Consultation Conclusions on

Proposed New Investor Compensation Arrangements

Hong Kong
March 2002

INTRODUCTION

1. The Securities and Futures Commission issued a paper on 7 March 2001 to solicit comments on proposals for new investor compensation arrangements for Hong Kong ("the Paper"). A total of 12 submissions were received, two of which confirmed they had no comments. The material comments received and the Commission's responses are summarized below.

A New Single Compensation Fund

Comment

2. There was general overall support for the proposals described in the Paper. One respondent specifically supported a new single compensation fund that would replace the existing Unified Exchange Compensation Fund ("UECF"), the Commodity Exchange Compensation Fund and the Dealers' Deposits Schemes for non-exchange participant dealers and provide a single point of access for investors. One respondent considered that the present arrangements are satisfactory and had reservations about the new arrangements.

Commission's Response

3. A single compensation fund will facilitate claims by investors and will achieve economies of scale in operation.

Expanded Coverage of Intermediaries

Comment

4. Five respondents supported extending coverage to claims against non-exchange participants including Authorized Institutions. One respondent suggested that to ensure fairness and a level playing field, Authorized Institutions should be subject to the same levy and also the same regulatory requirements as Exchange Participants.

Commission's Response

5. Expansion of coverage will provide a certain level of protection to all retail investors trading in Hong Kong Exchanges and Clearing Limited ("HKEx") products whether through Exchange Participants or non-Exchange Participants. Trading in HKEx products is subject to a levy including when Authorized Institutions initiate the trade.

Comment

6. One respondent sought clarification as to whether overseas clients of covered intermediaries should be able to claim.

Commission's Response

7. Overseas clients trading through Hong Kong covered intermediaries will be able to claim as they can under the existing arrangements. This enhances the attractiveness of the Hong Kong markets.

Comment

8. Four respondents opposed the exclusion of institutional investors.

Commission's Response

9. The Commission considers that the scheme should be aimed at protecting retail investors. Institutional investors are better equipped to assess their counterparties and do so in practice. We also believe that the proposed maximum amount of compensation of $150,000 is not a meaningful amount for institutional investors.

Coverage of Non-HKEx Products and Overseas Products

Comment

10. Comments were split on whether the new arrangements should cover non-HKEx products and overseas products. Those supporting extension of coverage considered that it would be in keeping with the aim of providing a secure level of compensation to retail investors. Some of the respondents objecting to the

extension raised concern about cross subsidy since the bulk of the assets in the new compensation fund will come from levy from HKEx products. One respondent considered that extension of coverage might be acceptable if a levy of similar rate was imposed on trades in non-HKEx products.

Commission's Response

11. The Commission notes that trading in some overseas products is covered by overseas compensation arrangements. The Commission will study, including via Commission surveys of intermediary activity and of investors, the extent of retail investor activity in non-HKEx and overseas products. The Commission will consider whether coverage might be appropriate and if so how it should be funded.

Funding of Compensation Fund

Comment

12. One respondent supported the 0.002% levy to achieve the $1 billion target fund size for the new Compensation Fund. One respondent commented that the residual compensation fund assets of about $655 million would be enough and the 0.002% levy unnecessary.

Commission's Response

13. Having considered actuarial estimates and other risk factors, the Commission believes $1 billion is a prudent level.

Comment

14. One respondent was concerned that the 0.002% increase in levy might affect trading volumes or require institutions who may not benefit from the new arrangements to nevertheless fund the scheme.

Commission's Response

15. The Commission expects that the 0.002% increase in levy will be in place for a relatively brief period of time to enable the new fund

to reach $1 billion, after which the new fund may be self-sustaining, subject to continuing assessment. Meanwhile, overall transaction costs have fallen with a decrease in stamp duty, thus softening the impact of the 0.002% levy. On balance, the Commission believes the overall arrangement is fair. It is also the case that previous funding for the existing compensation fund has come partly but indirectly from the transaction levy.

Comment

16. One respondent suggested that HKEx would be a beneficiary of the new arrangements and should contribute to their cost.

Commission's Response

17. HKEx previously contributed $300 million to the UECF. The Commission considers this to be an appropriate contribution by HKEx.

Comment

18. One respondent commented that the covered intermediaries will have no incentive to reduce or control their risks if they are not asked to contribute to or top up the fund.

