PROPOSED NEW INVESTOR COMPENSATION ARRANGEMENTS

Hong Kong
March 2001

FOREWORD

This Paper is published by the Securities and Futures Commission to solicit comments on proposals for new investor compensation arrangements for Hong Kong. Comments are invited from all interested persons.

Comments should be addressed to the Supervision of Markets Division of the Securities and Futures Commission, 12th Floor, Edinburgh Tower, 15 Queen's Road Central, The Landmark, Hong Kong and should be submitted before 6 April 2001.

This Paper can also be downloaded from the SFC's website *http://www.hksfc.org.hk*.

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I. Executive Summary

Prior Consultation

1. In September 1998, the SFC published a Consultation Paper on New Investor Compensation Arrangements for Hong Kong. Taking into account comments received and intervening developments, the SFC is now publishing this Paper describing proposed expanded new compensation arrangements. The comments received on the 1998 Consultation Paper are summarised at Appendix A.

Objectives

2. The objectives of the new compensation arrangements are set out in paragraph 29 of this Paper. They are essentially the same as the objectives in the 1998 Consultation Paper, but with expanded coverage as described in paragraph 3 below. In summary, the main objectives of the new 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 (HKEx), based on the principles of user pays and equal treatment for all retail investors irrespective of the intermediary through whom they trade. *We also seek comments on whether coverage should extend to other products, including overseas products.*

Expanded Coverage of Intermediaries

3. The arrangements would, as previously proposed, cover defaults by licensed persons authorized to deal in securities and who are exchange participants of the Stock Exchange. The new arrangements would also cover defaults by other licensed persons authorized to deal in securities, licensed persons authorized to deal in commodity futures contracts, and licensed persons authorized to provide securities margin financing ("covered intermediaries") in relation to products traded on HKEx. This means coverage of all securities and commodity dealers and margin financiers who receive and hold client securities and/or money whether or not they are exchange participants. The SFC also proposes

that coverage should extend to retail investors who deal through authorized persons under the Banking Ordinance who are exempt from SFC licensing and subject to regulation by the Hong Kong Monetary Authority ("HKMA"). *The SFC seeks specific comments on whether coverage should be so extended.*

Per Investor Limit

4. As previously proposed, the arrangements would provide a limit of compensation per investor. We believe this can initially be $150,000, and should be reviewed as necessary. The basis for making compensation claims would largely follow existing arrangements. But specified institutional investors would be excluded from claiming compensation.

A New Single Compensation Fund

5. There would be a new single Investor Compensation Fund that would replace the existing Unified Exchange Compensation Fund, the Commodity Exchange Compensation Fund and the Dealers' Deposit Schemes for non-exchange participant dealers. The new arrangements would eliminate the existing requirements for exchange participant dealers to make deposits to the compensation funds and for other dealers to make deposits to the Dealers' Deposit Schemes. Existing deposits would be returned to the Exchanges and to non-exchange participant dealers. The arrangements would also remove the existing requirement for the Stock Exchange to replenish amounts paid from the Unified Exchange Compensation Fund.

The Investor Compensation Company

6. As previously proposed, the arrangements would be administered by an Investor Compensation Company (ICC) recognized and regulated by the SFC. The ICC would receive and determine claims under rules made by the SFC, make payments to claimants, and pursue subrogated rights against defaulters. We also suggest that the ICC be classified as a public body under the Prevention of Bribery Ordinance.

Funding

7. Initial funding would come from a transfer of assets in the existing compensation funds, but with sufficient amounts reserved in those funds to cover outstanding liabilities. We consider it desirable to build up the new Fund's assets beyond the level transferred from the existing funds. In order to provide reasonable protection to investors trading in Hong Kong securities and futures products, the SFC estimates that the new Fund should build its reserves to a level of $1 billion as quickly as possible. This can be achieved effectively by increasing the existing transaction levy on Stock Exchange transactions from 0.01% to 0.012% and having the SFC pay the additional levy into the existing Unified Exchange Compensation Fund for transfer to the new Fund when formed. There would also be a need for other forms of funding to cover catastrophe loss. We propose that the existing $0.5 levy for each side of a contract executed on the Futures Exchange should continue for the new Fund.

Securities and Futures Bill

8. The arrangements for the new Fund would be implemented under the Securities and Futures Bill, introduced into the Legislative Council in November 2000. We expect the new arrangements to be put in place at the time of or very soon after the enactment of the Bill. However, we believe that the process of building up the assets for the new Fund should commence as soon as practicable.

II. Recent Developments

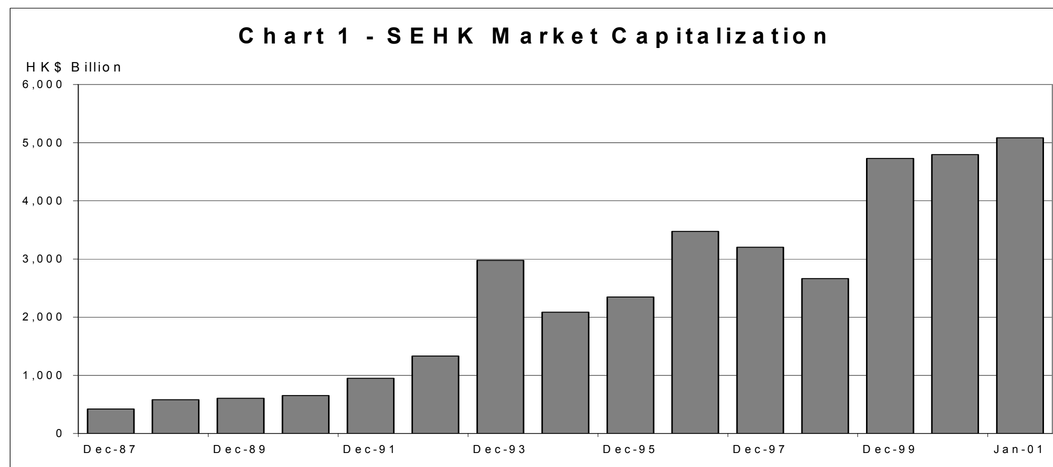
Merger of Exchanges and Clearing Houses

9. As part of the Financial Secretary's 1999 market reforms, the Exchanges and Clearing Houses (Merger) Ordinance was enacted in February 2000. This facilitated the March 2000 merger of the Stock Exchange, the Futures Exchange, and their three associated clearing houses under the common control of HKEx. HKEx was later listed in

June 2000 as a public company on the Stock Exchange. As an adjunct to the merger, the SFC assumed from the Exchanges the role of front-line regulator of exchange participants in relation to their financial condition and conduct. This means that the SFC is now the front line regulator of all 868 dealing firms licensed by the SFC.

Updated Market Statistics

10. The Charts below provide an update of the local markets since the 1998 Consultation Paper. Following a decrease in market capitalisation in 1998, total capitalisation rebounded sharply to new highs in 1999/2000. Stock Exchange turnover had fallen sharply in 1998 following the very high levels of 1997. Whilst turnover recovered smartly into 2000, it is still below 1997 levels. The relative market shares of the so-called category A, B and C brokers at the Stock Exchange have stayed more or less in a band with roughly 30% to 40% per category. The Growth Enterprise Market (GEM) was introduced in early 2000 with an initial flurry of volume followed by a consolidation with GEM turnover at roughly 1% to 2% of the main board.



