



SECURITIES AND
FUTURES COMMISSION
證券及期貨事務監察委員會

Consultation Conclusions on the Review of the Level and Funding of the Investor Compensation Fund, Broker Defaults since 1998 and the Operation of the Investor Compensation Arrangements

有關檢討投資者賠償基金的水平及經費、自1998年以來發生的經紀違責事件及投資者賠償安排運作情況的諮詢總結

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INTRODUCTION

1. The Securities and Futures Commission issued a Consultation Paper on “Review of the Level and Funding of the Investor Compensation Fund, Broker Defaults since 1998 and the Operation of the Investor Compensation Arrangements” (“the Consultation Paper”) on 22 December 2004.
2. The consultation period ended on 4 February 2005. Twelve submissions including a late submission were received. One respondent confirmed that it had no comment. The material comments of the remaining eleven respondents who have made comments and the Commission’s responses are summarized below.

Level and Funding of the Investor Compensation Fund

Comment

3. Nine respondents supported the Commission’s recommendations to suspend and reimpose the current investor compensation levies if the net asset value of the Investor Compensation Fund (“ICF”) exceeds \$1.4 billion or falls below \$1 billion respectively. They also supported the procedures for the automatic levy triggering mechanism proposed in the Consultation Paper. One other respondent agreed that the investor compensation levies should not continue to be collected after the ICF has reached a prudent level but it suggested that the review of fund requirements be made subsequent to a review and consultation on the appropriate level of compensation coverage. In addition, this respondent suggested that \$1.63 billion or above appeared to be a more appropriate prudent level for the ICF. Another respondent agreed that there should be an automatic triggering mechanism for suspension and reinstatement of levies.

Commission’s Response

4. The proposed upper and lower levels of \$1.4 billion and \$1 billion respectively specified in the automatic levy triggering mechanism have been determined based on the actuarial model and funding approach adopted for assessing the appropriate size of the ICF. The Commission considers that it is inappropriate to use \$1.63 billion or above as the prudent level for the ICF because the figure of \$1.63 billion as stated in the Consultation Paper reflects the potential size of the exposure of the ICF due to a possible default by the largest retail broker under an extreme and unlikely scenario where all clients assets of the failed broker would be missing or misappropriated. In order not to accumulate amounts beyond what is necessary for the ICF and to reduce burden on investors, the Commission should proceed to introduce the automatic levy triggering mechanism as soon as practicable.

Level of Compensation Coverage

Comment

5. Nine respondents supported the Commission's recommendations to retain the \$150,000 per investor compensation limit. One other respondent suggested that the review of fund requirements should be made subsequent to a review and consultation on the appropriate level of compensation coverage and it suggested that \$204,000 should be used as a starting point in determining the compensation level. Another respondent commented that the existing level of compensation limit may be inadequate because on average only 76% of claimants have losses paid in full from the ICF and it suggested increasing the per investor limit so that the percentage of claimants receiving full compensation would be increased.

Commission's Response

6. In determining to retain the current per investor compensation limit of \$150,000, the Commission has considered several factors including the percentage of claimants whose losses are paid in full from the compensation fund, the average size of allowed claims for compensation, inflation and the level of the Hang Seng Index. The \$150,000 per investor compensation limit has provided consistent coverage to investors since 1998 by providing a 76% accumulated percentage of claimants paid in full and most respondents support it. Moreover, setting the limit at too high a level would increase moral hazard. As such, the Commission concludes that the \$150,000 per investor compensation limit should be maintained. The Commission will, however, review the per investor compensation limit if experience shows that the average level of coverage has fallen significantly.

Power for the ICF to advance funds to redeem pledged shares

Comment

7. Nine respondents supported the Commission's recommendation not to pursue the suggestion to advance funds to liquidators to facilitate the return of clients' shares pledged by a broker to a bank as security for a loan.
8. One respondent considered that this suggestion is worthy of further exploration by the Commission. In order to balance the investor benefits against any cost implication to the ICF and deal with the alteration of the existing proprietary rights of investors as noted in the Consultation Paper, the respondent suggested that rules could be made to specify circumstances (e.g. possibility of substantial delay in the liquidation process) under which the ICF may, in appropriate cases, advance funds for facilitating the return of client's shares pledged by a

broker as a security for a loan. Another respondent indicated that it is worth re-examining the current practice in which shares held under margin financing accounts are not segregated and can be pledged irrespective of whether a loan is collateralised with the shares held under respective clients' accounts.