Commission's Response

19. Covered intermediaries are already subject to the prudential supervision of the Commission or the HKMA, including being subject to risk-based capital requirements.

Per Investor Limit

Comment

20. One respondent expressed support for the per investor level of compensation. Two respondents expressed concern that the new arrangements might create moral hazard.

Commission's Response

21. The Commission believes a number of factors weigh against moral hazard. First is the compensation limit. Assets in excess of the limit held with a covered intermediary will not be eligible for compensation. Second, there is the inconvenience of claiming compensation and a delay in the receipt of compensation payments, meanwhile securities remain at risk during this period. Third, the Commission and HKMA regulate the covered intermediaries using risk-based methods that either prohibit certain risky practices or impose added capital requirements. Finally, the Commission notes that although moral hazard will exist to some extent, investor compensation arrangements are the norm in developed overseas markets.

Comment

22. One respondent suggested further study of the $1 billion target and the $150,000 limit with a view to increasing coverage for investors.

Commission's Response

23. The $150,000 limit will be reviewed after initial experience is gained under the new arrangements. Generally, the Commission expects to maintain a relatively consistent measure of coverage in relation to a typical retail investor, subject to funding constraints.

Comment

24. One respondent suggested there should be a $150,000 limit for each type of licence held by a covered intermediary.

Commission's Response

25. To maintain past coverage, the Commission proposes that a claimant be eligible for $150,000 coverage for a securities account, and $150,000 coverage for a futures trading account when dealing with a single intermediary in default. However, consistent with past coverage, the claimant must have a cause of action against the intermediary in default and will not be able to claim indirectly through a non-defaulting intermediary.

Comment

26. One respondent sought clarification whether investors may open more than one account with the same intermediary in the names of different nominees to ensure that his loss would not be limited to $150,000. The respondent asked whether the entitlement to compensation is only available to a claimant who is the beneficial owner of the account in question.

Commission's Response

27. The Commission's intention is that the limit applies per investor and that if multiple accounts are held for the same beneficial owner with the same broker the coverage will be capped at $150,000 for all such accounts.

The Investor Compensation Company ("ICC")

Comment

28. One respondent suggested that if there were no defaults, ICC's cost will not be justified.

Commission's Response

29. The Commission intends that the ICC will be very small with most of the ICC functions outsourced. The ICC can perform investor education work when not occupied by a default.

Comment

30. One respondent suggested that both industry and public interest representatives should be in the governing body of ICC.

Commission's Response

31. The Commission agrees.

Alternative Mandatory Private Insurance Scheme

Comment

32. One respondent suggested that a mandatory insurance scheme, regulated by the Commission or other relevant authority could provide the appropriate level of comfort for market participants without the headaches of establishing an ICC.

Commission's Response

33. The Commission has discussed this possibility with its consultants and understands that it is difficult if not impossible to obtain in Hong Kong insurance for potential unlimited losses such as would be posed by coverage of $150,000 per investor.

Securities and Futures Bill ("SF Bill")

Comment

34. Three respondents opposed the SFC's subrogated rights.

Commission's Response

35. The Commission considers that the total removal of subrogated rights would have made the new scheme more expensive. In the SF Bill the Commission's subrogated rights were modified so that its rights now rank proportional to the claimants rather than having any priority. There are also defaults where a winding up is not instituted. In such cases, it is important for the Commission to have subrogated rights to bring an action against the defaulter effectively on behalf of all claimants.

Other Issues

Comment

36. One respondent suggested that the Commission should take steps to educate investors about the limitations of the coverage of the new arrangements.

Commission's Response

37. An investor education campaign will be undertaken when the proposals are finalized and in advance of implementation.

Comment

38. One respondent expressed concern that the new arrangements might create increased competition among brokers.

Commission's Response

39. Competition has already increased through Internet broking and will increase with the deregulation of brokerage commission. The Commission also believes that competition benefits investors.

IMPLEMENTATION

40. The SFC staff have commenced preparing for the launch of the new compensation arrangements. Parts III and XII of the Securities and Futures Ordinance, which was enacted on 13 March 2002, enable the details for the new arrangements to be provided in rules made by the Chief Executive in Council and the SFC. This subsidiary legislation will be the subject of a public consultation paper.