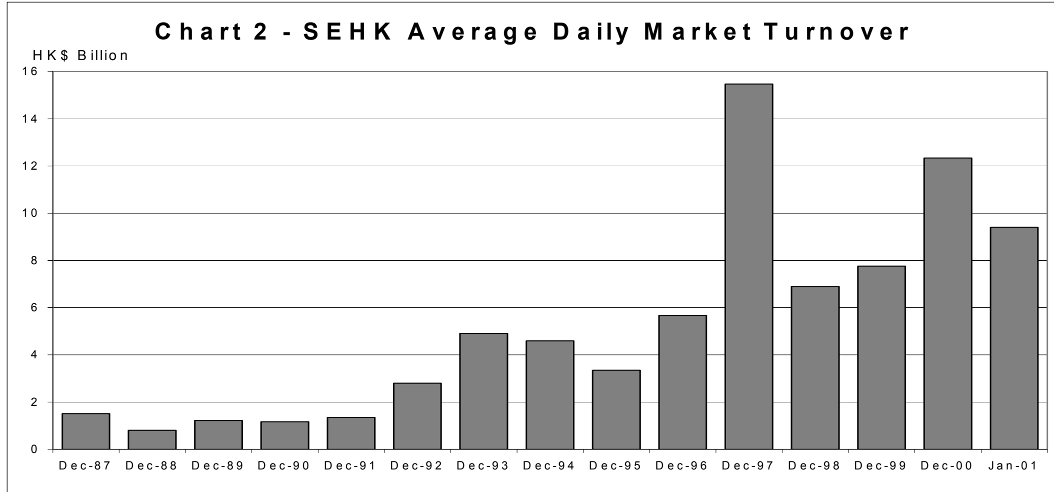


Chart 2 - SEHK Average Daily Market Turnover
HK$ Billion
16
14
12
10
8
6
4
2
0
Dec-87
Dec-88
Dec-89
Dec-90
Dec-91
Dec-92
Dec-93
Dec-94
Dec-95
Dec-96
Dec-97
Dec-98
Dec-99
Dec-00
Jan-01

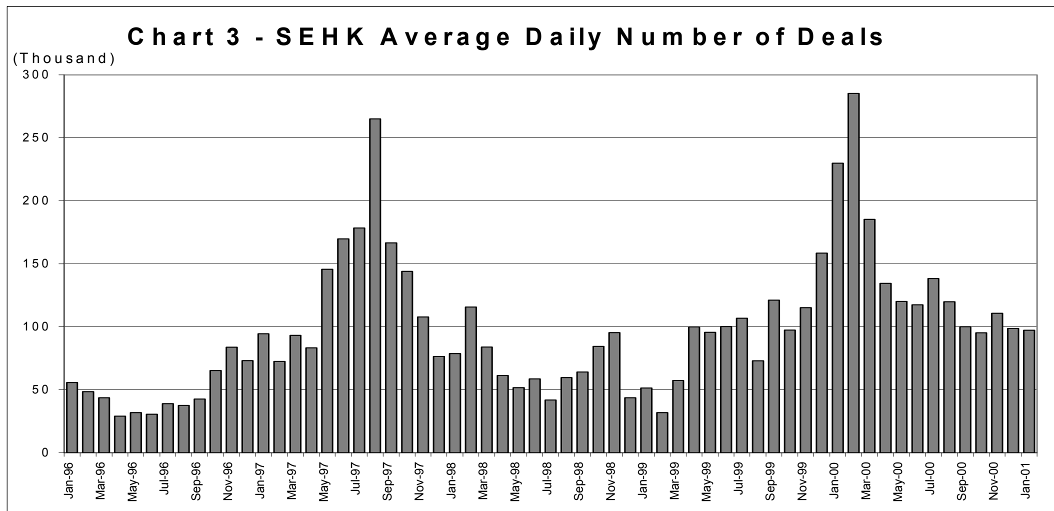


Chart 3 - SEHK Average Daily Number of Deals
(Thousand)
300
250
200
150
100
50
0
Jan-96
Mar-96
May-96
Jul-96
Sep-96
Nov-96
Jan-97
Mar-97
May-97
Jul-97
Sep-97
Nov-97
Jan-98
Mar-98
May-98
Jul-98
Sep-98
Nov-98
Jan-99
Mar-99
May-99
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Sep-99
Nov-99
Jan-00
Mar-00
May-00
Jul-00
Sep-00
Nov-00
Jan-01

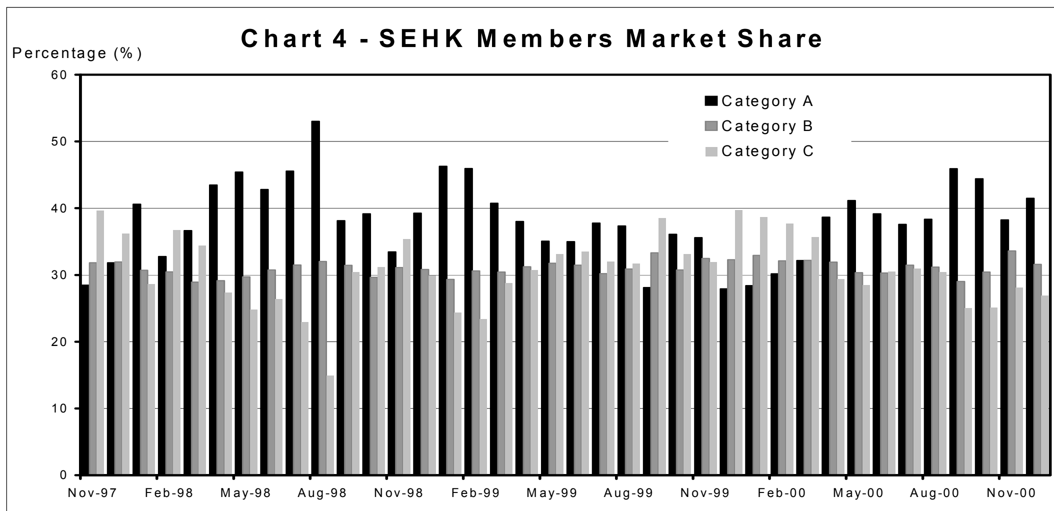


Chart 4 - SEHK Members Market Share
Percentage (%)
60
50
40
30
20
10
0
Category A
Category B
Category C
Nov-97
Feb-98
May-98
Aug-98
Nov-98
Feb-99
May-99
Aug-99
Nov-99
Feb-00
May-00
Aug-00
Nov-00

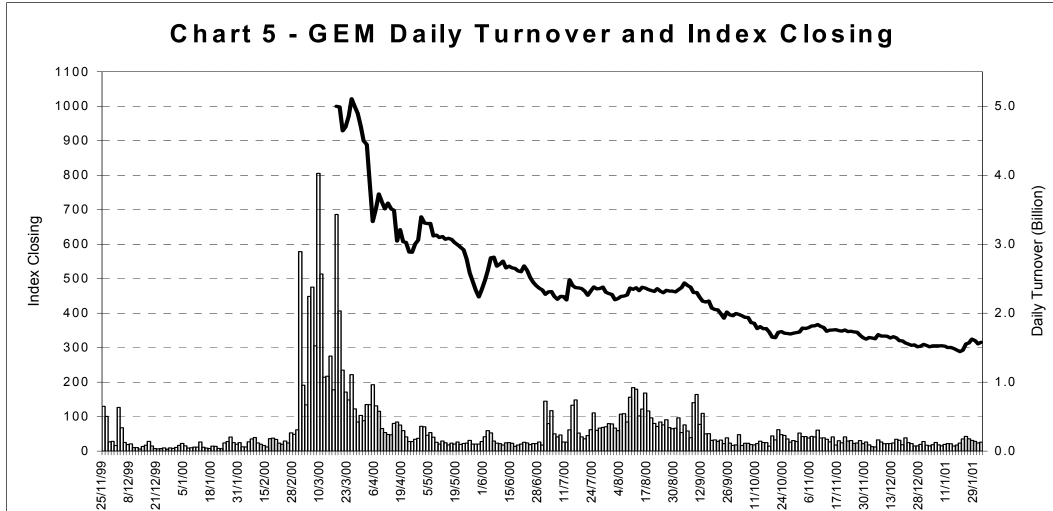


Chart 5 - GEM Daily Turnover and Index Closing

11. Futures Exchange turnover and open interest grew strongly in the seven or eight years into 1998, but have since fallen to 1994/95 levels. Stock options turnover and open interest show a steady increase from 1998 with a spike to record levels in the third quarter 2000. Derivative warrant market capitalisation picked up slightly in 1999 only to retreat to lower levels in 2000, far below the record levels of 1997. Despite the variances in stock and futures market activity in recent years, most statistics show continuing long term growth.

