

**For discussion
on 19 February 2019**

Legislative Council Panel on Financial Affairs

**Proposed Enhancements to the Investor Compensation Regime and
Wind-up of the Dealers Deposit Scheme**

PURPOSE

This paper briefs Members on the proposals of the Securities and Futures Commission (“SFC”) to enhance the investor compensation regime (“the regime”) and to wind up the Dealers Deposit Scheme (“DDS”).

BACKGROUND

2. The regime came into operation under the administration of the SFC in 2003 when the current Securities and Futures Ordinance (Cap 571) (“SFO”) took effect. It establishes a new investor compensation fund (“ICF”) to replace the three previous compensation arrangements, namely the Unified Exchange Compensation Fund (“UECF”), the Futures Exchange Compensation Fund (“FECF”) and the DDS.

3. The regime is designed to provide a degree of compensation to investors who have suffered loss in relation to exchange-traded securities or futures in Hong Kong as a result of a default by their intermediary. The current compensation limit is \$150,000 per investor per default in respect of securities-related losses and futures-related losses respectively. The ICF is mainly funded by a transaction levy (“the ICF levy”) payable by persons who buy or sell securities or futures contracts on the Stock Exchange of Hong Kong (“SEHK”) or the Hong Kong Futures Exchange (“HKFE”). There is a mechanism for suspending and reinstating the ICF levy when the net asset value of

the ICF reaches certain trigger levels. This is to ensure that the size of the ICF is maintained at an appropriate level that allows for the payment of compensation when needed but does not result in the accumulation of excessive amounts at the market's expense. Under this mechanism, the payment of ICF levy has been suspended since 2005. Further details on the regime are at [Annex](#).

4. The SFC reviews the regime from time to time, and if necessary, introduces enhancements to ensure that the arrangements are in keeping with the times. For example, the levy suspension and reinstatement mechanism was introduced in 2005 after review. The SFC also conducts regular surveys of selected intermediaries ("intermediary surveys") to collect data on client asset portfolios and other relevant areas to assess the continued suitability of the various aspects of the regime.

5. Our securities and futures markets have undergone substantial growth and development in terms of market capitalisation, average daily turnover, market reach and investor base in the last decade or so. Between the end of 2008 and the end of 2018, the number of companies listed on the SEHK rose by 84% from 1 261 to 2 315. Market capitalisation almost tripled from about \$10 trillion to about \$30 trillion. Average daily turnover rose by about 49% from \$72 billion to \$107 billion. The number of exchange participants rose by 38% from 487 to 673. Also, with the implementation of the Stock Connect programme, the Hong Kong and Mainland stock markets are now accessible to investors in both markets.

6. Against this backdrop, and having conducted another review of the regime in 2017, the SFC considers it an appropriate juncture to further enhance the regime in certain areas. A public consultation in this regard was conducted from April to June 2018¹. Taking into

¹ The SFC's press release about the consultation can be found at <https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=18PR44> and the consultation document can be found at <https://www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo=18CP4>

account views received during the consultation, the SFC is proposing to enhance various aspects of the regime.

PROPOSED ENHANCEMENTS TO THE REGIME

7. The regime is proposed to be enhanced as set out in paragraphs 8 to 11 below. The proposed enhancements require amendments to three pieces of subsidiary legislation under the SFO.²

Raising the compensation limit

8. It is proposed that the **compensation limit be raised from \$150,000 to \$500,000 per investor per default**. This should keep the “coverage ratio” (i.e. the percentage of investors that would be compensated in full if their intermediary was to default) at a level of around 80%³ amid the substantial growth in client assets⁴. The proposed compensation limit of \$500,000 is on par with the Hong Kong Monetary Authority’s Deposit Protection Scheme. While not directly

² They are the –

- (a) Securities and Futures (Investor Compensation–Levy) Rules (Cap 571AB);
- (b) Securities and Futures (Investor Compensation–Compensation Limits) Rules (Cap 571AC); and
- (c) Securities and Futures (Investor Compensation–Claims) Rules (Cap 571T).

³ The SFC generally aims for the compensation limit to achieve a coverage ratio of about 80%. It should be noted that this target may not always be met on average or per individual default case. The SFC’s 2014 and 2017 intermediary surveys suggest that the current \$150,000 compensation level should result in an average coverage ratio of about 75% in 2014 but only around 64% in 2017. If the compensation limit is raised to \$500,000, the average coverage ratio should rise to around 83%.

⁴ With the growth and development of our securities and futures markets, the value of client assets held with intermediaries has increased substantially. Data from the SFC’s 2014 and 2017 intermediary surveys indicate that the total value of client assets held with the securities intermediaries surveyed had increased by more than 50%, from \$598 billion to \$918 billion. For some intermediaries, the increase was close to or over 100%.

comparable, the proposed limit is also within the range of that adopted by selected overseas jurisdictions⁵.

Raising the trigger levels for levy suspension and reinstatement

9. Consequential to raising the compensation limit, it will be necessary to **raise the trigger levels for suspending and reinstating the ICF levy** to enable the ICF to continue to maintain a reasonable level without overburdening investors. **The SFC proposes to increase the suspension level from \$1.4 billion to \$3 billion, and the reinstatement level from \$1 billion to \$2 billion.** In proposing the new trigger levels, the SFC has taken into account the potential future growth in client assets and is cognizant to the need that the new levels should be sustainable for a reasonable period of time. The levels will not affect the levy suspension that is currently in place. This is because the current net asset value of the ICF, at \$2.37 billion, is higher than the proposed new reinstatement level.

