

## **LEGISLATIVE COUNCIL BRIEF**

### **Securities and Futures Ordinance (Cap. 571)**

#### **SECURITIES AND FUTURES (INVESTOR COMPENSATION - CLAIMS) RULES**

#### **INTRODUCTION**

Pursuant to section 244(2) of the Securities and Futures Ordinance (Cap. 571) (the SFO), the Securities and Futures Commission (the SFC) has made the Securities and Futures (Investor Compensation - Claims) Rules (the Claims Rules) at the **Annex**.

#### **BACKGROUND**

##### **The SFO**

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

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

## **THE PROPOSALS**

### **Major policy considerations**

4. Parts III and XII of the SFO make provisions for the legal framework for the operation of the new investor compensation arrangements, the establishment of a new investor compensation fund (ICF) and the establishment of an investor compensation company. The Claims Rules supplement Part XII and the circumstances in which a person is entitled to claim compensation, the manner in which a claim for compensation is to be made, the information to be supplied to the SFC to enable the claim to be determined and the persons who are not entitled to make a claim.

5. The Claims Rules should be read in conjunction with two other Rules and two Orders that have been made by the Chief Executive in Council and published in the Gazette on 13 December 2002 -

- (a) the Securities and Futures (Investor Compensation – Levy) Rules
- (b) the Securities and Futures (Investor Compensation – Compensation Limits) Rules;
- (c) the Securities and Futures (Transfer of Functions – Investor Compensation Company) Order; and
- (d) the Securities and Futures Ordinance (Amendment of Schedule 8) Order 2002.

In this Brief these Rules and Orders are referred to as the Compensation Levy Rules, the Compensation Limits Rules, the Transfer Order and the Schedule 8 Order.

### *The existing compensation arrangements*

6. Part X of the Securities Ordinance (Cap. 333) (the SO) has provided for a compensation fund for securities market investors since 1974. The fund originally applied to a default by a member of any of the four stock exchanges in operation until 1986. Since the unification of those exchanges in 1986, the Unified Exchange Compensation Fund (the UECF) has replaced the original fund and has applied to a default by any member of the Stock Exchange of Hong Kong Limited (the Stock Exchange).

7. Another fund, known as the Futures Exchange Compensation Fund (FECF), has been established under Part VIII of the Commodities Trading Ordinance (Cap. 250) providing investors compensation for defaults by futures exchange participants. Further limited compensation is provided for investors under the Dealers' Deposit Scheme established under section 52 of the SO.

8. The compensation ceilings for the UECF and the FECF are respectively \$8 million per stockbroker and \$2 million per futures broker.

*The new compensation arrangements*

9. Under Part XII of the SFO, the SFC will establish a new investor compensation fund (ICF). The ICF will replace the existing UECF, the FECF and the Dealers' Deposit Scheme.

10. The new arrangements will significantly enhance the compensation available to investors. They will cover defaults by all -

- (a) securities and futures dealers; and
- (b) margin financiers,

who receive and hold client securities and/or money whether or not they are exchange participants in relation to all products traded on markets operated by Hong Kong Exchanges and Clearing Limited (the HKEx). Coverage will also be extended to retail investors who deal through registered institutions. Institutional investors will be excluded from claiming compensation. The circumstances under which claims can be made are set out in the Claims Rules and are described in greater detail below.

11. A "per investor" compensation limit of \$ 150,000 is imposed under the Compensation Limits Rules. These Rules provide that where a claimant claims compensation in respect of loss sustained as a result of a default in relation to -

- (a) securities listed or traded on a recognized stock market; or
- (b) futures contracts traded on a recognized futures market,

the maximum amount of compensation that may be paid to each claimant is \$150,000. This is in line with the on-going policy adopted by existing UECF for awards to claimants in recent years.

12. The arrangements will be administered by the Investor Compensation Company Limited (the ICCL) which is recognized and regulated by the SFC. Under the Transfer Order certain functions of the SFC relating to the management of the ICF are transferred to the ICCL subject to the reservation that these functions are to be performed concurrently with the SFC. The ICCL will receive and determine claims under the Claims Rules, make payments to claimants, and pursue subrogated rights against defaulters. The ICCL is to be classified as a public body under the Prevention of Bribery Ordinance (Cap. 201).

13. Initial funding of the ICF will come from a transfer of assets from the existing compensation funds under sections 74 and 75 of Schedule 10 to the SFO, but with sufficient amounts reserved in those funds to cover outstanding liabilities. The net assets of the UECF and the FECF as of 30 September 2002, were approximately \$800 million and \$100 million respectively .

14. Ongoing funding will be provided under the Compensation Levy Rules which impose a levy on the sale and purchase of securities and futures contracts. This will help ensure that the new ICF will be properly funded on establishment to meet with its obligations. The SFC will keep under review the funding level and the rate of levy in the light of the operational experience of the ICF and prevailing circumstances. With this, the existing requirements for exchange participant dealers to provide deposits for the compensation funds and for other dealers to make deposits to the Dealers' Deposit Schemes would no longer be required.

