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Panel on Financial Affairs
Special meeting on 17 December 2004

Background Brief
on the review of levies of the Investor Compensation Fund

Purpose

This paper sets out the background of the review of the rate of levy of the Investor Compensation Fund, and summarizes the major views and concerns expressed by Members on related issues at meetings of committees of the Legislative Council (LegCo).

Background

2. In the past, investor compensation was mainly provided through the two compensation funds for the Stock Exchange of Hong Kong (SEHK) and the Hong Kong Futures Exchange (HKFE), i.e. the Unified Exchange Compensation fund (UECF) and the Commodity Exchange Compensation Fund (CECF). These compensation funds were derived partly from deposits paid by the exchange participants and partly from statutory transaction levies. The compensation ceilings for UECF and CECF are $8 million per stockbroker and $2 million per futures broker respectively, but the Securities and Futures Commission (SFC) may allow a higher level of compensation. The per broker ceilings give an uncertain level of investor protection, as the amount of coverage available to individual investors is uncertain.

3. In September 1998, SFC published the "Consultation Paper on New Investor Compensation Arrangements for Hong Kong". The main objective of the new arrangements was to provide a secure per investor level of compensation for retail investors under a formal and transparent structure. The proposed new arrangements were generally well received. The Administration then provided in the Securities and Futures Bill, which was introduced into LegCo in November 2000, the legal framework for the establishment of the new Investor Compensation Fund (ICF). Under the Bill,

SFC may make rules to provide for various matters for the operation of the new ICF.

4. In March 2001, SFC published the consultation paper on the "Proposed New Investor Compensation Arrangements", setting out the details about the new ICF, and briefed the LegCo Panel on Financial Affairs (FA Panel) on the consultation paper. Members noted that the initial funding for the new ICF would come from a transfer of assets in the existing compensation funds, but with sufficient amounts reserved in those funds to cover outstanding liabilities. The initial funding from this source was approximately $655.8 million. In order to provide reasonable protection to investors, SFC recommended that the new ICF should build its reserves to a level of $1 billion. This could be achieved by collection of levies on securities and futures transactions.

5. In February 2002, a subcommittee was formed by LegCo to study the draft subsidiary legislation to be made under the Securities and Futures Ordinance (SFO), including the Securities and Futures (Investor Compensation — Levy) Rules which provided for a levy at the rate of 0.002% on securities transactions and a levy in the amount of $0.5 on each futures contract payable by both the buyer and the seller. On 10 December 2002, the Chief Executive in Council decided that a number of subsidiary legislation, including the Rules mentioned above, should be made under SFO. In the LegCo Brief issued on 13 December 2002, the Administration indicated that it would keep under review the funding level and the rate of levy in the light of operational experience of ICF and prevailing circumstances.

6. On 1 April 2003, SFO came into operation after all the subsidiary legislations necessary for commencing the Ordinance were gazetted and approved by LegCo. ICF was established under SFO on the same day.

Main features of the Investor Compensation Fund

7. The main features of ICF are as follows:

(a) ICF is established under SFO to pay allowed claims of investors who suffer pecuniary losses as a result of a default[Note 1] of a covered intermediary in relation to trading products on the Hong Kong Exchanges and Clearing Limited (HKEx)[Note 2]. The defaulting intermediary must be –

Note 1

"Default" is defined in the Securities and Futures (Investor Compensation – Claims) Rules. It means that an intermediary, its employee or its associated person is in bankruptcy, winding up or insolvency or has committed breach of trust, defalcation, fraud or misfeasance.

Note 2

As part of the Financial Secretary's 1999 market reforms, the Exchanges and Clearing Houses (Merger)

- licensed or registered for dealing in securities or dealing in futures contracts; or
- licensed for securities margin financing; or
- an authorized financial institution which provides securities margin financing.

(b) ICF only covers defaults arising on or after the date of the commencement of SFO, i.e. 1 April 2003.

(c) The total amount of compensation payable to each successful claimant will not exceed $150,000 in respect of securities listed or traded on SEHK and also $150,000 in respect of futures contracts traded on HKFE.

(d) The current levy on securities transactions is 0.002% payable by buyers and sellers. For futures contracts, it is $0.5 per side of a contract or $0.1 per side of a mini contract.

(e) ICF is administered and managed by the Investor Compensation Company Limited (ICC). ICC assesses and determines claims against ICF, makes payments to claimants with valid claims and pursues recoveries against defaulting intermediaries.

Members' major views and concerns on ICF and the levy rates

8. When the proposed new investor compensation arrangements were deliberated by the Bills Committee on Securities and Futures Bill and Banking (Amendment) Bill 2000, members noted SFC's undertaking to review the funding need of the new ICF when the fund had accumulated to the target level of $1 billion. Some members of the Bills Committee and some members of the FA Panel (at the Panel meeting on 29 March 2001) expressed the following major views and concerns:

(a) To address the concern about the risk of cross-subsidization in contributions by different sectors of the industry, SFC should monitor the situation and consider adjusting the levies for different sectors to address any possible imbalance of levy contributions from the securities and futures sectors; and

(b) If ICF were to assume an unlimited liability, in the event of disastrous broker defaults and ICF were unable to compensate the losses, the Government would be forced to inject money to the fund or to provide a guarantee for it to obtain loans in the market.

Ordinance was enacted in February 2000. This facilitated the merger in March 2000 of SEHK, HKFE, and their three associated clearing houses under the common control of HKEx.

A mechanism should be put in place for LegCo to approve any funding request for ICF or to provide any guarantees.

Recent developments

9. In response to a Member's written question for the LegCo meeting on 30 June 2004, the Administration confirmed that the balance of ICF as at 31 May 2004 was $1,041 million and that SFC had already started the review process. SFC was considering various aspects, including a levy adjustment mechanism relating to the imposition and removal of the existing transaction levy of 0.002 % once the assets of ICF reached a certain level. The proposed design would take into account the desirability of self-funding for ICF so as to enable the expected annual income generated by ICF to be sufficient to cover its expected annual expenditure. The Administration indicated that it would discuss with SFC on the relevant proposals and it aimed to brief the FA Panel by the end of 2004 before conducting a public consultation exercise on the proposals.

References

10. A list of relevant papers is in the **Appendix**.

Council Business Division 1
Legislative Council Secretariat
15 December 2004

Appendix

Review of levies of the Investor Compensation Fund

List of relevant papers

(Position as at 15 December 2004)

Paper/Report	**LC Paper No.**
Administration's paper on "Proposed new investor compensation arrangements"	CB(1)916/00-01(03) *(discussed at the FA Panel meeting on 29 March 2001)*
Minutes of FA Panel meeting held on 29 March 2001	CB(1)2182/00-01
Report of the Bills Committee on Securities and Futures Bill and Banking (Amendment) Bill 2000	CB(1)1086/01-02 *(submitted for the House Committee meeting on 22 February 2002)*
Report of the Subcommittee on Draft Subsidiary Legislation to be made under the Securities and Futures Ordinance	CB(1)434/02-03 *(submitted for the House Committee meeting on 2 December 2002)*
Legislative Council Brief on the Subsidiary Legislation under the Securities and Futures Ordinance	CB(1)434/02-03 *(issued on 13 December 2002)*
Written Question No. 11 on Investor Compensation Fund raised by Hon Henry WU for the Council Meeting on 30 June 2004	—