Adjusting coverage to cater for Stock Connect

10. The SFC proposes adjusting the coverage of the ICF regime so that it also **covers the northbound leg of Stock Connect** (i.e. Hong Kong investors trading on the Mainland stock market through Hong Kong intermediaries). The regime is intended to protect investors against losses due to default by intermediaries in Hong Kong. As the transactions under the northbound Stock Connect must be routed through Hong Kong intermediaries, these transactions should be covered under the regime as well. Consistent with this, transactions under northbound Stock Connect should also be subject to the ICF levy (if and when triggered).

11. On the other hand, there is no need to expand the regime to also cover southbound trading under Stock Connect. This is because such trading must be routed through Mainland regulated intermediaries.

⁵ The SFC has looked into similar schemes adopted elsewhere including the European Union, Singapore, the United Kingdom, the United States and Canada. These schemes differ in terms of the precise scope of persons and assets covered, and the circumstances in which compensation is paid.

WINDING-UP OF DDS

12. As mentioned in paragraph 2 above, the ICF was formed to replace the three pre-SFO compensation funds/scheme which include the DDS⁶. Owing to certain technical legal issues, the winding-up procedures for the DDS have not yet commenced, although it had ceased to operate since 2003.

13. The SFO was amended subsequently to deal with these technical issues⁷. We consider it timely to also take the opportunity to arrange for the winding-up of the DDS. As at 30 November 2018, the DDS had a balance of \$37.90 million from contributions made by dealers previously.

14. To wind up the DDS, the Secretary for Financial Services and the Treasury will appoint a date (“appointed day”) to begin the winding-up process by notice published in the Gazette. The notice is a piece of subsidiary legislation. After the appointed day, where there is any deposit or security forfeited by the SFC⁸ under the DDS that has yet to be disposed of, the SFC will specify a day on or before which claims for compensation against any such deposit or security may be made by the clients of the dealer(s) concerned and determine the claims (if any). Any remaining balance held in the DDS will then be returned to the dealer which made the deposit or lodged the security. Where the SFC is unable to locate the dealer within the specified period, the relevant money shall be transferred to the ICF.

⁶ The DDS was to compensate clients of a dealer (other than an exchange participant) who sustain pecuniary loss because of a default by the dealer. Its funding came from deposits paid by dealers (including securities margin financiers).

⁷ Schedule 10 to the SFO was amended to rectify an anomaly with respect to transitional arrangements for the DDS for securities margin financiers, thereby enabling the winding-up of the DDS.

⁸ The SFC may forfeit a deposit made by a dealer, or apply security lodged by a securities margin financier, for compensation purposes under certain circumstances, such as conviction of an offence involving fraud in respect of client’s assets.

PUBLIC CONSULTATION

15. The SFC conducted a public consultation on the proposed enhancements to the regime from April to June 2018. 10 submissions were received. There was strong support for the proposed enhancements. The SFC has taken into account the comments received in finalising the proposals under paragraphs 8 to 11 above. Separately, the winding-up of the DDS is a technical house-keeping matter which will take place after the appointed day.

ADVICE SOUGHT AND WAY FORWARD

16. Members are invited to note and comment on the proposals as set out in paragraphs 8 to 13 above. Our target is to introduce the subsidiary legislation into LegCo in 2019 for negative vetting.

**Financial Services and the Treasury Bureau
The Securities and Futures Commission
February 2019**

Key features of the regime

- (a) **Compensation fund**: An ICF has been established under the regime from which compensation payments are made. Its key funding sources are: (i) monies from the pre-SFO compensation funds/scheme; (ii) transaction levies payable by investors when buying or selling securities or futures on the SEHK or on the HKFE¹; and (iii) investment income such as bank deposit interest. The ICF is administered by the Investor Compensation Company Limited, a wholly-owned subsidiary of the SFC.
- (b) **Compensation coverage**: The regime covers losses in respect of securities or futures contracts that are listed or traded on the SEHK or the HKFE, as well as any related assets (e.g. related purchase monies or sale proceeds). Losses covered under the regime should be attributable to the default of a dealing or financing intermediary², or a person related to such an intermediary (e.g. its employee).
- (c) **Compensation limit**: The regime sets a limit on the amount of compensation that can be paid to an investor in the event of a default. The current limit is \$150,000 per investor per default. This limit applies to securities-related losses and futures-related losses individually³.

¹ The current ICF levy on securities transactions is 0.002% payable per side by the buyers and the sellers. For futures contracts, it is \$0.5 per side of a contract or \$0.1 per side of a mini contract or stock futures contract.

² A dealing or financing intermediary refers to an intermediary or authorized financial institution (i.e. bank) engaging in dealing in securities or dealing in futures contracts and/or providing securities margin financing. These are Type 1, 2 and 8 regulated activities under the SFO.

³ For example, if an intermediary with both securities and futures businesses defaults, each of its clients can claim up to \$150,000 in respect of any securities-related losses and a further \$150,000 in respect of any futures-related losses. The \$150,000 limit for securities-related losses cannot be used to offset any futures-related losses that exceed \$150,000, and vice versa.

- (d) **Levy suspension and reinstatement mechanism:** The regime provides a mechanism for suspending and reinstating the ICF levy when the net asset value of the ICF reaches certain trigger levels. The current levy suspension and levy reinstatement levels are \$1.4 billion and \$1 billion respectively. Pursuant to this mechanism, the collection of ICF levy has been suspended since December 2005. As of end-November 2018, the size of the ICF was around \$2.37 billion.