Commission's Response

9. The Commission provided a detailed analysis of the pros and cons of the suggestion in the Consultation Paper. Most of the respondents agreed to the Commission's proposal not to pursue the suggested approach because such an approach would involve additional expense to the ICF, increase moral hazard for the banks and involve an alteration of the existing proprietary rights of clients. Legal uncertainties arising from the large broker defaults in recent years have been resolved by the courts which would help speed up the liquidation process and the return of pledged shares from banks in the future. Nevertheless, the Commission will continue to monitor the practices in this area in order to identify and address issues which may slow down the liquidation process.

Power for liquidators to sell securities and distribute money

Comment

10. Nine respondents agreed not to pursue the suggestion to give power to liquidators to sell securities and distribute money.
11. One respondent considered that, to save administrative costs in administering clients' securities, options other than empowering liquidators to sell clients' securities and distribute the money are worthy of further deliberation by the Commission. It noted that the Canadian Investor Protection Fund works with a trustee to arrange to have some or all client accounts transferred, or sale of an insolvent firm's business to another securities firm where the clients can access the account directly to permit clients to continue dealing with their accounts in an orderly way and to reduce losses. The overriding concern should be that if ownership of clients' shares is identifiable, they should be returned to their respective owners.

Commission's Response

12. Regarding the comments by a respondent on the arrangements to transfer client accounts of an insolvent securities firm to another securities firm or to sell the business of an insolvent securities firm to another securities firm, whether such arrangements are necessary or feasible will depend very much on the facts of each case. The Commission will consider any feasible options which would help reduce the difficulties encountered by clients in the event of a broker default on a case by case basis. In view of the majority view of the

respondents, the Commission will not pursue the suggestion but will continue to monitor the development of the law in other major jurisdictions.

Use of ICF funds to pay for the costs of an administrator

Comment

13. Ten respondents agreed not to pursue the suggestion to pay for the costs of an administrator. In addition, one of them supported the recommendation that the Commission should where practical strive to appoint an administrator at an early stage to protect client assets and return shares to clients. It also suggested that the ICF may consider, for benefits of claimants, to specify itself or the Commission as administrator in circumstances that the liabilities of a debtor to unsecured creditors appear to aggregate to a small amount and that there appears to be a small number of clients of such debtor.

Commission's Response

14. The ICF will not pay for the costs of an administrator. Under section 213(2)(d) of the Securities and Futures Ordinance, the Commission can apply for a court order to appoint a person to administer the property of another person including a defaulting broker under certain circumstances. It will consider the practicality of appointing the Investor Compensation Company Limited as administrator in straightforward cases.

Other Issues

Comment

15. One respondent considered that the cost of financing the ICF should, in principle, be borne by the firms involved instead of being primarily funded by investors as the source of compensation funding for similar investor compensation schemes in other jurisdictions (e.g. Canada, the UK and the US) is mainly industry-based. Funding source is an area which this respondent feels that there is the greatest need for immediate action. This respondent also pointed out that as to an industry-funded compensation scheme, some may argue that the costs of the levies although initially borne by firms are likely to be passed on to customers through higher charges. As a result, the benefits of not requiring direct payment from investors may be partly removed through the transfer of costs by firms. However, the respondent still sees a benefit in that the change in the way the ICF is funded may affect the behaviour of consumer, e.g. consumers may derive confidence from the commitment of the industry through contributions to an industry-funded compensation scheme and hence be more likely to invest in the securities market.

Commission's Response

16. The framework for the current funding arrangements for the ICF was first discussed in the consultation paper "Proposed New Compensation Arrangements" published by the Commission in 2001. At that time, the Commission did not receive any adverse comment on this issue. It is recognised that this is a complex issue and any change to the current funding arrangements will require careful consideration of the pros and cons of the proposal. Although the issue raised by the respondent is not one of the proposals discussed in the Consultation Paper, the Commission, nevertheless, takes note of the concerns highlighted by the respondent.

IMPLEMENTATION

17. The Commission is working with the Government to introduce the necessary legislative changes to facilitate the implementation of the proposals.