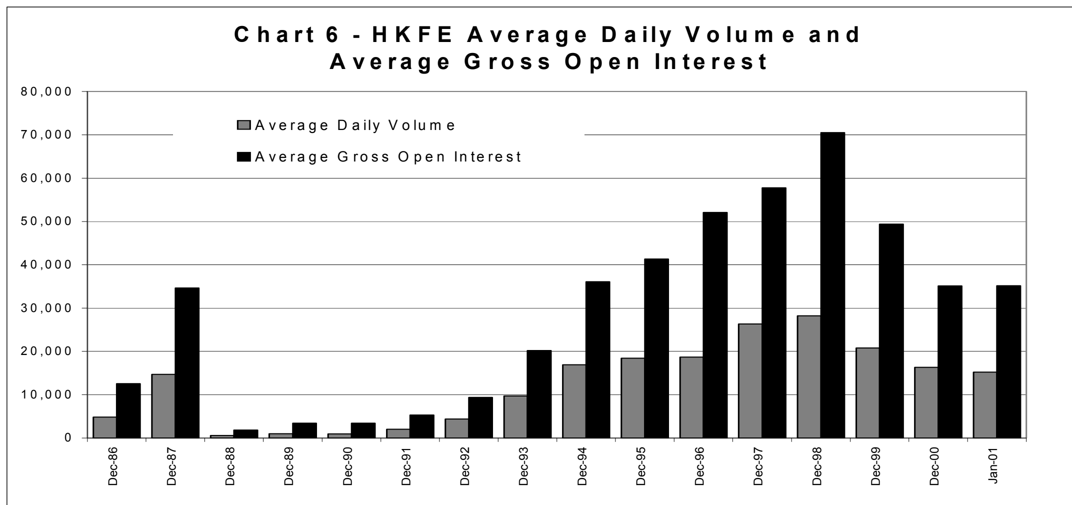
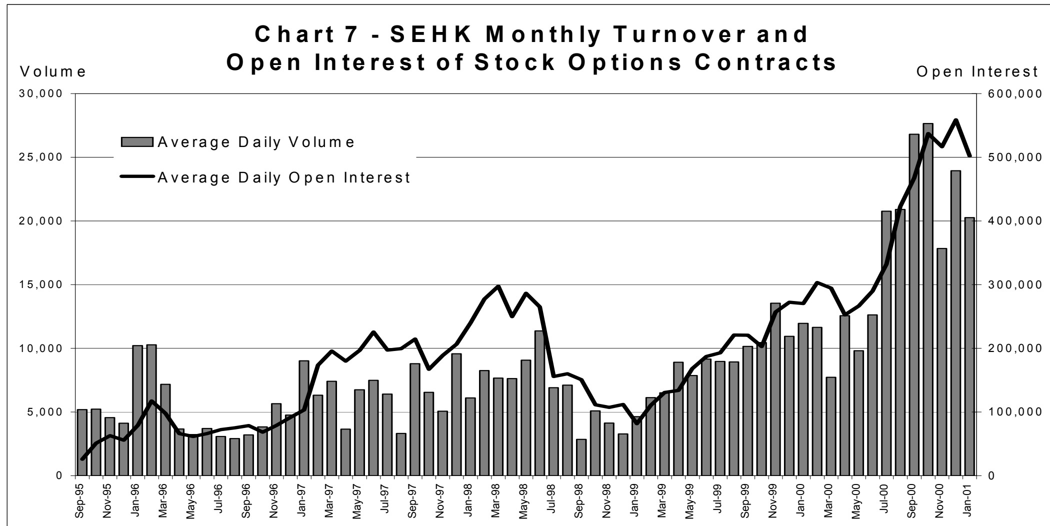
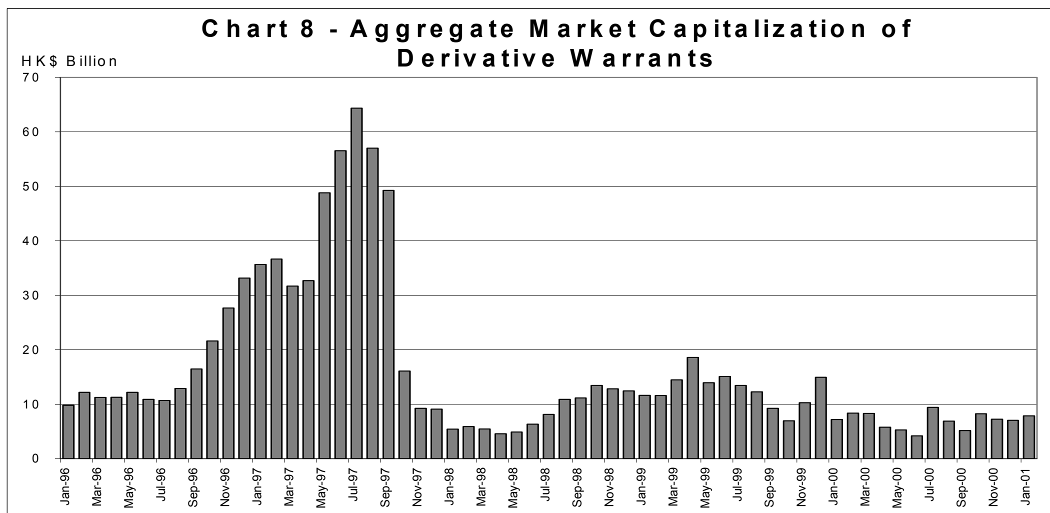


Chart 6 - HKFE Average Daily Volume and Average Gross Open Interest





12. Another development since 1998 is a significant increase in clients' assets held by covered intermediaries. This figure rose from approximately $378 billion in 1998 to approximately $1,230 billion at year end 1999. Most of this increase we attribute to the general rise in the market during that period and to a movement of client assets from unregulated finance companies to the control of covered intermediaries.

Deregulation of Brokerage Commissions

13. During 2000, HKEx proposed and the SFC approved rule changes that will eliminate fixed minimum brokerage commissions from 1 April 2002. Meanwhile, a number of non-exchange participants who are not subject to the Exchanges' minimum commission rules introduced

various waivers or rebates of brokerage commission leading to effective rates below the minimum levels set by the Exchanges. These developments are likely to lead to more widespread price competition among brokers with corresponding pressure on brokers' revenues.

Market Automation and On-line Trading

14. The Stock Exchange launched its AMS3 fully automated trading system in the fourth quarter 2000. This includes an Internet trading facility available to all brokers and supports other Internet facilities developed by on-line brokers. Earlier in 2000, the Futures Exchange migrated all trading to its electronic HKATS system and closed its trading floor. Overseas on-line brokers have established operations in Hong Kong and many local brokers and a number of Authorized Institutions have developed their own on-line trading systems.

15. A recent survey suggests that more than 200 brokers will provide on-line trading facilities to clients in the coming year, up from 80 odd recently. Experience overseas shows that on-line trading growth can increase trading volumes and the numbers of active retail investors, sometimes dramatically, whilst also adding new operational risks. In this regard, the SFC is conducting jointly with a firm of consultants focused reviews of the application control environment of brokers' on-line trading systems. We also published in December 2000 a Consultation Paper on the Regulation of On-line Trading of Securities and Futures.

Broker Initiatives in Investor Insurance Protection

16. During 2000, several Hong Kong brokers introduced new insurance products that provide certain coverage directly to clients in the event of the broker's insolvency. The per investor limit of compensation that would be provided by the new compensation arrangements would likely support further development of these insurance products in Hong Kong. Experience in the United States has been that, because the Securities Investor Protection Corporation (SIPC) covers most historical investor losses, there is relatively attractive pricing of

insurance products purchased by brokers to provide their clients with coverage above the SIPC limits.

1998 Defaults – C.A. Pacific, etc. Update

17. The 1998 Consultation Paper noted the default of four brokers in that year – C.A. Pacific Securities, Chark Fung Securities, Foreground Securities, and Forluxe Securities. It also described the special compensation arrangements made for those defaults, which involved paying each claimant the full amount of allowed loss up to a maximum of $150,000. Since then, there has been one additional default – Win Successful Securities in January 2000. The payment history for these defaults is detailed in Appendix B. In summary, approximately $458 million was paid to 6,419 claimants, whilst 176 claims have yet to be determined and $65 million has been provided for to compensate remaining claimants.

