

A Consultation Paper on
New Investor Compensation
Arrangements for Hong Kong

Hong Kong
September 1998

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A Consultation Paper on

New Investor Compensation Arrangements for Hong Kong by the Securities and Futures Commission

Prepared by the Supervision of Markets Division
September 1998

FOREWORD

This Consultation 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 30 November 1998**.

This Consultation Paper can also be found at the SFC's website *www.hksfc.org.hk*. Comments can be submitted by e-mail to *enquiry@hksfc.org.hk*.

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I. EXECUTIVE SUMMARY

1. The Securities and Futures Commission (SFC) is proposing for public consultation new investor compensation arrangements for clients of members of The Stock Exchange of Hong Kong Ltd. (Stock Exchange). The main features of the proposals are as follows.

New legislation would define an investor compensation company which would be recognized by the SFC in the public interest for facilitating new investor compensation arrangements. The company (NewCo) would be independent, but with representative directors from the SFC, the Stock Exchange, and Financial Secretary appointees to represent the public interest.

The new arrangements are designed to be flexible and to provide a framework upon which other compensation arrangements can be based. These might in future include arrangements in respect of non-exchange member dealers, securities margin finance company dealers, and members of the Hong Kong Futures Exchange. NewCo might also play a role in facilitating broker fidelity insurance arrangements.

The substantive and procedural requirements for claiming compensation would be contained in NewCo's rules, which would require approval by the SFC. A main feature would be the introduction of a per investor level of compensation, as used in other financial centres. We estimate that the level would be \$100,000 or more but less than \$250,000 using existing compensation fund assets and subject to negotiation with insurance underwriters.

The proposed risk financing structure for the new arrangements is designed to protect and leverage the existing assets of the compensation fund. With a relatively high level of confidence statistically, no new funds would be required from Stock Exchange members or investors. However, a regular funding source would be considered if the compensation fund assets fall below a prudential level. Moreover, the structure is sufficiently flexible to provide varying levels of protection, including higher per investor levels of compensation if risk exposures decrease or available funding increases.

A specified amount of risk would be retained by NewCo with certain of the excess risk covered by insurance. Specialist underwriters would assist in quantifying risk and in recommending ways to improve client asset protection mechanisms. These would likely include improved external audit requirements and "contingent premiums" payable by brokers who fail to correct inadequacies identified by external auditors, the Stock Exchange, or the SFC.

To be able to provide a true guarantee of coverage per investor, back-up funding sources would be needed. We propose to seek a credit facility from Government or from banks or other private lenders repayable by a levy at the Stock Exchange if the credit facility is activated. Based on the proposed risk financing structure and related actuarial and statistical analyses, there is a low probability that the facility would be used.

The implementation of already planned regulatory measures to reduce risk to client assets should reduce the costs of the new arrangements and enable higher investor compensation limits in future. These include the Government's proposals to regulate share margin lending and the SFC's proposed changes to the Financial Resources Rules.

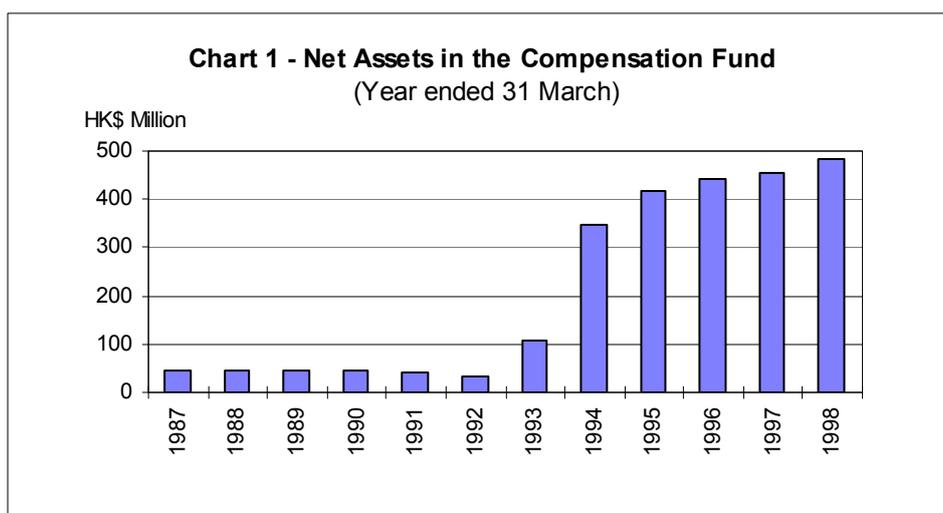
II. BACKGROUND

A. The Existing Compensation Fund Arrangement

2. The Securities Ordinance (Cap. 333) (Ordinance) Part X has provided for a compensation fund for securities market investors since 1974. The fund originally applied to a default by a member of any of the four stock exchanges in operation until 1986. Since the unification of those exchanges in 1986, it has applied to a default by any member of the Stock Exchange. The basic features of Part X of the Ordinance have remained essentially the same since 1974.
3. The Ordinance requires the SFC to establish and maintain a compensation fund. It also provides for a Securities Compensation Fund Committee to administer the fund on behalf of the SFC. The Committee consists of five persons appointed by the SFC, including two persons nominated by the Stock Exchange.
4. The basic requirement for making a claim is stated in section 109 of the Ordinance -
 - (1) *Where, in consequence of any act done in the course of or in connection with the stockbroking business of a stockbroker, a person has a cause of action against that stockbroker in relation to any money, securities or other property entrusted to or received by the stockbroker or any partner of the stockbroker or any person employed by the stockbroker, that person shall be entitled, subject to this Part, to claim compensation from the compensation fund in respect of any pecuniary loss suffered by him.*
5. Section 109 also sets a limit to the total amount of compensation that can be paid in relation to a default by a member of the Stock Exchange. The original limit was \$1 million, which was raised to \$2 million in the 1980's and to \$8 million in 1992. If the allowed claims of investors exceed the limit, the \$8 million is apportioned among the claimants under section 120(2) of the Ordinance. The fund pays compensation in cash only.
6. Whilst the SFC and the Securities Compensation Fund Committee are responsible for maintaining the fund, the Stock Exchange is responsible for determining the validity of claims under section 113 of the Ordinance. The Stock Exchange has a compensation committee to oversee compensation fund matters. The Stock Exchange must notify each claimant of its decision to allow or disallow the claim, and the reasons for any disallowance. The Stock Exchange is also responsible for apportioning claims where the total amount allowed exceeds the \$8 million limit. The SFC is responsible for paying claimants. A notice from the Stock Exchange allowing a claim is sufficient authority for the SFC to pay.
7. After a payment is made to a claimant, the SFC is subrogated to the claimant's rights against the defaulting broker to the extent of the payment under section 118 of the Ordinance. The SFC pursues its rights against the broker, for example by filing a proof of debt in a pending winding-up or bankruptcy proceeding involving the defaulting broker. If the SFC recovers money in this way and claimants have not

been paid the full amount of their allowed claims, the recoveries are paid to claimants under section 109(3).

8. The original funding for the compensation arrangement was provided under section 104 of the Ordinance, which requires the Stock Exchange to deposit and keep deposited with the SFC \$50,000 in respect of each membership in the Stock Exchange. The Stock Exchange's rules require each new member to make a \$50,000 deposit to the Stock Exchange. This arrangement has provided the compensation fund with approximately \$46 million. Moreover, when any of this money is paid out to claimants, the Stock Exchange is responsible under section 107 of the Ordinance for replenishing any unrecovered amounts paid, but only after the SFC has exhausted all its subrogated rights against the defaulting broker under section 118 of the Ordinance.
9. An additional source of funding the compensation arrangement was put in place in 1992. The Financial Secretary set budget guidelines for the Stock Exchange, which provided, among other things, that transaction levy paid by investors and retained by the Stock Exchange under section 52 of the SFC Ordinance (Cap. 24) would be limited to one-third of the Stock Exchange's budgeted expenses for each financial year. Any excess would be paid into the compensation fund. Between 1992 and 1994, the Stock Exchange paid approximately \$354 million in "excess" transaction levy to the fund. The budget guideline was amended from the year 1994/95 to provide for transfer of "excess" levy to the Stock Exchange's retained surplus.
10. The net asset position of the compensation fund from March 1987 to March 1998 is summarized in Chart 1 below. The assets include interest income from investments, which under the investment policy are confined to bank deposits and buying and holding to maturity Hong Kong dollar fixed income instruments of high credit quality. The net assets do not include the additional funds mentioned in paragraph 24 below. As of 31 August 1998, the net assets of the fund were approximately \$500 million.



