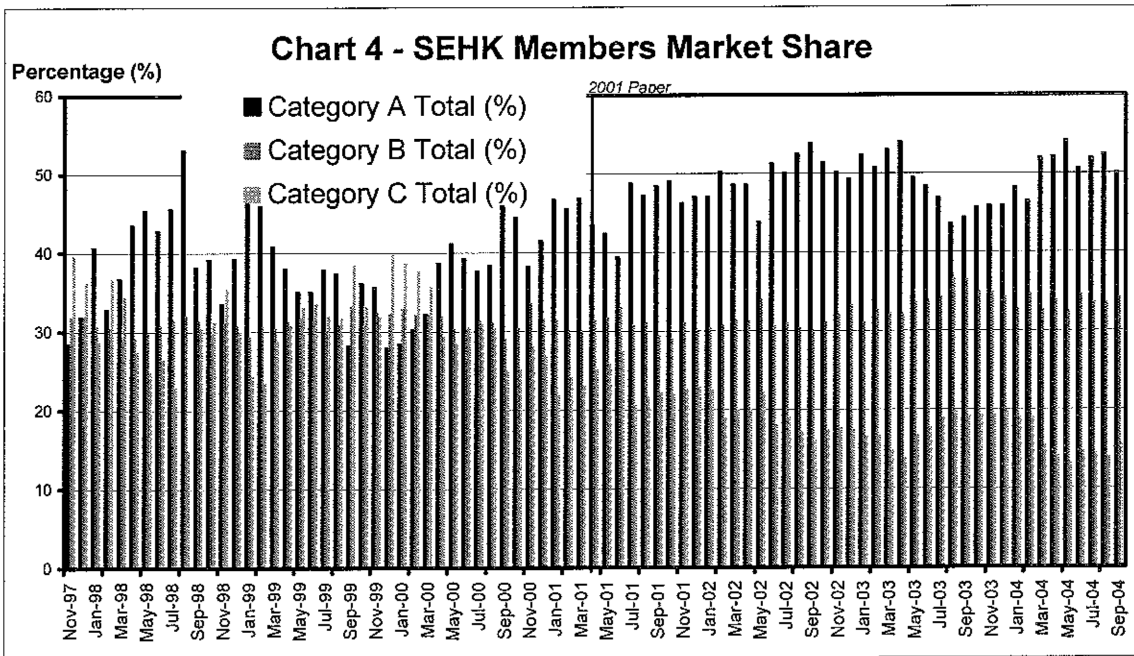


Chart 4 - SEHK Members Market Share
Percentage (%)
2001 Paper
Category A Total (%)
Category B Total (%)
Category C Total (%)
60
50
40
30
20
10
0
Nov-97
Jan-98
Mar-98
May-98
Jul-98
Sep-98
Nov-98
Jan-99
Mar-99
May-99
Jul-99
Sep-99
Nov-99
Jan-00
Mar-00
May-00
Jul-00
Sep-00
Nov-00
Jan-01
Mar-01
May-01
Jul-01
Sep-01
Nov-01
Jan-02
Mar-02
May-02
Jul-02
Sep-02
Nov-02
Jan-03
Mar-03
May-03
Jul-03
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Nov-03
Jan-04
Mar-04
May-04
Jul-04
Sep-04

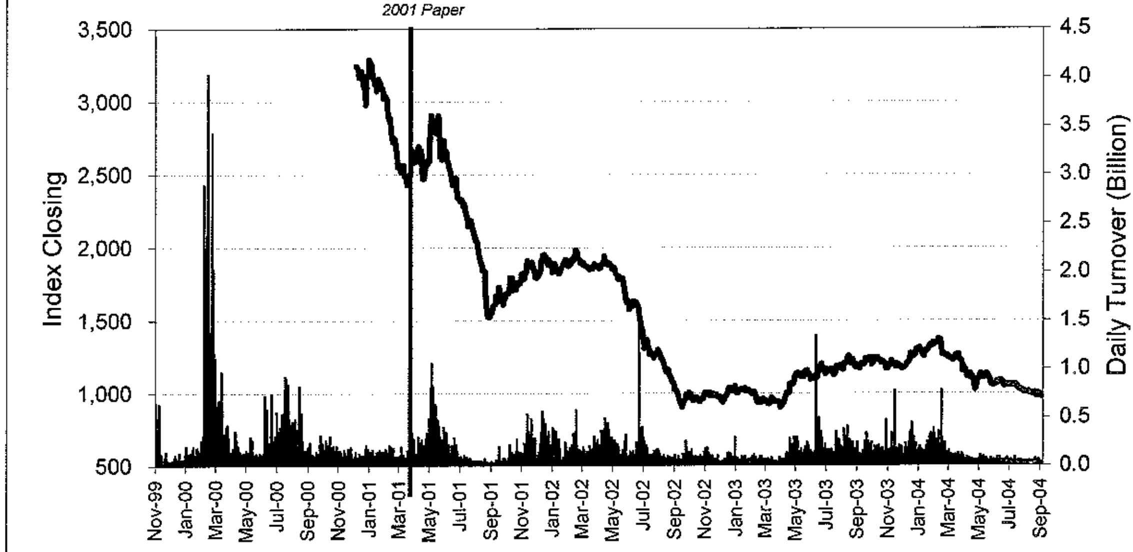
Chart 5 - GEM Daily Turnover and Index Closing
2001 Paper
Index Closing
Daily Turnover (Billion)
3,500
3,000
2,500
2,000
1,500
1,000
500
4.5
4.0
3.5
3.0
2.5
2.0
1.5
1.0
0.5
0.0
Nov-99
Jan-00
Mar-00
May-00
Jul-00
Sep-00
Nov-00
Jan-01
Mar-01
May-01
Jul-01
Sep-01
Nov-01
Jan-02
Mar-02
May-02
Jul-02
Sep-02
Nov-02
Jan-03
Mar-03
May-03
Jul-03
Sep-03
Nov-03
Jan-04
Mar-04
May-04
Jul-04
Sep-04

