



香港證券經紀業協會有限公司
HONG KONG STOCKBROKERS ASSOCIATION LIMITED

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Comments On

A Consultation Paper 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

**Hong Kong Stockbrokers Association
4 February 2005**



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Introduction

1. The Investor Compensation Fund (ICF) is an important component of the total package of investor protection that the SFC has implemented as part of the SFO. It is a last resort whereby investors will receive some compensation in case of broker default that could not otherwise have been prevented by the supervision of the SFC. As such, we believe that any changes to the operation of the ICF must be considered carefully, as it is the last level of investor protection.
2. In principle, we agree that the ICF levy should not continue to be collected after the ICF has reached a prudent level. However, we would suggest that the review of fund requirements be made subsequent to a review and consultation on the appropriate level of compensation coverage.
3. From the standpoint of investors, the levy of 0.002% is insignificant compared to the peace of mind of a compensation arrangement in case of default. For long term investors, a levy of 0.002% should not represent a significant cost when compared to their expected return. Our retail clients who trade much more actively, have also not complained about the added costs.
4. We believe that the only beneficiaries of turning off the levy would be issuers of derivative instruments who may be in the market to arbitrage their positions, and therefore look on the levy as an added cost. However, we must be careful that we do not adversely affect the genuine investors in order to lower the costs of operations of market operators.

Assessment of Compensation Coverage

5. We believe that there are two key issues in determining the adequacy of the ICF:
 - a. The compensation limit of HK\$150,000 per investor, and
 - b. The percentage of claimants paid in full of approximately 76% i.e. 76% of claimants would have allowed claims of less than HK\$150,000.



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6. The average allowed claim through 2002 was HK\$204,271. The highest allowed claim (since the HK\$150,000 limit was imposed) was \$438,389 (Foreground Sec. Co. Ltd.) where only 54% of claimants were paid in full i.e. had allowed claims of HK\$150,000 or less. The lowest allowed claim was HK\$80.28 (Teil) where 100% of claimants were paid in full i.e. had allowed claims of HK\$150,000 or less.
7. We suggest that the SFC reconsider whether the HK\$150,000 per investor limit is appropriate in light of the changed circumstances since the C.A. Pacific default in 1998. The level of compensation should not be set in absolute terms but should reflect changes in inflation levels, changes in the level of the market e.g. the HSI, and most importantly changes in investor behaviour and market developments.
8. Since C.A. Pacific, the Administration has moved to develop the HK capital market, and privatise government assets such as the Link Reit and the Airport Authority. Many investors who have previously not invested in listed securities, and cannot be classified as speculators have entered the market to take advantage of the better returns offered by these instruments. Thus, the percentage of assets of the general public invested in listed securities have risen and will continue to rise as the administration privatise more assets.
9. From the statistics presented, we are not able to draw any conclusions as to what the limit should be. We believe that a funding model should be developed that shows the compensation level charted against the percentage of claimants paid in full, and the total payment at each level. This would allow interested parties to make informed decisions as to the appropriate level of compensation, the coverage of claimants, and the total payment involved.
10. We understand that the HK\$150,000 compensation limit and the 76% coverage were set specifically for the C.A. Pacific payout. At that time, we did not have the ICF in place and the payment was made out of SFC and HKEx funds. Now that the ICF has been established, we have an opportunity to determine the appropriate level without the constraints imposed by the SFC and HKEx funding availability.
11. It would seem appropriate that the average allowed claim amount of HK\$204,000 should be used as a starting point in determining the compensation level.



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12. We understand that the SFC is concerned that a higher level of compensation may create a moral hazard in that investors would be less cautious in selecting their broker. We believe that this concern is misplaced. Investors choose their stockbroker on the basis of service offered, and lower costs is not a significant factor in the decision making process. In fact, an investor will choose a more expensive but reputable broker in order to protect their assets.

Level and Funding of the ICF

13. We understand that the proposal is to set a floor of HK\$1.0 billion on the ICF with a cap of HK\$1.4 billion. We believe that the decision on appropriate level for the floor and the cap can only be made after an appropriate level of compensation limit and coverage has been made. As discussed earlier, we do not believe that there is sufficient data to make an informed decision absent a funding model against which various scenarios can be tested.
14. In Appendix 3 Market Environment Compared to 2001 paragraph 6, we note that the SFC has performed a sensitivity analysis by simulating a possible default by the largest retail broker. The result suggested that the exposure would be about HK\$1.63 billion at the limit of HK\$150,000. Although, the paper concluded that this is an extreme and unlikely situation, it is nevertheless a possibility which must be planned for. Therefore, it would appear to us that HK\$1.63 or above would be a more prudent level for the ICF floor.
15. The paper assumes that at the proposed cap of HK\$1.4 billion the ICF would be self funding at its current level of operating expenditure of HK\$5 million and expected claims payment of HK\$55 million (based on historical average), and an investment return of 4.3%. We agree that the annual operating expenditure can be tightly controlled, and that over time, the expected claims payment would approximate the historical level. However, we are unable to assess whether 4.3% investment return is achievable over the long term given the need to be risk averse in investing the ICF.
16. We agree that after an appropriate level of compensation and coverage has been set, the mechanism to turn the ICF levy on and off would be workable with sufficient notice.



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Review of Broker Defaults

17. We note the discussions on various brokers default since 1998, and have no comments.

Suggestions on Handling of Defaults

18. We are not in a position to comment on the legal aspects of liquidators' power to deal with clients' securities. We would comment that ICF resources should not be made available to liquidators to be used to redeem shares pledged by a defaulting broker to banks, and that the costs of an administrator appointed by the SFC should not be paid from ICF assets.

Conclusion

19. We believe that the levy is not a significant burden on genuine investors, and that the ICF serves a useful purpose as the last resort in the case of a broker default.
20. We now have an opportunity to revisit the appropriateness of the compensation limit and the level of coverage to be provided without the pressures of a major default, and without having to consider the limit of funding resources available to the SFC and the HKEx. In the case of C.A. Pacific in 1998, an arbitrary decision was made to set the compensation limit at HK\$150,000. The 76% coverage was a result of the limit set, and therefore should not be set as a target to be achieved.
21. The proposed HK\$1.0 billion floor and HK\$1.4 billion cap would appear not to be sufficient as a default by the largest retail broker would expose the ICF to HK\$1.63 billion in potential allowed claims.