B. Claims and Payout History

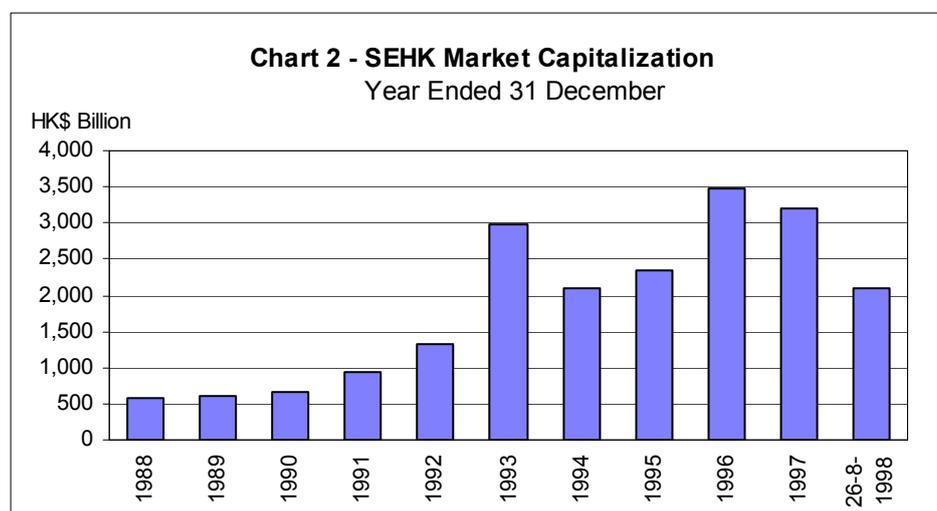
11. Since 1987, as summarized in Appendix A, there have been 13 cases of broker defaults resulting in payouts from the compensation fund. A total of 328 claims were allowed by the Stock Exchange with an average ratio of payment to the amount of allowed claim of 69 percent. Looking behind the average reveals a payment ratio from 17 percent to 100 percent. The total amount paid from the fund, excluding recoveries, amounted to \$39,324,000. At the time of publication of this Paper, there were 10 compensation fund cases pending, including those mentioned in paragraph 25 below.

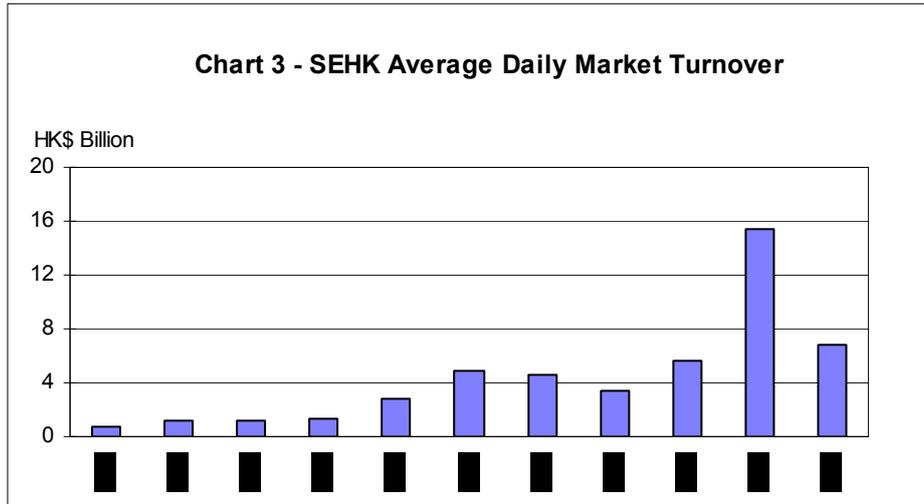
C. 1996 Actuarial Evaluation of the Compensation Fund

12. In response to the growth in the net assets of the compensation fund, the SFC and the Securities Compensation Fund Committee commissioned an actuary to evaluate the adequacy of the fund. Evaluation scenarios included payouts under the \$8 million limit, under different per broker limits, and under various per investor (rather than per broker) compensation limits. Data gathered for the evaluation was dated from 1995 and a report was finalized in October 1996.
13. The actuarial report concluded that the net assets of the compensation fund were sufficient to cover expected payouts under the \$8 million limit. It also concluded that an increased per broker limit could be considered as could per investor limits. But, the report noted that expansion of the market would need to be kept under review and that data limitations had prevented an analysis of, among other things, concentration of stocks in dealers' portfolios. Finally, the report did not analyze the margin financing activities of unregulated finance companies affiliated with Stock Exchange members.

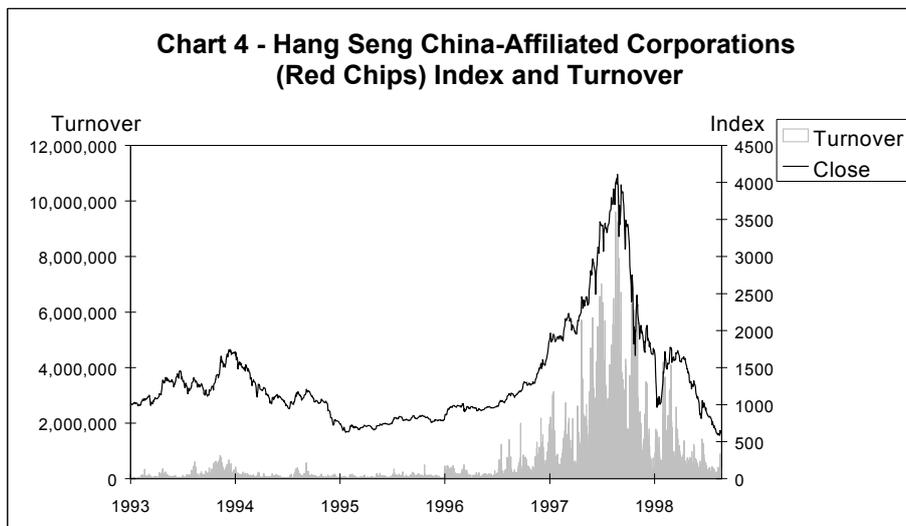
D. Securities Market Growth and Volatility

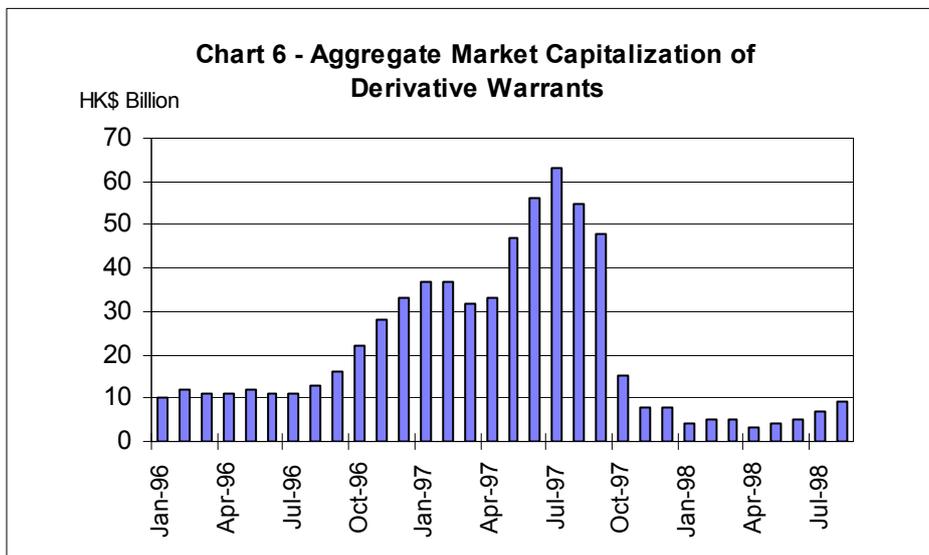
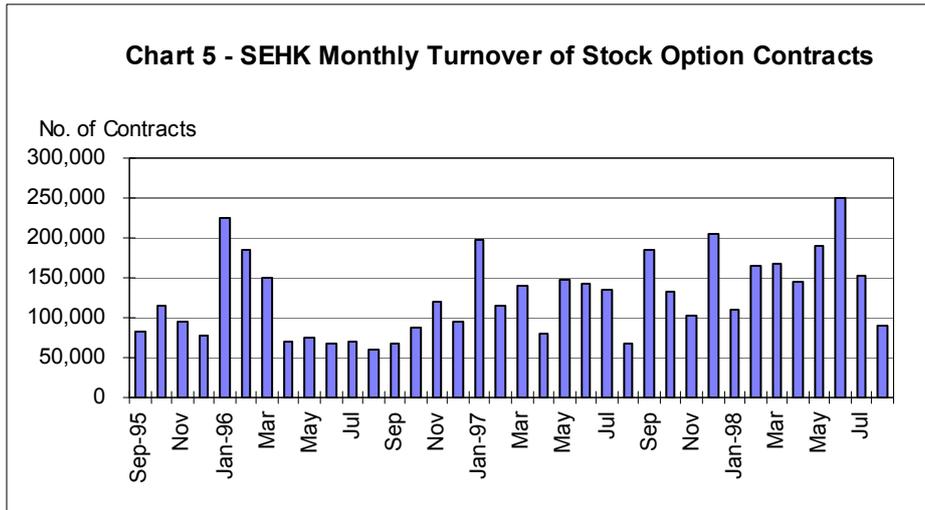
14. As shown in Chart 2, the market capitalization of shares at the Stock Exchange grew rapidly in the early 1990's. It increased roughly 7-fold from 1988 to 1996, but has since decreased in 1998. The volume of trading grew and fell along with market capitalization, but not in direct proportion as shown in Chart 3, in particular there was a surge in turnover in the summer and fall of 1997.