## **THE CLAIMS RULES**

15. Section 4 of the Claims Rules prescribes the circumstances in which a person is entitled to claim compensation. It provides that where a qualifying client of a specified person sustains a loss as a result of the default committed by the specified person, or an associated person of the specified person, in relation to specified securities or futures contracts, or related assets, he may claim compensation from the compensation fund.

16. The terms "qualifying client", "specified person", "default", "associated person", "specified securities or futures contracts" and "related assets" are all defined in section 2 of the Claims Rules. The interaction of these definitions prescribes the circumstances in which a claim for compensation can be made. Important features of these definitions are explained below -

- (a) a qualifying client is a person for whom the specified person provides a service but certain persons will not be able to claim. The persons who cannot claim are mainly institutional investors who should be able to look after their investments compared to retail investors;
- (b) a specified person covers intermediaries licensed or registered for dealing in securities or futures contracts, and licensed intermediaries and banks providing securities margin financing;
- (c) a default, as adapted from the SO, covers insolvency, bankruptcy or winding up, breach of trust, defalcation, fraud or misfeasance of the specified person, and extended to cover the insolvency, bankruptcy or winding up of an associated person of the specified person. Currently “default”, in relation to an employee of the exchange participant, is limited to a breach of trust, defalcation, fraud or misfeasance;
- (d) an associated person covers an employee of a specified person, a person who is authorized under section 164 of the SFO to hold client assets and such a person’s employee;
- (e) a specified securities or futures contracts are limited to securities or futures contracts listed or traded on the Stock Exchange of Hong Kong or the Hong Kong Futures Exchange which were entrusted to the intermediary in default, or its associated person, and to which the qualifying client was entitled; and
- (f) related assets cover money or other property entrusted to the intermediary in default by the qualifying client relating to the purchase, sale or pledge etc. of the securities or futures contracts.

17. Under section 7 of the Claims Rules the SFC will determine whether there has been a default and whether the claimant is entitled to compensation from the ICF. If satisfied, the SFC will determine a provisional amount of compensation.

18. A notice will be issued to a claimant under section 8 of the Rules specifying the amount of compensation payable under the Rules. However, the SFC will not issue a notice of determination specifying a provisional amount of compensation that is less than the compensation claimed unless it has first given the claimant a reasonable opportunity of being heard. If after this, the SFC decides to issue the notice of determination, it will give its reasons in the notice.

19. Under the Amendment of Schedule 8 Order, determinations by the SFC (and or the ICCL) as to whether there has been a default, the date of default, whether a claimant is entitled to compensation or the provisional amount of compensation, are all reviewable by the Securities and Futures Appeals Tribunal (SFAT) on application of the claimant who is dissatisfied with such a decision.

## **PUBLIC CONSULTATION**

20. The SFC first released a consultation paper on the concept and general framework of new investor compensation arrangements in September 1998. It outlined the rationale for the new arrangements to enhance investor protection and the objectives and key features of the proposal, including the establishment of an investor compensation company regulated by the SFC. There was broad agreement in principle to the new compensation arrangements and to the setting up of an independent investor compensation company.

21. Taking into account public comments received in the 1998 consultation exercise, the SFC released a more detailed consultation document in March 2001 on the key components of the new investor compensation arrangements. The proposals met with positive response from the public.

22. The SFC issued the final consultation document containing the exposure drafts of the Compensation Levy Rules, the Compensation Limits Rules, the Claims Rules and the Transfer Order on 28 March 2002 for comment by the public. Six submissions were received. The SFC considers that no major changes needed to be made to the substance of the Claims Rules in response to these submissions.

23. A draft of the Claims Rules was considered by the Subcommittee at its meetings on 6 June 2002 and 24 October 2002. The Claims Rules were further refined in the light of comments of the Members of the Subcommittee to better reflect the policy intention and to improve drafting.

## **FINANCIAL AND STAFFING IMPLICATIONS**

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

## **COMMENCEMENT DATE**

25. The Claims Rules will come into operation on the day appointed for the commencement of the SFO, together with other subsidiary legislation necessary for the commencement. We expect this to take place shortly, after completion of the negative vetting procedure through the Legislative Council and allowing the industry a reasonable period of time for making necessary adjustments with reference to the subsidiary legislation. We aim to announce the target commencement date by the end of 2002.

## **PUBLICITY**

26. The Claims Rules will be published in the Gazette on 13 December 2002. The SFC will issue a press release on the same day.

## **ENQUIRIES**

27. For any enquiries on this brief, please contact Mr. Gerald Greiner of the Supervision of Markets Department of the SFC at 2840 9304 or Mr. Anthony Wood of the Legal Services Division of the SFC at 2840 9276.

The Securities and Futures Commission  
13 December 2002