18. Also noted in the 1998 Consultation Paper was the decision by the SFC and the Stock Exchange to make contributions of their own funds to the Unified Exchange Compensation Fund. In a series of payments the SFC and the Stock Exchange have since each contributed or made provision to contribute $300 million of their own funds, for a total of $600 million.

Risk Reduction Measures

19. The 1998 Consultation Paper described the regulatory measures then planned that would reduce risk of broker default and in turn risk to compensation fund assets. These included the plans to regulate share margin financing, changes to the Financial Resources Rules (FRR), and new provisions for safeguarding client assets. These are generally now in place as described below. Also summarised are additional risk reducing measures proposed in the Securities and Futures Bill.

Securities (Margin Financing) Amendment Ordinance 2000

20. This Ordinance came into effect in June 2000. It provides a comprehensive regulatory environment for persons providing securities

margin financing. This will address the circumstances of the defaults of C.A. Pacific Securities and other firms in 1998, which were directly related to the wholly unregulated activities of the firms' affiliated finance companies.

21. In summary, the main features of the Ordinance are:–

- SFC licensing of the firm and its representatives/dealing directors.

- Margin financiers must confine their business to share margin financing and can lend only to finance the purchase or holding of listed securities.

- Application of comprehensive liquid capital requirements and segregation of clients' credit balances.

- Restricted scope of dealing with clients' securities.

- Daily/monthly account statements for clients, including all account movements in securities, collateral, and terms of financial accommodation.

22. In addition, the FRR require monthly financial reporting of, among other things, bank facilities outstanding, top 20 clients, concentrations in collateral matched with clients, and reconciliation of clients' ledgers with third-party positions with CCASS and bank lenders. The SFC has implemented separately an automated financial reporting and analysis system in which it tracks and stress tests, among other things, the most active brokers and the concentration of margin loans and securities collateral in the margin financing industry, whilst analysing the impact of stock suspension, price drop of selected stocks and clients' default.

Revised FRR

23. Revisions to the FRR for all licensees also took effect in June 2000. The main features of these revisions are –

- Standardised approach to setting regulatory capital for securities and futures dealers and margin financiers.

- Standardised **minimum** required liquid capital of $3 million (increases the minimum for sole proprietors from $500,000).

- New **minimum** required paid up share capital (or equivalent for sole proprietors) of $5 million, $10 million for those providing margin financing.

- New risk adjustments for concentrated lending/collateral holdings.

- Expanded monthly financial reporting.

Securities and Futures Bill

24. To address risks similar to those arising from margin financing, provisions in the Bill will apply to associated entities of licensed persons who handle client assets. The Bill would require segregation of such client assets, record keeping, statements of accounts, etc. It also enables the SFC to inspect the associated entities.

Clients' Rights in Securities

25. The 1998 Consultation Paper noted that there was uncertainty in the C.A. Pacific default of the rights of clients in securities held by the broker and by third-party lenders. Since then, the Court decided that in certain circumstances clients had proprietary rights in securities they held with C.A. Pacific. The Court also decided how securities held by C.A. Pacific should be distributed to clients.

Scripless Securities

26. The Steering Committee on the Enhancement of the Financial Infrastructure in Hong Kong appointed by the Financial Secretary released a Report in September 1999. The Report recommends, among other things, a move to a scripless securities market, including appropriate updates to the legal and regulatory framework and adoption of globally accepted standards for electronic transactions. We believe an appropriate scripless system can enhance client protection by

providing efficient direct registration of clients' interests whilst further clarifying the issues surrounding clients' rights in securities discussed above.

HKMA Deposit Protection Paper

27. In October 2000, the HKMA published a Consultation Paper on Enhancing Deposit Protection in Hong Kong. The Paper sought public comment on various ways of enhancing deposit protection, including insurance schemes to cover each depositor up to levels of $100,000 or $200,000 funded by premiums paid by banks on covered deposits. Whilst there have been securities and futures market compensation funds in place for more than 20 years, there has never been a formal deposit protection scheme in Hong Kong. There is a preference in favour of depositors up to $100,000 each as creditors in the winding up of a licensed bank. We do not propose that the investor compensation arrangements involve winding up preferences for investors, although where brokers hold investors' property in trust, these assets are protected in a winding up.

Consultancy for New Investor Compensation Arrangement

28. As mentioned below, consultants, Jardine Lloyd Thompson Ltd. and Risk Economics Ltd., assisted the SFC in the preparation of this Paper.

III. The Proposals for New Compensation Arrangements

Objectives – Update from 1998

29. The objectives of the new arrangements are essentially the same as those in the 1998 Consultation Paper.

Main Objectives of New Compensation Arrangements

- To enhance the existing investor compensation arrangement 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 provide the compensation arrangement through a new and independent entity that includes industry and public interest representatives and is subject to appropriate checks and balances.

- To protect and leverage existing compensation fund assets, including possible use of insurance, while minimising any additional costs to the industry.

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

- To initially provide a new compensation arrangement in relation to products traded on HKEx, but within a flexible structure that will allow additional arrangements to be developed for other segments of the market.

30. Within the objective of a flexible framework, we have since expanded the scope of covered intermediaries. The continuing objective of flexibility will enable us to consider further expansions of coverage if policy decisions are made to do so.

Overview of the Securities and Futures Bill regarding Investor Compensation

31. The Bill's approach to investor compensation arrangements is to set up a broad and flexible regulatory framework in primary legislation, leaving most of the details concerning compensation to be contained in

rules. Under Part XII, the SFC must establish and maintain a compensation fund, to be known as the Investor Compensation Fund. Proper accounts of the Fund must be prepared and published by the SFC. There is a provision similar to existing ones giving the SFC subrogated rights against a defaulter upon making payment to a claimant. Part XII of the Bill is reproduced in Appendix C of this Paper.

32. Clause 236(1) enables the Chief Executive in Council to make rules concerning: means of funding the compensation fund; the maximum amount of compensation that may be paid to a claimant; sub-accounting; and for the better carrying out of Part XII. Clause 236(2) enables the SFC to make rules that are not inconsistent with rules made by the Chief Executive in Council and for various matters, including: circumstances entitling a person to claim compensation; manner of claiming; payment of costs and interest; required documentation; persons who may not claim; manner of determining and paying claims; etc.

33. Part III of the Bill covers the recognition and regulation by the SFC of an investor compensation company (ICC) (the relevant clauses of Part III are contained in Appendix C). Clause 80 enables the Chief Executive in Council to transfer by order from the SFC to the ICC any function to which the clause applies (i.e. most of Part XII of the Bill). Clause 84 sets out the duty of the ICC, to supply the SFC with information it may require about the ICC's affairs. Clauses 82 and 83 empower the ICC to make such rules as are necessary or desirable within the remit set out in those clauses and for the SFC to approve the rules made by the ICC.

34. Section V. of this Paper details the steps to be taken under the Bill to wind up the old compensation funds and to put the new arrangements in place.

35. The Bill contains new provisions for the regulation of "automated trading services" (ATS), which raise the question of whether ATS activity will be covered by the new compensation arrangements. As described in this Paper, the new arrangements will extend compensation coverage to all covered intermediaries in relation to products traded on HKEx. We believe this should mean that an

investor who deals through a covered intermediary in any HKEx traded product should be covered, even if the product is traded through an ATS and whether or not it is also traded through an HKEx facility. This may mean that special funding arrangements may be needed in relation to ATS trading that is not done through HKEx facilities to ensure a fair and level playing field. Trading in offshore products through an ATS is not proposed to be covered initially. The existing compensation funds do not cover offshore products, and we propose that they not be covered in the initial stage of the new arrangements.

36. ATS may develop new products for trading in Hong Kong that are not offshore products. If these products were to be made generally available to retail investors in Hong Kong, we believe investor compensation coverage would likely be appropriate. We could do this by expanding the coverage of the new arrangements or devising an entirely new arrangement. In either case, funding would need to be provided for.

Expanded Coverage

37. As mentioned, the new arrangements would cover not only exchange participants of the Stock and Futures Exchanges, but also all licensed and exempt persons authorized to deal in securities, deal in futures, and to provide margin financing and in relation to HKEx traded products. The Tables below show the number of licensees who would be covered.