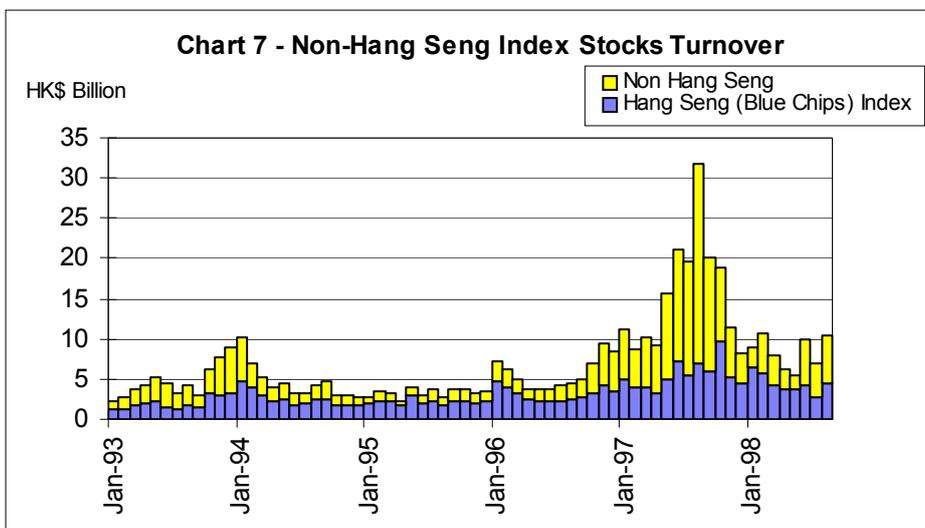


15. New products and trading patterns also emerged in 1990's. Chinese-related H-shares were introduced in 1993. In 1997, heavy trading occurred in so-called "red chip" stocks as reflected in Chart 4. The Stock Exchange began trading stock options in September 1995; the related trading volume is shown in Chart 5. There was also an increase in the issuance and trading in so-called derivative warrants in 1997 as reflected in Chart 6.

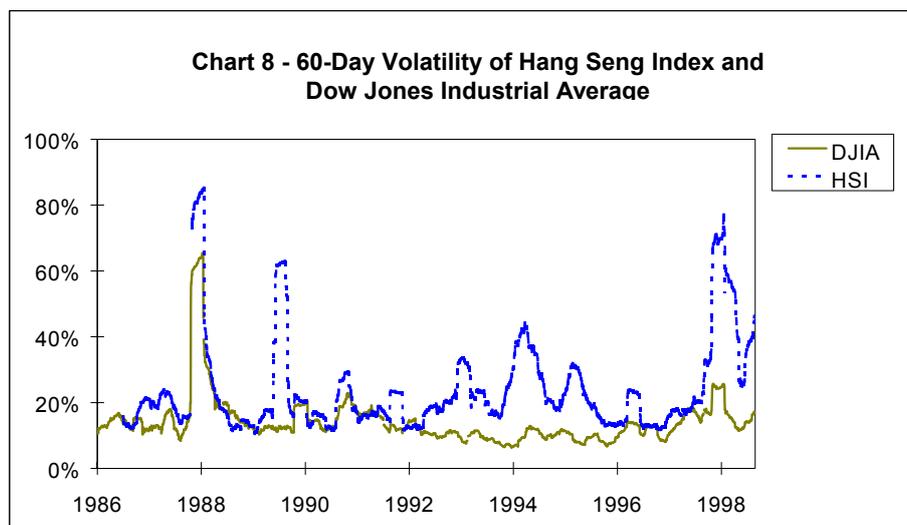




16. Another remarkable aspect of 1997 was an increase in trading in non-Hang Seng Index (HSI) stocks as shown in Chart 7. This was accompanied by an increase in retail participation in the market, often leveraged through margin accounts.

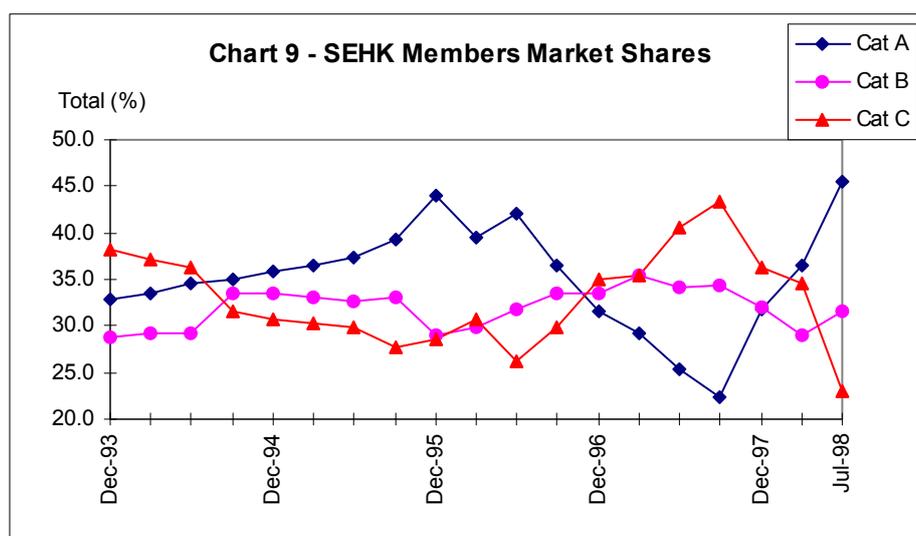


17. Chart 8 depicts the 60-day volatility of the HSI since 1986 along with that of the United States Dow Jones Industrial Average. The HSI exhibits significantly higher volatility over most of the period.



E. Stock Exchange Brokerage and Retail Investor Communities

18. The number of active trading firms at the Stock Exchange has remained relatively constant over the years. In 1986 the number was 615, declining to 495 in 1992, and rising to 561 in 1997. There has been a steady decline in the number of active sole proprietor firms falling from 594 in 1986 to 192 in 1997.
19. The market share among trading members at the Stock Exchange since 1993 is depicted in Chart 9. The chart shows the percentage market share of so-called Category A members (the top 14 firms), Category B members (the next 51 firms), and Category C (all remaining firms). In 1997 the market share of Category C firms increased reflecting increased retail market participation, but decreased by July 1998.



20. A profile of retail investor participation in Stock Exchange trading is provided by a 1997 Stock Exchange Survey. The Survey estimated that in September 1997 about 14 percent of the Hong Kong adult population, or 692,000 individuals, were

shareholders. This was up from 8 percent to 9 percent of the adult population in the period from 1989 to 1994, but is likely to have fallen, perhaps dramatically, in the wake of market volatility and broker defaults since September 1997. The Survey estimated that the typical retail investor held a portfolio value of \$150,000 and had a monthly income of about \$22,500.

F. New Proposals to Regulate Share Margin Financing

21. In May 1998, the Government's Financial Services Bureau issued a Consultation Paper on Proposed Regulation of Share Margin Financing. In summary, the proposals will require finance companies providing share margin financing to become securities margin finance providers licensed and supervised by the SFC and impose a series of new rules and standards to regulate share margin financing activity. The proposals also call for an investor education program concerning the risks arising from margin trading. If the proposals are implemented, the significant share margin financing provided historically by non-dealer finance companies will be conducted through either new securities margin finance providers who are not Stock Exchange members or will migrate to Stock Exchange member firms.

G. Defaults - C.A. Pacific

22. In January 1998, a relatively large retail-oriented brokerage firm C.A. Pacific Securities and its affiliated finance company were placed under the control of provisional liquidators (and later into formal winding-up proceedings). By May 1998, 5,212 claims against the compensation fund had been filed by C.A. Pacific Securities clients claiming losses of over \$2.4 billion (based on claims for securities valued at 19 January 1998). The magnitude of the default vastly exceeded the historical experience of the compensation fund as reflected in Appendix A. The Stock Exchange was still determining the claims at the date of this Paper.
23. In the light of market conditions and fragile investor confidence at the time, the Government along with the SFC and the Stock Exchange announced on 25 January 1998 that a flexible approach would be taken to compensating clients of C.A. Pacific Securities, including introduction of a per claimant level of compensation. This level was later announced to be \$150,000 per allowed claim. Legal advice was received indicating that legislative amendments were necessary to implement the announced arrangement. The Securities (Amendment) Bill 1998 was introduced into the Legislative Council in July 1998 and was still pending at the date of this Paper.
24. In response to the C.A. Pacific default, the SFC and the Stock Exchange announced that they would each add \$150 million to the compensation fund. They also announced that they would each contribute an additional \$150 million if necessary. Government announced that it had undertaken to apply to the Finance Committee of the then Provisional Legislative Council for a loan to top up the fund should it fall below prudential levels.
25. In the aftermath of the C.A. Pacific Securities default, the Stock Exchange called for compensation fund claims in relation to 2 other brokers - Chark Fung Securities Company Ltd. and Forelux Securities Ltd. At the date of this Paper, the Stock Exchange was processing compensation claims in relation to these brokers. No

decision had been made to extend the compensation arrangement for C.A. Pacific Securities to these cases.

H. Stock Exchange's Broker Fidelity Insurance Scheme

26. In October 1992, the Stock Exchange introduced a compulsory fidelity insurance scheme for its members to provide a new risk protection mechanism. Under a pooled arrangement all Stock Exchange members were insured up to \$8 million each per year for losses arising from theft by employees, defective securities, professional negligence, other errors and omissions and computer-related fraud. The coverage was later increased to \$9 million. One-third of the premiums are recovered from Stock Exchange members and the balance paid by the Stock Exchange. The scheme was renewed effective October 1998 with an increase in coverage to \$12 million but subject to a deductible of \$2 million to \$3 million.
27. The fidelity insurance scheme is not directly related to the compensation fund. However, it does bring significant additional financial resources to bear where financial difficulties due to infidelity arise in relation to smaller size brokers. In this regard, the 1996 Actuarial Report concerning the compensation fund observed that a significant decrease in compensation fund claims from 1992 to 1995 could possibly have been due to the fidelity insurance scheme.
28. In 1997, the Stock Exchange engaged insurance consultants to examine the possibility of devising new insurance arrangements in lieu of the compensation fund, the broker fidelity insurance scheme, and a Stock Exchange fidelity fund/guarantee scheme which applies to dealer-to-dealer defaults.