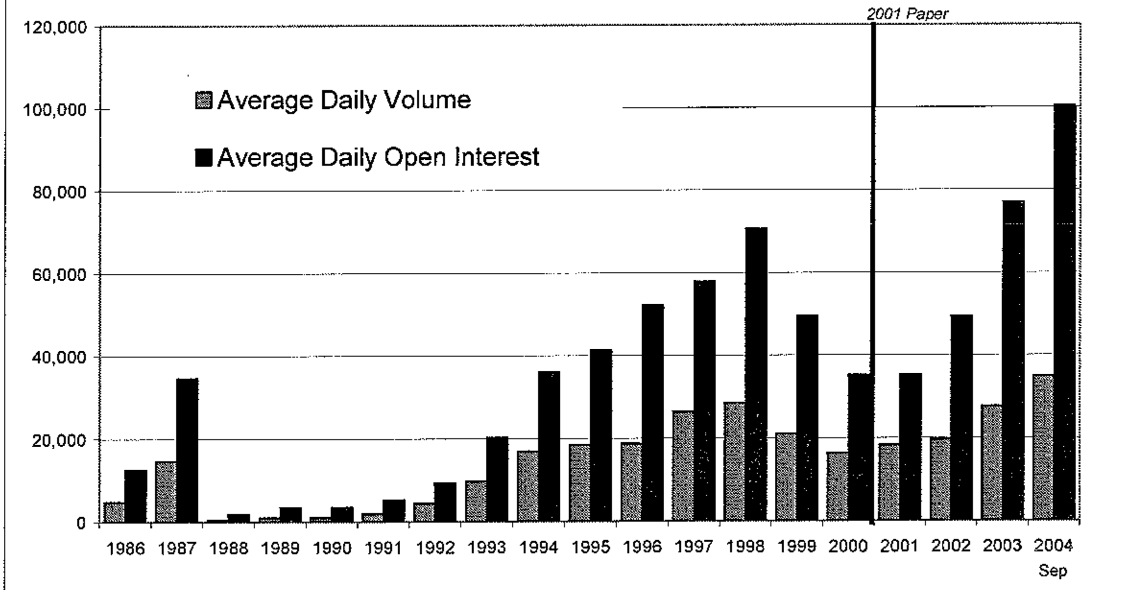
Chart 6 - HKFE - Turnover and Open Interest of HSI Futures Contracts
2001 Paper
Average Daily Volume
Average Daily Open Interest
120,000
100,000
80,000
60,000
40,000
20,000
0
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004 Sep