Stock Exchange dealers (corporation)	428
Stock Exchange dealers (individual)	80
Non-exchange securities dealers (corporation)	192
Non-exchange securities dealers (individual)	8
Total	*708*

Futures Exchange dealers (corporation)	138
Non-exchange futures dealers (corporation)	22
Total	*160*

38. In summary, the new arrangements would extend coverage to an additional 200 securities dealers and 22 futures dealers, plus 10

securities margin financiers, and 111 exempt dealers which are Authorized Institutions and 56 exempt dealers which are not Authorized Institutions. The risk implications of the extended coverage are discussed in Section IV. Risk Assessment and Funding.

39. The existing compensation funds do not cover defaults of exempt dealers, who are in most but not all cases Authorized Institutions under the Banking Ordinance. The operations of Authorized Institutions, including securities dealing business and financial soundness, are regulated by the HKMA. Under the principles of user pays and equal treatment, we believe retail investors who deal in products traded on HKEx through exempt Authorized Institutions should also be covered. Currently, exempt dealers include Authorized Institutions and some others. On commencement of Part V of the Securities and Futures Bill, only Authorized Institutions will be eligible to apply for exempt status. Other existing exempt dealers would have 2 years to transit into the new licensing regime but would have to take out a license by the end of that period. During the transitional period, we believe that clients of these persons should be covered under the new investor compensation scheme. *We seek specific public comments on whether the new compensation arrangement should extend coverage to exempt Authorized Institutions.*

Elimination of Dealer Deposits and Stock Exchange Replenishment

40. The Securities and Futures Bill Schedule 9 (relevant provisions are reproduced in Appendix C) provides for a winding up of the existing compensation funds and Dealers' Deposit Schemes for non-exchange participant dealers and a return of dealer deposits after outstanding liabilities have been satisfied. For deposits made to the existing compensation funds, the deposits are to be returned to the two Exchanges who may deduct amounts owing to them and then return any balances to the dealers concerned. Deposits from the Stock Exchange are $50,000 per trading right, deposits from the Futures Exchange are $100,000 per trading right holder, and deposits from non-exchange dealers are $50,000 per dealer. Refunds of deposits to the Stock Exchange would amount to $46.45 million and to the Futures Exchange $21.10 million. Refunds to non-exchange participant dealers would amount to $46.15 million.

41. Under the existing compensation fund for the Stock Exchange, the Securities Ordinance requires the Stock Exchange to replenish amounts paid out from the trading right deposits. In practice, following the arrangements made for the C.A. Pacific and later defaults, this has meant a maximum $8 million replenishment obligation on the Stock Exchange per broker default. The Futures Exchange does not have a replenishment obligation under existing arrangements.

42. The new arrangements detailed in this Paper do not rely on nor contemplate deposits by covered intermediaries nor Exchange replenishment obligations. However, the funding discussion from paragraph 79 of this Paper mentions that assessment of covered intermediaries could be an option but is not recommended. Clause 236 of the Securities and Futures Bill enables the Chief Executive in Council to make rules for the means of funding the new Investor Compensation Fund.

Basis for Making a Compensation Claim

43. Under the new arrangements, we envision a rule to be made under the Bill providing that a claim for compensation could be made where a person has a cause of action against a covered intermediary in relation to any money, securities, or futures contracts entrusted to or received by the covered intermediary or any person employed by it. The cause of action would need to relate to securities listed or traded on the Stock Exchange or futures contracts traded on the Futures Exchange.

44. The cause of action would also need to relate to a default by the covered intermediary. Default would mean: bankruptcy or winding up of the covered intermediary; or any breach of trust, defalcation, fraud or misfeasance committed by the intermediary or any person employed by the intermediary.

45. These basic requirements for making a claim are essentially the same as those under the existing compensation funds. But as explained, coverage would be extended to a broader range of intermediaries and the existing separate bases for claims in relation to securities or futures contracts would be combined into one. Coverage would also be limited

to claims made in relation to products traded on the Stock Exchange or the Futures Exchange. *The SFC seeks comments on whether coverage should extend to any other products, including overseas products.*

Exclusions from Claiming Compensation for certain Institutions

46. As set out in the 1998 Consultation Paper, an objective of the new arrangements is to provide a level of protection to retail investors. Following this objective, we believe it is appropriate to exclude institutional investors from claiming compensation under the new arrangements. This is consistent with provisions in the existing arrangements that exclude exchange participants from claiming compensation. The new arrangements would expand the exclusions as follows.

The following persons would not be entitled to claim compensation against a covered intermediary

- A person licensed under Part V of the Securities and Futures Bill (Bill) and any similar person licensed or regulated in another jurisdiction.
- A person granted an exemption by the SFC under clause 118 of the Bill and any similar person granted a similar exemption in another jurisdiction.
- An authorized institution under the Banking Ordinance and any similar person in another jurisdiction.
- A recognized exchange company, a recognized exchange controller, and a recognized clearing house under the Bill and any similar person in another jurisdiction.
- A person authorized to provide automated trading services under Part III of the Bill and any similar person in another jurisdiction.
- An insurance company licensed in Hong Kong and any similar person in another jurisdiction.

- A unit trust, mutual fund and any similar collective investment scheme and its management company in Hong Kong or elsewhere.
- A pension fund and its management company in Hong Kong or elsewhere.
- Any associate (as defined in Schedule 1 of the Bill) of the covered intermediary who has committed the default.
- Any government.

A Single Investor Compensation Fund

47. The new Investor Compensation Fund would be a single Fund to cover defaults of all covered intermediaries. Initial funding would come from residual assets of the existing compensation funds after reserving amounts for outstanding liabilities and returning deposits made by the Stock Exchange and Futures Exchange to the existing funds. As reflected in the table below, we estimate initial funding to be approximately $655.8 million, which is sensitive to intervening events. The vast bulk of these residual assets represent transaction levy paid by investors in the stock and futures markets and payments made to the existing funds by the SFC and the Stock Exchange. We believe the overall arrangement would be fair to all concerned parties.

Unified Exchange Compensation Fund (UECF)	
Balance in UECF after provision for compensation	$575.70 million
Plus future replenishment from the Stock Exchange	$52.20 million
Less refund of deposits to the Stock Exchange	$(46.45 million)
Balance available for transfer to Investor Compensation Fund	$581.43 million
Commodity Exchange Compensation Fund (CECF)	
Balance in CECF after provision for compensation	$95.47 million
Less refund of deposits to the Futures Exchange	$(21.10 million)
Balance available for transfer to Investor Compensation Fund	$74.37 million

Total available for transfer to Investor Compensation Fund	**$655.80 million**

<u>Other Changes to the Existing Compensation Funds</u>

48. In December 2000 in the winding-up of Forluxe Securities, the Court made several decisions concerning, among other things, the SFC's subrogated rights under the existing compensation funds. In summary, the decision was that upon payment of compensation to a claimant the SFC is entitled to a right of subrogation under section 118 of the Securities Ordinance to shares to which the claimant is entitled, but only to the extent which its payment of compensation bears to the loss claimed. The following example was given. A client has entrusted the broker with shares worth $500,000. The broker defaults and the SFC pays the client compensation of $150,000. The client would still have a loss of $350,000. Shares worth $100,000 are then recovered in a winding-up. Under the decision, the SFC would take 30% of the shares recovered (i.e. 150,000/500,000) and the client, 70% (i.e. 350,000/500,000). The provisions in the Securities and Futures Bill concerning subrogated rights are more or less the same as in the existing Ordinance. We would therefore expect the SFC's subrogated rights under the new arrangements to operate in line with the decision in Forluxe.

49. Currently, the UECF limits the total amount that may be paid to all claimants for a default by an exchange participant to $8 million (the limit under the CECF is $2 million). The arrangements for C.A. Pacific and other defaults since 1998 have provided for this limit to be exceeded and for claimants to receive the amount of their losses or $150,000, whichever is less. In addition, it was provided that no claimants would receive less than what they would have received under the $8 million limit arrangement. This meant that some claimants with large claims might receive a second payment in addition to the first payment of $150,000.