I. SFC Compensation Project

29. In the summer of 1998, the SFC and the Securities Compensation Fund Committee engaged a team of international consultants to assist in devising a new compensation arrangement. The project involved, among other things, benchmarking of international best practices in compensation arrangements and investor protection mechanisms, building an economic model to measure risk exposure, and evaluating the merits of using the insurance/reinsurance markets to protect and leverage existing compensation fund assets. This Consultation Paper presents the results of the project.

III. PROBLEMS WITH EXISTING ARRANGEMENTS

30. The problems with the existing arrangements are summarized below. Brief comparisons are also made to the compensation arrangements in overseas financial centres, which are described in greater detail in section IV.

A. Uncertain Level of Protection

31. Compensation is generally limited to \$8 million per broker. This does not communicate to investors the amount of coverage available to them individually. As illustrated in Appendix A, the ratio of payments to allowed claims has ranged from 17 percent to 100 percent. Moreover, pro-ration of the \$8 million amount among investors results in higher absolute payments to larger claims at the expense of smaller investors who are arguably less able to appreciate the risk and bear the loss of broker default. Arrangements in other financial centres provide a specified amount of compensation per investor.

B. Limited Funding/Risk Transfer Alternatives

32. Whilst the net assets of the fund are of sufficient size to enable expanded protection for investors, the law continues to impose a per broker \$8 million limit. A per investor compensation level would be difficult to achieve under the existing financing structure of the compensation fund. Following discontinuance of the transfer of “excess” transaction levy to the fund, the assets of the fund have been relatively static with growth only available from investment income. There are no current provisions for alternative funding nor for risk transfer arrangements using the insurance market.

C. Long Processing Period

33. No compensation payments can be made until all claims have been determined by the Stock Exchange. This means a 3-month period must first be allowed for claims to be submitted. Claim determinations can then require an extended period of time, particularly when a large number of claims are involved. Finally, a further 3-month appeal period must pass before any payments can be made, and yet further delays occur if appeals are made. Arrangements in other financial centres enable payments to be made as soon as each claim has been determined, which is typically within 3 months.

D. Payment in Cash Only

34. The compensation fund makes only cash payments taking into account the value of securities at the date of default. The compensation fund cannot return securities to claimants. Although securities can be returned to claimants in an insolvency or bankruptcy proceeding involving the defaulting broker, this typically takes many months, sometimes years. Depending on where securities are held at the time of default, some claimants may not have a proprietary claim for securities in an insolvency. Thus, investors do not know whether to repurchase securities or await the conclusion of insolvency proceedings if they wish to maintain a stock position or to mitigate their loss. Arrangements in some other financial centres return securities to claimants.

E. Uncertainties over Margin Accounts

35. Many retail investors in Hong Kong maintain margin accounts. Approximately 100 Stock Exchange members have affiliated finance companies to provide margin loans, but the finance companies may not be covered by the compensation fund. Where the

broker and finance company have similar names and share the same staff and premises, it is difficult for unsophisticated investors to know whether they are protected by the compensation fund.

F. Complicated Administration

36. The SFC administers the money in the compensation fund whilst the Stock Exchange receives and determines claims and makes apportionment where necessary. Both bodies have committees to carry out these tasks. Although this arrangement provides certain checks and balances, it is cumbersome. Concern has also been expressed that the Stock Exchange may have conflicts of interest in relation to its role in the compensation process, but it has also been noted that they contribute market knowledge. Compensation arrangements in other financial centres typically employ a specialized independent company to handle investor compensation matters.

G. Lack of Coordination with Insolvency Proceedings

37. The compensation fund process and a winding-up or bankruptcy proceeding in relation to the same defaulting broker often occur simultaneously. However, there is no coordination of the two proceedings, with each requiring the submission of claim forms and operating under different laws. At times the Stock Exchange has been unable to access needed books and records of the broker to verify claims, because these were under the control of a liquidator and subject to company law constraints. In some overseas financial centres the compensation and insolvency processes are combined into one proceeding.

IV. DESCRIPTION OF OTHER COMPENSATION ARRANGEMENTS

A. United States Securities Investor Protection Corporation (SIPC)

38. SIPC was established by the Securities Investor Protection Act of 1970 to protect securities clients of broker members of the U.S. exchanges. It is a statutory corporation governed by a 7-member Board comprised of 5 appointees of the President (subject to senate confirmation) of whom 2 represent the general public (including the SIPC Chairman and Vice Chairman) and 3 represent the securities industry, and 1 representative each from the Treasury and the Federal Reserve Board. SIPC is regulated by the Securities and Exchange Commission (SEC), which, among other things, approves the SIPC rules.
39. SIPC protects clients' cash and securities within defined limits if a broker becomes insolvent. Each customer is protected up to US\$500,000 inclusive of a US\$100,000 limit for cash (the same level as Federal Deposit Insurance for bank deposits). SIPC petitions the courts to place a defaulting broker into insolvency and to appoint a trustee; sometimes SIPC itself acts as the trustee. The compensation arrangement and the insolvency effectively are combined in one proceeding. SIPC works with the trustee to transfer client accounts to solvent brokers. In general, clients share pro-rata in the client property held by the insolvent broker. Since 1970, SIPC has completed

242 proceedings making distributions to 422,717 clients at a net cost to the SIPC fund of US\$191.5 million.

40. SIPC is funded by assessments collected from brokers. At 31 December 1997, SIPC had net assets of approximately US\$1.1 billion. SIPC can also borrow up to US\$1 billion from the Treasury through the SEC if the SEC determines that a loan is necessary to protect customers and maintain confidence in U.S. securities markets. SIPC must then present a plan for repayment. If the SEC determines that the normal broker assessments are insufficient to repay loans, it may impose a transaction levy not exceeding US\$0.20 per US\$1,000. SIPC also has a US\$1 billion revolving line of credit with a consortium of banks.

B. Canadian Investor Protection Fund (CIPF)

41. CIPF was established in 1969 by the Canadian stock exchanges. In addition to providing investor compensation, it also oversees the work of the exchanges' self-regulatory systems and establishes national standards for financial responsibility and monitoring to contain the risk of providing the compensation arrangement. It has a Board comprised of public directors and directors from the stock exchanges.
42. CIPF covers clients' losses of securities or funds, within defined limits, that result from broker insolvency. The limits are Canadian Dollar 500,000 per investor for securities inclusive of a Canadian Dollar 60,000 limit for cash. It is funded primarily by quarterly assessments of brokers based on their gross revenues and by risk premiums based on brokers' capital deficiencies. At 31 March 1998, CIPF had a balance of Canadian Dollars 153 million and a bank credit line of Canadian Dollars 40 million.
43. CIPF may petition the courts to appoint a trustee where a broker is insolvent. CIPF works with the trustee to transfer customer accounts from the insolvent broker to a solvent broker and notifies investors accordingly, although this may not be possible if the insolvent broker's records are inaccurate. In addition, under the Canadian Bankruptcy and Insolvency Act, customers of the insolvent broker are entitled to share prorata in all cash and securities held by the broker for customers. Compensation is calculated after the account transfer and pro-rata distribution of customer assets

C. United Kingdom Investors Compensation Scheme (ICS)

44. ICS was established under the Financial Services Act 1986 (FSA) to provide a compensation fund for clients of investment firms authorized under the FSA. ICS is governed by rules written by the Securities and Investment Board. ICS is a separate company governed by an 11-member Board, including an independent Chairman, 5 public interest representatives, 4 nominees of the U.K. self-regulatory organizations, and the ICS Chief Executive.
45. Claims can be made where a regulated firm fails to meet its civil liabilities to clients. Each client is entitled to receive up to £48,000, including 100 percent of the first £30,000 of a claim and 90 percent of the next £20,000. ICS is funded on a pay-as-you-go basis by levies on regulated firms. There is no standing fund. Since 1988,

340 firms have been declared in default and payments of about £125 million have been made to 10,500 investors.

46. In December 1997, the Financial Services Authority issued a consultation paper on consumer compensation. The paper discussed 5 different compensation arrangements covering deposit taking business, insurance business, friendly societies, investment business, and investment business carried on by professional firms. The paper proposed a combination of these into a single independently managed compensation scheme with 3 sub-schemes covering deposit taking, insurance, and investment.
47. We also note that there is a European Community Directive on Investor Compensation Schemes, which sets out minimum requirements for compensation schemes which must be put in place by Member States. The directive (97/9/EC of 3 March 1997) requires Member States to ensure that compensation schemes provide for cover of not less than ECU20,000 per investor.