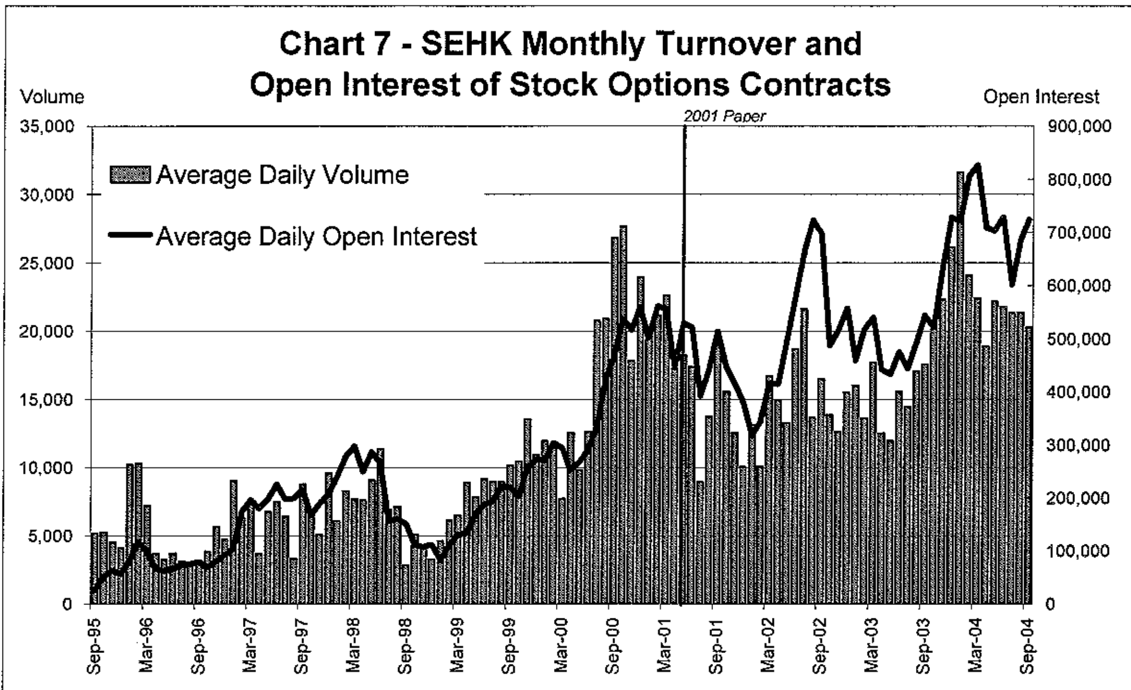
Chart 7 - SEHK Monthly Turnover and Open Interest of Stock Options Contracts
Volume
Open Interest
2001 Paper
Average Daily Volume
Average Daily Open Interest
35,000
30,000
25,000
20,000
15,000
10,000
5,000
0
900,000
800,000
700,000
600,000
500,000
400,000
300,000
200,000
100,000
0
Sep-95
Mar-96
Sep-96
Mar-97
Sep-97
Mar-98
Sep-98
Mar-99
Sep-99
Mar-00
Sep-00
Mar-01
Sep-01
Mar-02
Sep-02
Mar-03
Sep-03
Mar-04
Sep-04

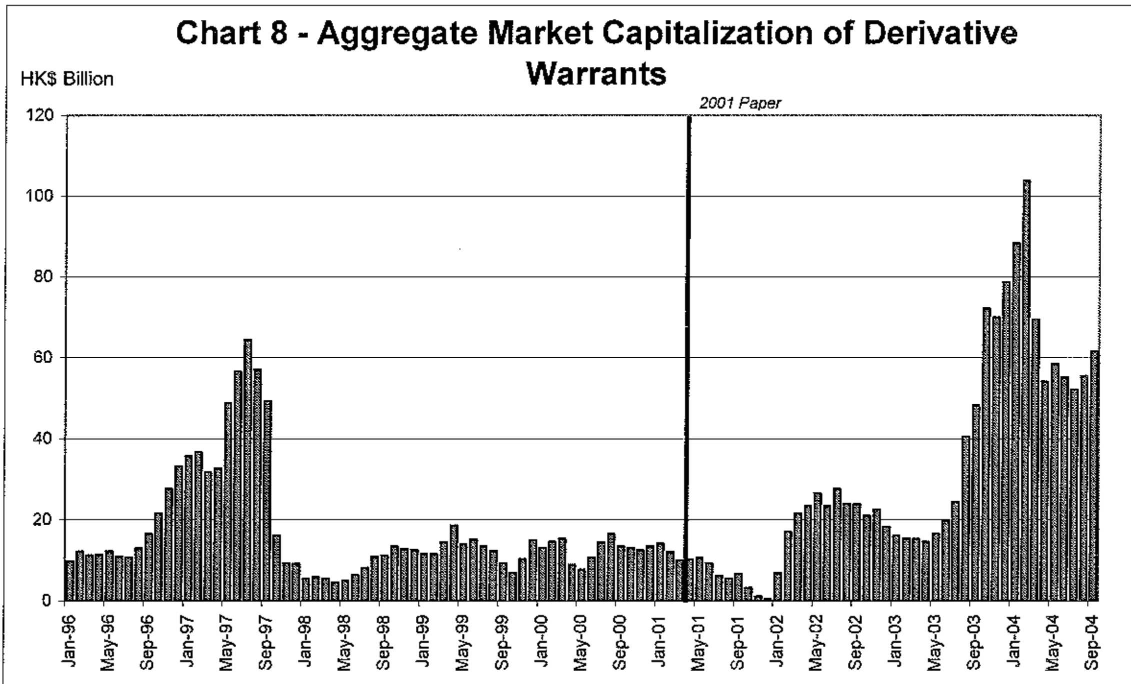
Chart 8 - Aggregate Market Capitalization of Derivative Warrants
HK$ Billion
2001 Paper
120
100
80
60
40
20
0
Jan-96
May-96
Sep-96
Jan-97
May-97
Sep-97
Jan-98
May-98
Sep-98
Jan-99
May-99
Sep-99
Jan-00
May-00
Sep-00
Jan-01
May-01
Sep-01
Jan-02
May-02
Sep-02
Jan-03
May-03
Sep-03
Jan-04
May-04
Sep-04