50. Under the existing UECF, section 109(3) of the Securities Ordinance provides, in effect, that the first $8 million received by the SFC under its subrogated rights is to be paid out to claimants who still suffer a loss after receiving initial compensation payments and after receiving any

recoveries in the winding-up. This final payment from the UECF is typically made on a pro-rata basis to each claimant's remaining loss. We have not proposed for this additional payment to continue under the new arrangements. Under the new arrangements, the total that would be paid for any size loss would be the claimant's loss or $150,000, whichever is less.

51. The reasons for not continuing the payment arrangements described in paragraphs 49 and 50 relate to the main objectives of the new arrangements set out in paragraph 29. In particular the objective of providing a secure per investor level of compensation for retail investors under a transparent structure that is easy to understand. The payment arrangements concerning the $8 million limit and the first $8 million in recoveries are difficult to understand and do not provide a secure level of compensation.

The ICC

ICC Governance

52. We believe the ICC Board should include representatives of the various persons interested in the new compensation arrangements. This would include representatives of the SFC and HKEx and a representative from the broker community. We also believe that there should be representation of the "public interest".

ICC Staffing

53. The major demand on staff would be the processing and investigation of claims. Historically this responsibility has been with the Exchanges. In view of unpredictability of timing of losses and number of claimants, only a skeleton staff would be retained by the ICC. The staff would be able to respond to investor inquiries and handle a certain amount of the claims processing in the event of a default. A full time Chief Executive Officer of the ICC would not yet be warranted, but this would be kept under review, depending on the level and scope of activity that develops at the ICC.

ICC Outsourcing

54. The collapse of a major retail broker could involve more than 25,000 investors. We believe the ICC should have a goal of claims settlement within 6 months of receipt of satisfactory investor documentation. The workload that is beyond the capacity of the ICC staff, including temporary staff, would be outsourced under ICC control and preliminary costings of $300 per claim have been obtained from loss adjusters.

ICC Costs

55. Indications of costs have been obtained for a staff complement of 6, which would consist of a Manager, a Claims Supervisor, 3 Claims Handlers/Clerks and a Secretary, the computer equipment, suitable office space and other associated business costs. The initial annual costs are estimated at $3,500,000. The additional costs of outsourcing claims are included separately in the modelling referred to in Section IV.

ICC Computer Systems

56. A new enhanced computer system is proposed for the ICC which would have Internet access facilities for both claimants to monitor the progress of their claim and for the loss adjusters to allow central maintenance of records at the ICC. The proposed system would allow for compilation of statistical records, including key ICC performance indicators and other efficiency-related functions to improve the overall claims process.

IV. Risk Assessment and Funding

Historical Losses Updated

57. One method of assessing the risk of loss to the new Investor Compensation Fund is to update historical losses and then calculate an

average annual updated historical loss. We updated each historical loss of the Unified Exchange Compensation Fund (UECF) since 1988 to reflect a payment of up to $150,000 per claimant (prior to 1998 a maximum payout of $8 million per defaulter was applied). We also calculated losses at per investor limits of $200,000 and $250,000. We adjusted each claim to reflect the change in the Hang Seng Index from the date of default to 31 December 1999 (HSI then 17,000). For claims received but not yet determined (see Appendix B) we assumed the claims were valid and would be paid up to the limit. Finally, a concentration factor was applied to reflect the actual change in the number of dealers and an assumed increase in the population of investors of 10% per year.

58. As at 16 October 2000, there had been 6,652 historical successful claims against the UECF with a total allowed amount of $1.17 billion and actual payments made to claimants of $492 million. The results of the updating mentioned above show an updated allowed amount of $2.7 billion and an updated payout at a $150,000 limit of $847 million. We then calculated an average annual updated loss of about $71 million at the $150,000 limit.

Non-exchange Participant Dealers

59. We estimated losses to reflect the extension of coverage to the 200 securities dealers who are not exchange participants of the Stock Exchange. We used SFC data indicating that although trading by these dealers at the Stock Exchange represented 13% of total trading, there were only 13 such firms holding Stock Exchange products for clients amounting to only 0.5% of total assets held by Stock Exchange participants and 2% of the estimated retail assets held. Thus, an increment of 2% of the updated historical losses from exchange participants, or $1,400,000 per year was added.

The Futures Market

60. Next we updated the historical losses of the Commodity Exchange Compensation Fund. The history shows defaults by 22 brokers in 1987 involving 167 successful claimants, and one default since then –

Winton Commence in 1998 involving 21 claimants (see Appendix B). Similar to the updating noted in paragraph 57, we recalculated each historical loss as if there had been a $150,000, $200,000, and $250,000 limit (historically a $2 million limit per broker has applied). We adjusted the amount of each loss by the change in the Hang Seng Index from the date of default to 31 December 1999. A risk improvement factor was applied to reduce the inflationary effect of the Hang Seng adjustment by 20%, as risk management measures applied since 1987 have clearly impacted on the exposure to CECF and resulted in only one loss in the intervening period. We also adjusted each claim amount by a factor reflecting the increase in the number of Futures Exchange participants and in the growth in contracts traded. Finally, we projected an increase of 10% per annum in the number of claimants. The results show a total updated loss for the period of $4.1 billion and at a $150,000 limit an updated payout of $70 million; this results in an average annual updated historical loss of $5.8 million.

61. Similar to paragraph 59, we estimated losses to reflect extension of coverage to futures dealers who are not Futures Exchange participants. Our data indicates that in 1999 the 22 such dealers were responsible for 6% of the number of contracts traded at the Futures Exchange and thus $348,000 was used as an estimate of the additional annual exposure.

Exempt Dealers

62. The updating exercise was performed in relation to licensed dealers only, because the SFC possesses detailed data in relation to that sector of the industry. If, as we propose, exempt Authorized Institutions are to be covered by the new compensation arrangements, these figures will require further fine-tuning to take account of the exempt dealers. The data for this exercise is still being gathered but it is not expected that adjusting the model in the light of that data will produce a fundamentally different analysis.

63. We believe the updated historical losses are conservative. The recently introduced regulation of margin financing and revisions to the FRR described at paragraphs 19 to 24 should lessen significantly the chance of a repeat of the margin financing related defaults in 1998. In addition, experience in other markets does not show a high correlation

between investor compensation claims and stock index appreciation and growth in retail investor participation, although we have built such a correlation into the model.

Actuarial Results/SIPC model

64. In addition to the analysis of Hong Kong loss experience referred to above, an actuarial analysis was performed by Risk Economics Ltd. that incorporates aspects of SIPC payout experience in the United States but retains the Hong Kong pattern and frequency of losses. This approach reflects payouts without reference to per investor limits, and the results are statistically consistent with actual Hong Kong experience. This is a significant indicator that the updated historical losses discussed in this Paper are statistically credible. The potential payouts and the attendant probabilities that payouts would not exceed the indicated amount are shown in the table below.

	Net Payout	Probability Less than Net Payout
Mean	$113 million	62.9%
Mean + 1 Standard Deviation	$252 million	85.6%
Mean + 2 Standard Deviations	$391 million	94.8%
Mean + 3 Standard Deviations	$530 million	98.3%

ICC Model to Assess Risk and Funding Needs

65. Jardine Lloyd Thomson Ltd. has developed for the SFC a model to assess, among other things, the ICC's risk and funding needs. In this section we describe the basic features of the model, the reasoning behind certain inputs to the model, and some of the conclusions that can be drawn from the model. The model used for the purposes of this Paper was able to draw on the extensive data possessed by the SFC in relation to the experience of broker defaults. In order to increase its accuracy and usefulness as a planning tool for the ICC, it is currently undergoing adjustment to take into account the impact of the judgement in the Forluxe Securities case on expected recovery rates and to integrate data being gathered with respect to exempt dealers. Notwithstanding that these adjustments have not yet been made, the

model is sufficiently flexible to have allowed the examination of a wide range of scenarios and we believe it permits valid general conclusions to be drawn.