D. Australian National Guarantee Fund

48. The National Guarantee Fund (NGF) was established by the Australian Stock Exchange National Guarantee Fund Act of 1987. The NGF is administered by the Securities Exchanges Guarantee Corporation Limited (SEGC). SEGC is a company limited by guarantee and is a subsidiary of the Australian Stock Exchange (ASX), but operates independently.
49. Claims can be made on NGF where a client suffers loss due to, among other things, a broker's insolvency. There is no maximum payable on a per investor basis, but there is an aggregate limit of AU\$7 million per broker insolvency.
50. NGF is comprised of assets transferred in 1987 from each of the former State Stock Exchange Fidelity Funds and income derived from investment and recoveries. SEGC has the power to borrow funds and to take out insurance. If the NGF falls below the "Minimum Amount", currently set at AU\$50 million, SEGC may impose levies on ASX and on transactions on ASX markets. NFG was valued at approximately AU\$137 million as at June 1998.

E. Hong Kong Protection of Wages on Insolvency Scheme

51. The Protection of Wages on Insolvency Ordinance enacted in 1985 established a fund to provide payments of unpaid wages and severance to employees whose employers become insolvent. It is administered by a Board of 10 members appointed by the Chief Executive, including 4 public officers and equal numbers of persons representing employers and employees. The Board may delegate its functions to the Labour Department, which conducts the day-to-day operations.
52. Limits per employee apply of \$36,000 for wages, \$22,500 for wages in lieu of notice, and \$36,000 for severance plus 50 percent of severance entitlement in excess of \$36,000. After the Board makes a payment to an employee it is subrogated to the extent of that payment to the employee's rights against the employer. Section 265 of the Companies Ordinance then gives certain priorities to payments by the Board over all other debts in a winding-up of the employer. However, the preferential treatment

is limited to \$8,000 for wages, \$2,000 for wages in lieu of notice, and \$8,000 for severance payments.

53. The scheme is funded by a \$250 levy on the issue of each business registration certificate in Hong Kong. As end of March 1997, the Fund had assets of \$905 million.

F. Bank Deposits in Hong Kong

54. There is no bank deposit protection fund or compensation scheme in Hong Kong. However, in 1995 following the collapse of the Bank of Credit and Commerce a preferential status was created for bank deposits under section 265 of the Companies Ordinance. Each depositor is afforded a preference on amounts held on deposit with an insolvent bank up to a maximum of \$100,000.

G. Travel Agent Scheme

55. The Travel Agents Ordinance (Cap. 218) provides for a Travel Industry Compensation Fund (TICF). It provides ex-gratia payments to outbound travelers upon default by travel agents. The maximum payment is 90 percent of the outbound tour fare paid by the traveler. The scheme is funded by a levy of .30 percent of outbound tour fares, half of which goes to the TICF. As of February 1998, the TICF held a reserve of approximately \$244 million.

H. Mandatory Provident Fund Schemes Compensation Fund

56. The Mandatory Provident Fund (MPF) Schemes Ordinance (Cap. 380) provides for an MPF Compensation Fund, but neither the provident fund schemes nor the compensation fund are yet in operation. The MPF Compensation Fund will be administered by the MPF Authority to compensate members of registered MPF Schemes for losses of accrued benefits due to misfeasance or illegal conduct by trustees or other persons concerned with MPF Schemes. The MPF Authority is authorized to impose levies payable by trustees of MPF Schemes out of members' contributions. The Financial Secretary is authorized to provide grants or loans out of the general revenue that may be provided by the Legislative Council for this purpose. We understand that Government has committed to inject \$600 million into the MPF Compensation Fund.

V. PROPOSAL FOR NEW COMPENSATION ARRANGEMENTS

A. Main Objectives

57. In developing the proposals for new compensation arrangements we have set a number of main objectives. These objectives are described as follows.
- To enhance the investor compensation arrangement and increase investor confidence whilst keeping costs commensurate with benefits. Also, to avoid creating moral hazards (see paragraph 72).

- 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 independent entity that includes industry and public interest representatives and is subject to appropriate checks and balances.
- To protect and leverage existing compensation funds assets, including use of insurance, whilst minimizing any additional cost to the industry.
- To employ market-based commercial risk management mechanisms and incentives within the arrangement.
- To initially provide a new compensation arrangement in relation to members of the Stock Exchange, but within a flexible structure that will allow additional arrangements to be developed for other segments of the market.

B. Legislation and Corporate Structure

58. Implementing new compensation arrangements will require extensive legislative amendments. At this time, draft amendments have yet to be prepared, but the main proposed concepts are set out in this section and in section VI. The time needed to enact new legislation will be the key factor determining when new arrangements can be put in place.
59. We propose that new legislation define an *investor compensation company* which would be recognized by the SFC, in the public interest, for facilitating investor compensation arrangements relating to transactions in securities or futures contracts. After a new investor compensation company (NewCo) is recognized it would be regulated by the SFC. The approach is similar to the recognition and regulation of a clearing house under the Securities and Futures (Clearing Houses) Ordinance (Cap. 420). It is also broadly similar to the regulation of SIPC in the U.S.
60. NewCo's rules would require approval by the SFC. Most of the requirements for making, determining, and paying compensation would be contained in NewCo's rules. It is not practicable for these matters to be in the primary legislation. This is because they will depend on the arrangements to be negotiated in the insurance/reinsurance market (see section V). In addition, we believe that the already planned introduction of new regulatory measures to enhance the protection of investors' assets will enable us to initiate the negotiation of increased levels of compensation protection in the medium term which would then be reflected in NewCo's rules.
61. Appendix B contains an indicative set of draft rules for NewCo. The goal is to have clear and public procedures. The main features are summarized as follows.
- The basic requirement for claiming compensation is broadly similar to the existing provision in section 109 of the Securities Ordinance (Rule 3).

- A list of persons would be excluded from claiming compensation being “professionals” and associates of the defaulting broker (Rule 5).
 - NewCo would determine all claims and notify claimants accordingly (Rule 7).
 - The limits to compensation on a per claimant basis would be specified in NewCo’s rules (Rule 9).
 - A provision will enable NewCo to return securities to a claimant (potentially by purchasing them in the market) rather than making cash compensation and in the discretion of NewCo (Rule 10).
 - The rules would be subject to any insurance/reinsurance arrangements put in place by NewCo (Rule 11).
 - A subrogation provision similar to existing section 118 of the Securities Ordinance (Rule 12).
62. The indicative draft rules for NewCo in Appendix B are put forward for illustration of the type of rules envisioned, and to solicit comments and suggestions. NewCo would in future be responsible for formulating its own specific rules, subject to SFC approval.
63. The corporate structure proposed preliminarily for NewCo, and subject to discussion with the Stock Exchange, is that of a company limited by guarantee with the SFC and the Stock Exchange being the members and providing undertakings to contribute to the company in the event of its winding-up. This is the structure of Hong Kong Securities Clearing Co Ltd (HKSCC), a recognized clearing house with the SFC which operates the Central Clearing and Settlement System (CCASS) in Hong Kong.
64. The Board of Directors of NewCo should include members appointed by the SFC and the Stock Exchange and there should be a significant public interest element. We propose that the Board be comprised of 2 members appointed by the SFC, 2 members appointed by the Stock Exchange, and 3 persons appointed by the Financial Secretary (including the Chairman of NewCo) to represent the public interest. In addition, there should be a director appointed by the Board with experience in the fields of insurance and risk management. This structure would be reflected in NewCo’s Memorandum and Articles of Association, changes to which would require SFC approval.
65. Another important aspect of the legislation necessary to implement the proposed arrangements is in relation to back-up funding. We propose that the legislative amendments empower the Chief Executive-in-Council to impose a levy at the Stock Exchange (payable by investors or brokers or a combination of the two) to raise funds for NewCo should this be necessary. This contingent levy also would be used to arrange a credit facility from Government or private lenders. The levy would be subject to a maximum rate that would be set low enough to minimize the negative effect on transaction costs. The proposed financing structure described in section V is designed so that it is unlikely statistically that the credit facility and levy would ever be used.

66. Although the legislative amendments are designed to facilitate the creation of NewCo to provide a compensation arrangement in relation to Stock Exchange members, they are also designed to be flexible enough to enable NewCo or another recognized investor compensation company to provide compensation arrangements for other segments of the market in future. These might include, for examples, the members of the Hong Kong Futures Exchange, dealers who are not exchange members, or the new category of finance company/dealer proposed in the Government's consultation paper on share margin financing.
67. The legislative amendments would also enable NewCo or an affiliate of NewCo to provide risk management services to the market. Although no specific proposals are being made at this time, there is a potential for the investor compensation role of NewCo to be combined with other risk management services in ways that increase efficiency and reduce risk.

C. Assessing Risk

68. We have developed with the assistance of consultants 3 models to measure the risk to NewCo of providing new compensation arrangements. These are : (1) an actuarial model based on historical Hong Kong default experience; (2) an actuarial model based on U.S. historical default experience adjusted for the characteristics of the Hong Kong market; and (3) a sizing of the aggregate potential retail investor assets at risk.
69. The first approach is an actuarial analysis of historical Hong Kong default experience (Appendix A). The results suggest a payout potential of \$27 million, but with a 22 percent probability of a payout exceeding \$112 million and a 10 percent probability it will exceed \$156 million. Due to the relatively small sample size of broker defaults this may not be a reliable indicator of future experience.
70. The second approach is based on retail investor assets at risk held by a representative sample set of Stock Exchange members. This actuarial analysis draws from the SIPC historical payout experience and accounts for differences between the U.S. and Hong Kong markets. The resulting potential payouts and related probabilities are shown in the table below. They reflect payouts without any reference to compensation limits.

| | Net Payout | Probability Less Than Net Payout |
|---------------------------|-------------------|---|
| Mean | \$160 million | 55.9% |
| One Standard Deviation | \$310 million | 84.5% |
| Two Standard Deviations | \$460 million | 95.3% |
| Three Standard Deviations | \$610 million | 98.7% |

71. The third approach is based on a sizing of the aggregate risk to retail investor assets held by Stock Exchange members. It assigns high-risk status to certain segments of the market, such as tightly-controlled firms and those with affiliated finance companies, factoring in a per investor compensation level of \$100,000 and a recovery rate of 30 percent. The results project a net risk exposure of \$1 billion to \$2 billion.

D. The Proposed Financing Structure

72. This section describes a proposed risk financing structure for NewCo. It is based in part on the research conducted, including benchmarking of international best practices, interviews with key market participants, data gathering and analysis, and preliminary market testing. The following parameters were set for the risk financing structure.

- To provide a true guarantee (of a given level) to retail investors, no per broker limits should apply. This guarantee replicates best practice in world markets and is designed to instill confidence in retail investors. However, it also means that the aggregate exposure to NewCo will be much greater than under the existing compensation fund, and the quantification of exposures is more complex. Protection must be provided not only for potential net losses, but also against the liquidity problems associated with an early payout to investors whilst pursuing recovery from the defaulting broker in an insolvency or bankruptcy proceeding.
- The structure should assist current SFC and Stock Exchange efforts to bring risk management controls in the market up to world best practice standards. Experience is that provision of financial incentives for good practices, and disincentives for bad practice, combined with an efficient monitoring system, produce best results. The provision of outside expertise from specialist insurance underwriters in the areas of identifying and quantifying risk factors will facilitate creation and imposition of an equitable system of incentives and disincentives. More detailed requirements concerning external audits will assist in monitoring compliance.
- The structure should not impose undue financial pressure on brokers. It must concentrate on using existing funds to best advantage in providing protection, most especially in the immediate future whilst the improved control environment takes effect. Its emphasis must be on using funds to promote improvements, and on using a contingent premium levy (which is used in the Canadian scheme) to discourage inadequate risk management practices.
- It should be flexible enough to allow for additional coverage in future. Other protection schemes, such as the Stock Exchange's fidelity insurance scheme, are complementary to the investor compensation arrangement and there may be an opportunity in future for these to be brought profitably into the same vehicle, both for economies of scale and for control and coordination. The structure should be flexible enough to accommodate this objective. The structure should also have the flexibility to extend to market participants other than Stock Exchange members.

- The structure must promote retail investor confidence. Given recent events it is imperative that investor confidence be given a boost by the creation of a strong, clearly understood system for provision of protection, backed by recognized specialist underwriters.
- The structure should not create significant moral hazards. By this we mean the danger that brokers and investors might lower their attention to risk due to an overreliance on the compensation arrangement, particularly relatively sophisticated investors who should be expected to bear the risk of counterparty default as they do in other commercial transactions. We believe our focus on retail investors coupled with the existing funding constraints and related levels of compensation achievable mitigate against moral hazards. However, the issue will be kept in view, including in relation to the potential for increased compensation levels following negotiation with underwriters and as control environment enhancements take effect.

Improved Audit Requirements

73. We expect that the specialist underwriters who provide the types of insurance NewCo will seek will suggest measures to reduce the risk of broker failure. One area in particular that we believe will be important to the underwriters is the annual external audit of Stock Exchange members. Improvements can and should be made in the Stock Exchange's requirements for auditors to provide clearer instructions on the controls that should be in place and the sample range of transactions to be audited. The Stock Exchange has already begun this process. Some specified areas for improvement may include -
- requirements to conduct forensic transaction analyses concerning internal controls, asset segregation, and Financial Resources Rules to determine if there are any material compliance deficiencies; and
 - an improved audit questionnaire to be more proactive in prompting auditors to look for deficiencies.

Contingent Premiums

74. We also propose that the Stock Exchange rules provide for a "contingent premium" payable by any member who fails to correct problems identified in the annual audit or in management letters issued by the Stock Exchange. This contingent premium would be paid by the Stock Exchange to NewCo after collection from the member concerned. This would actively discourage inadequate risk management practices and be important in obtaining best terms with the underwriters. It is particularly important given that the Stock Exchange's fidelity insurance scheme does not provide external checks by specialist insurance underwriters on a per broker basis in the way that fidelity insurance arrangements do in most other financial centres. This concept will need to be discussed further with the Stock Exchange.

Operating Costs

75. Claims, operating and risk financing costs of NewCo will need to be met from existing compensation fund assets if brokers are exempted from paying premium (other than for failure to correct inadequacies). This is a vital practical constraint which we address in the proposed risk financing structure. The key purpose of this is to direct any extra cost to brokers towards proactive risk control improvements and to pay for any extra audit costs involved, rather than impose upon brokers the requirement to build a reactive fund. We also note that the existing requirement that the Stock Exchange replenish unrecovered amounts paid from the compensation fund would no longer apply, thus relieving the Stock Exchange and its members of this cost.

Assessing Risk Exposure

76. Subsection C above described the results of our risk assessment models. In summary, these are -
- Historical Hong Kong default experience suggests an annual payout of \$27 million, but there is a 10 percent probability it will exceed \$156 million.
 - U.S. historical default experience adjusted to reflect Hong Kong market characteristics suggests a payout of \$160 million. At a 95 percent confidence level the payout is less than \$460 million and at a 98.7 percent confidence level it is less than \$610 million.
 - A sizing of the aggregate risk to retail investor assets held by Stock Exchange members suggests total potential exposure of \$1 billion to \$2 billion.
77. Considering these risk exposures, the existing \$500 million compensation fund could be exhausted in 5 years out of 100 and those could be 5 consecutive years. In 1 in 100 years the fund would be inadequate for even one year's exposure. In a catastrophe scenario, up to \$2 billion could be required to meet the obligation of a per investor compensation level of \$100,000.

Insurance Arrangements

78. We have therefore concluded that to provide retail investors with a meaningful per investor compensation level, access to substantial funding in addition to the existing compensation fund will be required.
79. Commercial insurance can be an efficient source of such funding. A vital added benefit is that, when provided by companies expert in the field of investor protection, underwriters can bring that expertise to bear in helping NewCo, the Stock Exchange and the SFC quantify, control and reduce the exposure to broker default.
80. To determine the parameters within which an insurance programme may operate most efficiently to meet the financing needs of NewCo we return to the risk assessment data. Using the second actuarial approach, losses are conservatively estimated at \$160 million. Insurance is least efficient when used to pay for expected losses and most efficient when used to cover fortuity beyond expected losses. This is because insurers will charge in the premium base for the expected losses plus expenses and

profit charges. Specialist underwriters will also expect NewCo, the Stock Exchange and the SFC to retain a reasonable level of risk before insurance attaches. For these reasons we suggest that a retention of \$250 million, or approximately 150 percent of expected losses, would be appropriate.

81. Losses at a 95 percent confidence level are estimated at \$460 million. Whilst the existing assets from the compensation fund are sufficient to cover this level, they could be exhausted in a single year. We therefore believe insurance would be of benefit if it can be obtained on a multi-year basis providing cover over and above the \$250 million cash-funded retention. That cover needs to extend to at least \$460 million and preferably to as close as possible to the total exposure of \$1 billion to \$2 billion.
82. The overall recommended financing structure has 3 tranches of financing (1) risk retained by NewCo, (2) insurance, and (3) a back-up credit facility from Government or private lenders. Example Programmes A and B below illustrate types of potential insurance coverage for NewCo. They are based on retention by NewCo of \$250 million in risk, meaning NewCo must pay any losses up to this amount each year. They also provide multi-year coverage for 3 to 5 years. They are illustrative only. Specific parameters that best meet NewCo's objectives would be sought from underwriters as would flexibility to reflect changes in NewCo's exposure over a multi-year term.

| |
|--|
| <ul style="list-style-type: none">• Programme A Term 3 years Premium \$200 million Annual Limit \$500 million Term Limit \$750 million |
|--|

| |
|--|
| <ul style="list-style-type: none">• Programme B Term 5 years Premium \$40 million per year Annual Limit \$200 million Term Limit \$600 million |
|--|

83. In these programmes the premiums are paid into an experience account with the underwriters. Any losses to the insurer would first be met out of these funds. However, if no claims are made on the insurance policy, 75 percent of the premiums plus an agreed rate of interest would be returned to NewCo at the end of the policy period.
84. Programme A would cover exposures beyond the 99 percent confidence level for 1 year and to the 95 percent confidence level for a second year. Programme B would cover exposures up to the 95 percent confidence level for 3 out of 5 years.
85. Under these programmes, NewCo would need to maintain full funding of the retention risk of \$250 million. Initially this could be done via existing compensation fund assets. However, to the extent these are paid out they would need to be replenished. We propose that the SFC and the Stock Exchange convert their earlier commitment to add if necessary up to \$300 million to the compensation fund (see

paragraph 24 above) to a commitment to top up the retention fund if necessary. If there was a further need to top up the retention fund during the policy period, we propose a drawing on the credit facility described in paragraph 65 above.