66. The model contains various inputs of revenue for the ICC, including initial contributions, interest income, and proceeds of a market levy. There are also inputs for compensation payments made by the ICC due to updated historical losses and catastrophe losses, and for administration expenses. Based on these and other inputs, the model calculates a profit and loss statement, balance sheet, and cash flow statement for the ICC. The model simulates borrowings by the ICC captioned "contingent capital" in the model, and interest expense. There is also a feature that simulates insurance coverage and related costs.

Several key aspects of the model are:

Contributions – includes $655.8 million of residual assets from the existing compensation funds and $165 million in recoveries expected from defaults since 1998, assuming a recovery rate of 30% or approximately the historical rate.

Transaction Levy – Volume inputs are based on approximations of historical per annum volume of trades. Stock Exchange volumes are projected to grow at 16% per year, a smoothing of the recent historical rate of 22%. Futures Exchange volumes are projected to grow at 10% per year. There is provision in the models both for an ongoing levy and a special levy to cover a catastrophe loss. The model can simulate an ad valorem or a flat rate levy.

Salaries and Overhead – simulates administration costs of the ICC based on the discussion at paragraph 55.

"Known Losses" – the potential losses that could arise from known margin finance exposure stemming from 1998.

"Expected Losses" – initial inputs are derived from the updated average annual historical losses described from paragraph 57 to 63. In future years, the updated historical loss estimates are increased in

severity in the model by assuming a 10% per year increase in the size of each claim due to assumed Hang Seng Index growth and a 10% per year increase in the number of claimants. Payments from the Fund are assumed to lag by one year. Recoveries are assumed to lag four years from payment.

Cat Losses – simulates catastrophe losses over and above the "expected losses".

Contingent Capital – simulates borrowings and related costs.

Max Loss per Investor – simulates compensation limits per investor of $150,000, $200,000, and $250,000.

Net Assets – simulates the annual net assets of the ICC based on the other variable inputs to the model.

67. The model was used to simulate the condition of the ICC over a ten-year period with no regular levy for income and with updated historical losses as explained above. In this scenario, the net assets of the ICC decline steadily except for one year where a large recovery was assumed. This deteriorating financial condition is largely explained by the growth in historical losses exceeding investment income. Of course if the assumed historical losses did not recur or were less than assumed, the financial condition of the ICC would be better; if historical losses were worse than expected, ICC's condition would be worse. In addition, a levy could be added to the scenario to generate income and improve the ICC's financial condition.

68. Another scenario simulated catastrophe losses in years 3 and 6. These catastrophe losses simulate the severity of the C.A. Pacific default, but with severity increased by increasing investor losses by 10% per year and increasing the number of investors by 10% per year. The gross amounts of these losses amount to $2.84 billion and $5.37 billion. The model reduces these to net payouts based on sample distributions of clients' account sizes and reflecting the $150,000 per investor limit. Net losses amount to $582 million and $914 million. Note also that the updated historical losses continue to apply and that these include the

C.A. Pacific default updated, thus this scenario simulated in a ten-year period three C.A. Pacific losses with severity updated as indicated.

69. A third scenario simulated an extreme catastrophe loss in year 3 of a gross amount of $23.625 billion, resulting in a catastrophe payout of $5.9 billion. This effectively represents the largest retail stockbroker licensed with the SFC in 2000, but with assets and numbers of clients each increased by 10% per year.

70. In each of these two scenarios, the Fund is required to borrow at commercial rates to meet the additional claims but is able to restore itself to a comfortable financial position over the next several years by charging a relatively low rate of additional levy on transactions.

71. It is important to note that the scenarios described above are indicative only. The model is sensitive to the major inputs and assumptions. For example, higher levy rates or higher market volumes would result in higher revenues and vice versa, with knock on effects to the rest of the model. Higher (lower) losses would lead to a worse (better) financial condition for the ICC. Prior to implementation of the new arrangements, changing market conditions or broker defaults could lead to very different results from the model. Importantly, the model would be used by the ICC to regularly update inputs to reflect actual experience.

Conclusions for Funding Needs

72. We believe the results of the modelling lead to several conclusions. First, the assumption that adjusted historical losses continue, the assets of the Fund will be depleted unless it has a regular source of funding. It would be imprudent to relax this assumption until sufficient additional experience had been built up to justify the conclusion that the risk of loss had been reduced. Secondly, as discussed in paragraphs 68 and 69, the Fund could suffer quite large losses under some scenarios. It is a question of judgement how provision should be made for such scenarios in advance of a crisis occurring. To build the Fund to a size sufficient to cover extreme catastrophe losses would involve imposing significant costs on the market that might prove to be unnecessary. It follows that the Fund would need back-up funding

arrangements at least to cover extreme contingencies. On the other hand, to set the size of the Fund too low would not only be inconsistent with the objective of promoting investor confidence, but would increase the likelihood of needing to resort to back-up funding arrangements, with the additional cost this would entail. Balancing these factors, we believe the Fund should build its assets to $1 billion as quickly as possible.

Transaction Levy

73. The levy rates simulated in the scenarios are in our view sufficiently low as not to have an adverse effect on transaction costs or market participant behaviour, even where extreme catastrophe losses are involved. An initial and ongoing levy on market transaction value could also be seen as fairly having collected revenue from those who subsequently might make or be the subject of claims for compensation. A levy could be raised as a part of the transaction levy received by the SFC and the Stock Exchange under section 54 of the Securities and Futures Commission Ordinance.

74. We are mindful that Hong Kong already has relatively high transaction costs. The Stock Exchange and Futures Exchange maintain fixed minimum brokerage commissions, but these are due to be eliminated in April 2002. The present minimum rate at the Stock Exchange is .25% of the trade value. In addition, stamp duty is charged on Stock Exchange trades at the rate of .1125% of the trade value. The Government has indicated that this may be reduced as fixed minimum commissions fall away. There is also a transaction levy of .01% of trade value split equally between the SFC and the Stock Exchange. The table below shows a transaction cost breakdown for various trade sizes at the Stock Exchange, including a .002% compensation fund levy. Also included is the CCASS stock settlement fee of .002% of value (but subject to a $2.00 minimum and a $100 maximum).

Trade size (HKD)	50,000	% Total	150,000	% Total	500,000	% Total
Brokerage	125.00	66.05%	375.00	66.40%	1,250.00	66.40%
Stamp duty	56.25	29.72%	168.75	29.88%	562.50	29.88%
Transaction levy	5.00	2.64%	15.00	2.66%	50.00	2.66%
CCASS settlement fee	2.00	1.06%	3.00	0.53%	10.00	0.53%
Compensation levy at .002%	1.00	0.53%	3.00	0.53%	10.00	0.53%
Total	189.25	100.00%	564.75	100.00%	1,882.50	100.00%

75. We believe a small compensation levy would not harm Hong Kong's competitiveness. Any possible reduction in stamp duty and elimination of fixed brokerage commission should lead to a significant lowering of overall transaction costs. This would offset by far the effect of a small compensation levy.

76. A percentage of trade value levy is how the existing transaction levy works. One option would be to provide funds as needed for the new compensation arrangements out of the existing transaction levy revenues. This has the advantage of not being perceived to impose a "new" transaction cost on the market, unless the levy had to be increased to cover a catastrophe loss.

77. However, this approach would divert funds now used to fund the SFC and thereby reduce the SFC's revenues. The amount involved would be roughly 40% of the SFC's annual transaction levy income. This might result in the SFC having to resume the past practice of seeking funding under provisions that enable an annual payment to fund the SFC out of general revenue in an amount as may be appropriated by the Legislative Council. This would result in general revenues being used to fund the SFC/compensation arrangements, rather than funding from the markets. We note that the SFC has not sought this annual grant since 1993, but the amount involved would be of the same order of magnitude as the amount required to fund adjusted historical losses.

Direct Government funding

78. There is an option that has been used in other contexts for the Government to directly pay for the compensation arrangements. For example, and as mentioned in the 1998 Consultation Paper,

Government has committed to inject $600 million into the Mandatory Provident Fund Compensation Fund. This approach would avoid further taxing the markets, but would result in the general public rather than market participants funding the compensation arrangements.