86. Whilst we see either programme as providing protection during the next three to five year period during which control environment improvements are expected to come into full effect, underwriters will of course wish to review, quantify and attempt to mitigate their potential exposures to loss. We know that underwriters are prepared in principle to write programmes similar to both our examples, but only as the underwriting process nears completion will we be able to say with any certainty the precise terms and conditions of the cover they will actually be prepared to provide.
87. The detailed enquiries underwriters will make will assist NewCo, the Stock Exchange, and the SFC in identifying and valuing risk exposures, and the recommendations they will provide for risk improvements will be of significant value overall.
88. To maximize the value to be added by the underwriters, we recommend working with a chosen specialist underwriter of the highest credit rating, reputation and expertise. There are a few AAA rated guarantee companies of this nature. The underwriting process may extend to 6 months.
89. The risk financing structure illustrated is capable, on conservative assumptions, of financing a per investor compensation level of \$100,000 or more, using the \$500 million in existing compensation fund assets and considering market conditions and the regulatory framework at the time of the issue of this Paper. There is potential for the level to be increased as implementation proceeds and planned regulatory measures are introduced, negotiations with underwriters progress, and more market data is collected. The likely range of the per investor level would be from \$100,000 but less than \$250,000.

E. Proposed Legislative/Regulatory Measures to Reduce Risk

90. Experience shows 3 factors as having contributed to the defaults of brokers in recent years. The first is that securities margin finance companies have not been regulated. As shown in the C.A. Pacific default, the collapse of an associated finance company can contribute to a regulated broker default. The second factor is the failure by brokers to implement proper internal controls in managing the risk exposures relating to securities margin financing and over-the-counter derivatives activities. The collapse of Wei Xin Securities in 1995 was associated with defaults by margin clients and losses in the over-the-counter stock options market. The third factor is the misappropriation of clients' securities by the owners or senior management of brokers. This has been a major factor in more than a few compensation fund cases. The Government, the SFC, the Stock Exchange, and HKSCC have been taking a number of measures to address these factors.
91. As mentioned, the Government issued in May 1998 a consultation paper on proposed regulation of share margin financing conducted by unregulated finance companies. The objective is to bring such activities under direct regulation by the SFC. We

expect the new requirements to take effect in 1999. In addition, we have reviewed the existing regulatory framework with a view to strengthening the following key aspects of the operations of a securities dealer or securities margin finance provider, also to take effect in 1999.

Capital Requirements

- A securities dealer (including a securities margin finance provider) providing securities margin financing will be required to have a minimum paid-up capital of \$10 million.
- In calculating the discounted value of securities used as collateral to support margin loans, a higher discount percentage of 30 percent (as compared to 15 percent for constituent stocks of the HSI) will be applied to less liquid stocks.
- Additional capital will be required to support excessive concentration in lending to particular margin clients or in accepting concentrations in particular stocks as collateral.

Safeguarding Clients' Assets

- We will prescribe certain new limitations on the pledging of clients' securities by securities dealers.
- A securities dealer will be required to inform clients in an expanded risk disclosure statement of the potential risks associated with pledging their securities for margin financing.
- Monies belonging to margin clients will be required to be maintained in designated trust accounts.

Internal Control and Conduct of Business Standards

- We will issue amendments to existing internal control guidelines to assist securities dealers in formulating comprehensive margin lending policies. We will also issue supplements to the existing Code of Conduct to require securities dealers to make more pertinent disclosure to margin clients to enable them to monitor more closely their dealings with securities dealers (e.g. indicating in the contract notes or statements of accounts whether a particular account is a cash or margin account, and specifying whether securities held are for custody or margin financing purposes).
92. In addition to the various measures designed to more effectively regulate securities margin financing activities as discussed above, we will soon introduce new amendments to the existing Financial Resources Rules to ensure that they are kept up-to-date and can adequately cope with the many changes occurring in the markets since their introduction in December 1993. In the context of this Consultation Paper, the more important changes include the following, which are expected to take effect in 1999.

- A securities dealer (including both a corporate entity or a sole proprietorship) who does not provide securities margin financing will be required to have minimum paid-up capital (or a capital account in the case of a sole proprietorship) of \$5 million. Currently, there is no requirement in relation to paid-up capital.
 - A securities dealer or securities margin finance provider is required to submit to the SFC monthly financial returns together with summary on banking facilities, margin positions of the top 20 margin clients and proprietary derivative positions.
 - The minimum liquid capital requirement under the Financial Resources Rules for sole proprietors will be increased to \$3 million from \$500,000.
93. In May 1998, HKSCC introduced a new service which allows investors to open securities custody accounts directly with HKSCC. The service provides investors with a practical means to maintain direct control of their securities. Recently, the Stock Exchange and HKSCC formed a working group to study ways to improve the operations of the service and encourage more investor participation. In addition, the planned upgrading of the Stock Exchange's Automatic Order Matching and Execution System (AMS) over the next several years will bring advanced straight-through-processing technology to the market and this, in turn, will streamline the use of investor accounts by both investors and securities dealers.
94. The effect of implementing the measures mentioned above will be to strengthen the existing regulatory framework in supervising the activities of securities dealers and securities margin finance providers and reduce risk to NewCo (and insurance underwriters). This should lead in future to reduction in the costs of financing the compensation arrangement and enable better investor coverage.

VI. LEGISLATIVE AMENDMENTS TO SUPPORT THE PROPOSED ARRANGEMENTS

A. Part X of the Securities Ordinance

95. As mentioned in section V, extensive changes to the existing legislation in Part X of the Securities Ordinance will be necessary to implement the proposed new compensation arrangements. Amendments to various other Ordinances are also proposed as discussed in this section. Although drafting instructions have yet to be prepared, the key concepts for replacing Part X of the Securities Ordinance are summarized as follows.
- Statutory recognition of NewCo by the SFC and regulation broadly similar to that of clearing houses, including approval of the company's rules.
 - Publication of the rules, annual report and accounts by the compensation company.

- Provision of an offence for persons who provide false information to the compensation company.
 - Provision for the Chief Executive-in-Council to impose a transaction levy if additional funds are needed.
 - Provision to enable NewCo to delegate powers and duties and to enable SFC and Stock Exchange staff to assist NewCo.
 - Rulemaking authority for the SFC.
 - Immunity for NewCo for anything done in good faith in the performance of its functions.
 - Transitional provisions for the migration from the existing compensation fund to the new arrangements.
96. We expect that some additional amendments will be proposed as a result of this consultation and as the implementation stage of the project is further defined.

B. SFC Ordinance (Cap. 24)

97. A definition of a recognized investor compensation company would be added to section 2. Section 4(1)(d) would be amended to make the SFC responsible for supervising a recognized investor compensation company in addition to the Exchange Companies and clearing houses.
98. Section 33 would be amended to enable the SFC to appoint an investigator to investigate any matter referred to in subsection (1)(b) or (d) to assist a recognized investor compensation company in performing its functions.
99. Section 48(1) enables the Exchange Companies, clearing houses, and the SFC to share confidential information with one another. Subsection (2) enables the SFC to obtain information from Exchange Companies and clearing houses. Section 48 would be amended to include in subsections (1) and (2) references to a recognized investor compensation company. We will also consider amendments to enable disclosure of information to insurance underwriters.
100. The Schedule to the Ordinance would be amended to provide that the SFC's function of approving the rules of a recognized investor compensation is non-delegable vis a vis section 9.

C. Companies Ordinance (Cap. 32)/Bankruptcy Ordinance (Cap. 6)

101. A new provision would be added to the Companies Ordinance concerning the winding up of a defaulting member of the Stock Exchange who has been the subject of claims for compensation with a recognized investor compensation company. The provision would provide that the Official Receiver or any appointed provisional liquidator or liquidator would give the recognized investor compensation company such information and access to any facilities for inspecting the books and documents

of the defaulting broker, and generally such aid as may be appropriate to enable the recognized investor compensation company to carry out its functions under its rules and the Securities Ordinance. An analogous provision would be added to the Bankruptcy Ordinance.

102. A statutory or administrative arrangement would be put in place to provide that a claim for compensation with a recognized investor compensation company could be copied by the company to the Official Receiver or a provisional liquidator or liquidator and be considered as a proof of debt filed by the claimant in the liquidation proceeding, unless a formal proof of debt was requested. The claim form used by a recognized investor compensation company would be designed in consultation with the Official Receiver to ensure that it contained necessary information. This provision is designed to eliminate the situation, for example, in the C.A. Pacific default where over 5,000 claimants had to file separate claim forms with the compensation fund and with the provisional liquidators. An analogous arrangement would apply under the Bankruptcy Ordinance.
103. We note that having considered the views of the Law Reform Commission in its April 1998 Consultation Paper on the Winding-Up Provisions of the Companies Ordinance, we have not proposed any preferences in relation to amounts owed to clients by a defaulting broker.
104. In some overseas financial centres, such as Canada and the United States, the investor compensation process and insolvency process in relation to a defaulting broker are effectively combined. The compensation company can seek the appointment of a liquidator or can itself act as a liquidator. The insolvency law and commercial law contain provisions as to how the security or other property of clients of the defaulting broker should be handled and distributed. Although we have not proposed such an approach at this time, we believe it would be a sensible and efficient approach longer term and plan to consider this again in future. See also the request for comments in section VII below.
105. The Official Receiver and a number of insolvency practitioners have had extensive experience with the winding-up of a number of brokers in recent years. We specifically seek their views and advise on this Consultation Paper.