Assessment of covered intermediaries

79. Another option used in other markets is to assess the covered intermediaries, either on a regular basis or following a default. In this regard, the levy discussed above could be imposed on the covered intermediaries rather than directly on investors. This would give the option to the covered intermediaries to absorb the levy themselves or pass it on to investors. In some overseas markets levies are imposed on covered intermediaries not on a per trade basis, but based on a brokers' revenues or as a lump sum share of a default. This would make it difficult for covered intermediaries to pass the cost on to investors on a uniform per trade basis and each intermediary would determine itself how to pay the cost. These funding alternatives collect the cost from the class of persons who are responsible for defaults, but this is arguably unfair to non-defaulting intermediaries and those dealing for institutional investors who will not receive compensation from the new Fund.

80. In the deposit protection context, one option put forth by HKMA is to collect "premiums" from banks based on "covered deposits", meaning only those deposits that would receive protection (e.g. each covered deposit up to a $100,000 or $200,000 limit). This could conceivably be done with brokerage accounts by collecting funds from each broker for each account up to a $150,000 limit. This has similar pros and cons to the paragraph above, and would include an administrative cost as well.

81. Although the new Investor Compensation Fund will need funding from a levy or some other source as discussed, we would not wish to see the Fund accumulate amounts beyond what is necessary. We believe the SFC and the ICC should adopt a policy that compensation fund assets and income should not exceed a prudent base amount of assets with annual income sufficient to cover updated average annual historical losses plus any likely future adjustments in the per investor limit upon review. If these amounts were to be exceeded, the SFC and the ICC

would look to consulting the market and recommending an increase in the compensation limit and/or a reduction or elimination of any levy that might apply at the time.

82. The modelling also shows the need for back-up borrowing facilities in the event of contingency. These might take the form of, among others, contingent capital from the insurance market or lines of credit from the banking industry. This would have a cost which has yet to be input into the model. We understand that potential lenders would be concerned with the certainty of the levy or other payback arrangements. The availability and cost of back-up financing would vary with the financial condition of the ICC and the certainty of repayment of borrowings.

Conclusion

83. Taking all of these considerations into account, we consider that the new Fund should build its assets to $1 billion. Approximately $650 million of this can be provided from the assets of the existing Compensation Funds but the rest will need to be provided from one of the sources discussed above. On the whole, we favor providing the additional funding gradually from an increase in the existing pro rata transaction levy charged on Stock Exchange transactions. As shown above, the effect on total transaction costs need not be large and the transaction levy provides an administratively straightforward way of collecting the necessary funding to provide protection for retail trading in Hong Kong products irrespective of whether the intermediary used is an exchange participant, a licensed person who is not an exchange participant or an exempt Authorized Institution, since all transactions are ultimately consummated on or reported to the Exchange. (The principles in relation to ATS are set out at paragraphs 35 and 36). There is a trade-off between building up the assets of the new Fund quickly and imposing additional costs on the market. The growth of the Fund largely will depend on whether the historical patterns of losses continues or is reduced by the factors discussed at paragraphs 19 to 24 above. We believe an additional levy of .002% would be adequate to build the assets of the new Fund up to the desired level over time, although this is sensitive to the rate of growth in Stock Exchange transactions, as well as the rates of losses. We believe that the process

of building up the assets should commence as soon as practicable. Pending the enactment of the Bill, the process could start by increasing the existing transaction levy and having the SFC pay it into the existing Unified Exchange Compensation Fund for transfer to the new Fund when formed.

84. We considered whether additional levy, over and above the existing levy of $0.50 per contract per side, should also be charged on Futures Exchange transactions but decided against this, essentially because the model indicates that the major source of claims is expected to arise from Stock Exchange-related business. Should this assumption prove to be incorrect, so that the ICC finds it is facing disproportionate claims in relation to the futures industry, it will be open to it and the SFC to consult the market and to recommend to the Government a corresponding increase in the futures transaction levy.

85. We would expect the additional levy imposed to be terminated once the new Fund had reached assets of $1 billion. We also expect that the ICC will continually re-evaluate its funding needs by using the model developed by Jardine Lloyd Thompson and updating it in the light of the ICC's actual claims experience. Should this reveal that the Fund is likely to be depleted below a prudent level, it would be open to the ICC and SFC to consult the market and to recommend to the Government the resumption of a levy or the increasing of the Fund's assets by some other means.

Alternative Risk Transfer Mechanisms

86. Because of the nature of the underlying losses to the Investor Compensation Fund, which occur as a result of financial default, we believe that only limited traditional insurance capacity would be available. Insurers might be available to underwrite Alternative Risk Transfer programmes that include an element of risk transfer where some premium is paid away for a limit of indemnity. This type of programme would make funds available to enable the ICC to continue to operate and pay compensation claims through periods which would otherwise present liquidity problems, with the "borrowed" funds being paid back over time.

87. The downside of such an arrangement would be that it is relatively expensive in terms of the required premium and the insurer's margin. Furthermore, the available limit would be governed by the amount of premium paid into an experience account, plus any risk transfer amounts. The benefits would be that short term liquidity problems could be overcome, risk transfer elements might be included and that if the funds were not used, they would be substantially returned to the ICC with interest at the end of the term.

88. Both the banking sector and the insurance market may be available to provide contingent capital to the ICC. This would be by way of a standby credit facility to be utilised in the event that the available funds to the ICC breach a pre-agreed threshold.

89. The availability of credit commands an option price which would be payable annually on the amount of credit facility available. Once drawn upon to provide funds to the ICC the drawn amount would be subject to an interest rate.

90. The benefits of a contingent capital facility would include the ready availability of liquid funds from a first class credit counterparty in a simple format and potentially at relatively low additional cost. In addition, it is likely that the size of such a facility could be increased. The downside would be that in the event of a good experience, there would be no return to ICC of the option price paid.

91. A combined experience account, contingent capital and pure risk transfer structure might offer attractive options for the ICC. Support from the Hong Kong Government to provide comfort to potential counterparties with regard to the ability of the ICC to repay amounts loaned, via guaranteed income streams from transaction levy or other sources, would be influential in the final determination.

Government Guarantees/Loan

92. An alternative source of liquidity would be for the Government to make a credit facility available to the ICC whereby the ICC would pay commercial interest rates on any amount drawn down. In commercial markets, the ability of the ICC to secure credit would be affected by the extent of guarantee provided by the Government to potential counterparties. We note that in the C.A. Pacific arrangements, the Government indicated that it would seek funding from the Legislative Council if necessary. This approach could be continued.

V. Implementation

93. Following enactment of the Securities and Futures Bill (Bill), the following steps would need to be taken to bring the new investor compensation arrangements into place.

Constitute the ICC

94. The ICC would need to be incorporated, provisions made for its staffing and operations, including information technology systems, and its Board constituted. The SFC would need to recognize the ICC following consultation with the Financial Secretary under clause 79 of the Bill, including considering whether to apply any conditions to recognition.

Rules to be Made by the Chief Executive in Council

95. The Chief Executive in Council would need to make rules under clause 236(1) to set, among other things, the maximum amount that can be paid to a claimant. Rules might also be made to set the framework for funding as discussed in Section IV. The Chief Executive in Council would also be asked to transfer certain functions of the SFC to the ICC, with concurrent exercise of those functions by the SFC, in particular relating to ICC's handling of monies and administration of the compensation arrangements.

Rules to be Made by the SFC

96. The SFC in consultation with the Financial Secretary would need to make the main rules for the compensation arrangements under clause 236(2) and consistent with rules made by the Chief Executive in Council. The SFC would need to approve the ICC's rules under clause 83. The SFC would also need to make rules under clause 88 to set reporting requirements for the ICC.

Winding up of the Old Funds, etc.

97. Under Schedule 9 of the Bill (clauses 72 and 73), the SFC would need to determine the amounts needed in the old compensation funds to pay outstanding liabilities and to return deposits to the Exchanges and to transfer other amounts to the new Investor Compensation Fund. There are numerous other procedures to be followed under Schedule 9, including in relation to the Dealers' Deposit Funds. Also under Schedule 9, the Secretary for Financial Services would need to set the appointed days for the start of the new arrangements. Finally, the SFC would need to undertake a public awareness and education programme for the new arrangements.

Encl.