D. Other Matters

106. We will be taking legal advice to determine whether there is a need for a recognized investor compensation company to have exemptions under the Insurance Company Ordinance and the Societies Ordinance. We also propose that a recognized investor compensation company be a public body under the ICAC Ordinance. Finally, we note that the new arrangements will require various changes to the rules of the Stock Exchange and HKSCC.

VII. SPECIFIC ISSUES ON WHICH COMMENTS ARE REQUESTED

A. Clients' Rights in Securities

107. As noted in sections IV and VI, in some overseas financial centres, statutory insolvency or commercial law provisions spell out the rights of clients to securities held by brokers on their behalf. For examples, in the U.S. and Canada customers are entitled to a return of securities registered in their specific names. All other customer securities and cash held by the broker (e.g. in an account at a clearing house) are distributed to clients on a pro-rata basis. If there is a shortfall in relation to specific securities, the compensation company may buy these in the market, subject to the compensation limits.
108. In Hong Kong this matter is governed by the common law. In the default of C.A. Pacific and several other brokers there was uncertainty as to whether clients' securities held in CCASS segregated accounts were held in trust for clients thus giving clients proprietary rights in the securities. We are following developments in this regard and if necessary plan to require a specific earmarking of at least one CCASS segregated account per broker as a client trust account and to reinforce the trust aspect in the client agreement.
109. Nevertheless, even where securities in a CCASS segregated account are clearly the property of clients, it appears to be unclear whether clients should share pro-rata in the account or whether "tracing" should apply on a client-by-client basis. A similar, but more complicated issue arises where clients' securities are pledged by the broker to third-party lenders to finance the broker's margin lending activity.
110. We request comments on whether it would be appropriate for Hong Kong to enact legislation to specify the rights of clients in client property held by a broker, including how clients' property should be distributed in the event of the winding-up or bankruptcy of the broker. This could take the form of a pro-rata sharing as provided in the U.S. and Canada, or a codification of clients' right to trace securities. Consideration might also be given to enabling the courts to specify a distribution that is equitable in the circumstances.

B. Dealers Who Are Not Exchange Members

111. In our April 1996 Consultation Paper on a Draft for a Composite Securities and Futures Bill, we proposed eliminating the existing dealers' deposit arrangements under section 52 of the Securities Ordinance and section 31 of the Commodities Trading Ordinance. These arrangements require a \$50,000 deposit by each non-exchange member dealer, which can be used to satisfy clients' and other creditors' claims in specified circumstances. The \$50,000 amount on a per broker basis was viewed as clearly inadequate. We proposed repealing these provisions in favour of compulsory fidelity insurance. In this regard, we request comments on the fidelity insurance requirements and levels of coverage that should apply if the draft Bill is enacted.
112. We also request comments on whether it would be appropriate to consider an investor compensation scheme for dealers who are not exchange members. As discussed in this Consultation Paper, the methodology used to formulate new compensation arrangements for Stock Exchange members could also be used to analyze risk and construct compensation arrangement parameters for non-exchange member dealers. Importantly, funding for such a scheme would need to come from the non-exchange

member dealer community, because we believe it would be inappropriate for existing compensation fund assets to be used in this regard. Other relevant factors include the large extent to which these dealers are engaged in wholesale activity in overseas markets and the lack of homogeneity within this group of dealers.

VIII. IMPLEMENTATION

113. The implementation of new compensation arrangements is dependent upon many factors. First, we need to build consensus among key stakeholders following the issue of this Consultation Paper, in particular the Stock Exchange community and the Government. Of key importance will be the time needed to enact legislative amendments. The key implementation tasks are listed below. They will be scheduled in an implementation plan once a consensus has been built. Apart from the necessary legislative amendments, we believe the implementation time period would be approximately 12 months.

- Consultation exercise
- Revise proposals (if necessary)
- Initial business plan for NewCo
draft rules and memorandum and articles of association
incorporation
operations and administration
- Legislative drafting and timetable
- Additional market data gathering
- Negotiate and place risk transfer mechanism
- Draft insurance documentation
- Stock Exchange rule changes
- Finalize NewCo business plan
- Control environment enhancements
- Legislative amendments enacted
- New arrangements take effect

Appendix A - Compensation Fund Claims History

| Name | Year | No. Claims | Allowed | Average | Apportionment | Total Payments |
|-----------------------------|------|------------|------------|---------------|---------------|----------------|
| | | Allowed | Amount | Allowed Claim | | |
| Myra Kan & Co. | 1988 | 11 | 889,000 | 80,818.18 | 100% | 1,097,000 |
| Gisella Ma & Co. | 1987 | 6 | 1,273,000 | 212,166.67 | 100% | 1,617,000 |
| Bonus Securities Co. | 1987 | 117 | 23,453,000 | 200,452.99 | 17% | 4,000,000 |
| Blooming Stock Co. | 1990 | 15 | 1,036,000 | 69,066.67 | 100% | 1,258,000 |
| Tri-Pro Stocks & Shares Co. | 1991 | 34 | 6,327,000 | 186,088.24 | 32% | 2,000,000 |
| HW Securities Co. Ltd. | 1992 | 24 | 5,295,000 | 220,625.00 | 38% | 2,000,000 |
| Hung Wai Securities Co. | 1992 | 11 | 898,000 | 81,636.36 | 100% | 1,060,000 |
| W.H.& Company | 1987 | 1 | 6,000 | 6,000.00 | 100% | 10,000 |
| Top-Fit Securities Co. | 1987 | 15 | 6,180,000 | 412,000.00 | 32% | 2,000,000 |
| Youngs Family Investment | 1990 | 1 | 211,000 | 211,000.00 | 100% | 282,000 |
| Wei Xin Securities Ltd. | 1996 | 8 | 25,800,000 | 3,225,000.00 | 31% | 8,000,000 |
| Cheong Woon Securities Co.* | 1996 | 32 | 10,920,000 | 341,250.00 | 73% | 8,000,000 |
| C.K. Securities Co. | 1996 | 53 | 10,420,000 | 196,603.77 | 77% | 8,000,000 |

* payment pending

Appendix B - Illustrative Compensation Company Rules for Investor Compensation Arrangements in relation to Members of the Stock Exchange of Hong Kong Ltd

1. Introduction

These Rules set out the procedures to be followed and the basic requirements for claiming compensation with the Compensation Company in relation to a default by a Member of the Exchange Company.

2. Definitions

In these Rules, the following terms have the following meanings.

“Commission” means the Securities and Futures Commission;

“Exchange Company” means the Exchange Company as defined in section 2(1) of the Securities Ordinance;

“Rules” means these rules as approved by the Commission;

“stockbroking business” means -

- (a) a business of dealing in securities listed or quoted on the Unified Exchange carried on by a member of the Exchange Company;
- (b) the administration of any trust, or the carrying on of the business of any company, in conjunction with, or as an adjunct to, a business specified in paragraph (a);
- (c) the retention of securities whether for safe keeping or otherwise, and whether for specific consideration or otherwise, in conjunction with, or as an adjunct to, a business specified in paragraph (a).

All questions concerning the interpretation or application of these Rules shall be determined by the Compensation Company whose decision shall be final and binding on all parties.

3. Claims for compensation

There are two main requirements that must be satisfied to make a claim. First, a person must have a cause of action against a Member of the Exchange Company in relation to any money, securities, or other property entrusted to or received by the Member of the Exchange Company or any person employed by the Member of the Exchange Company, in connection with the Member’s stockbroking business. Second, the Member of the Exchange Company must have committed a default, which means -

- (a) the bankruptcy, winding up or insolvency of the Member of the Exchange Company; or
- (b) any breach of trust, defalcation, fraud or misfeasance committed by the Member of the Exchange Company or by any person employed by the Member of the Exchange Company.

4. Submission of claims

- (1) If the Compensation Company believes that a Member of the Exchange Company has committed a default, it may publish notices calling for compensation claims. Claims must be submitted within 3 months after publication of the notice and in the manner specified in the notice.
- (2) If any person believes he is entitled to compensation under these Rules, that person must submit a claim with the Compensation Company using the claim form specified by the Compensation Company.
- (3) If no notice has been published by the Compensation Company under subsection (1), the claim must be submitted within 6 months after the person became aware of the default giving rise to the claim.
- (4) Any claim not submitted within the time specified in this Rule shall be barred, unless the Compensation Company in its discretion decides to accept the claim.
- (5) A person shall not have a claim against the Compensation Company for any default committed before [the appointed day].

5. Persons not entitled to claim compensation

The following persons shall not be entitled to claim compensation under these Rules:

- (a) a registered dealer, dealing partnership, dealer's representative, investment adviser, investment advisers' partnership, or investment representative under the Securities Ordinance (Cap. 333);
- (b) an exempt dealer or exempt investment adviser under the Securities Ordinance (Cap. 333);
- (c) a registered person under the Commodities Trading Ordinance (Cap. 250);
- (d) an authorized institution under the Banking Ordinance (Cap. 155);
- (e) a recognized clearing house under the Securities and Futures (Clearing Houses) Ordinance (Cap. 420);
- (f) the Exchange Company;

- (g) money lenders and finance companies;
- (h) any associate as defined in section 2(1) of the Securities and Futures Commission Ordinance (Cap. 24) of the Member of the Exchange Company who has committed a default under the Rule 3.

6. Compensation Company may require information or documentation

- (1) For any claim made under these Rules, the Compensation Company may at any time require any person to produce any securities, documents, or statements of evidence necessary -
 - (a) to substantiate any claim; or
 - (b) to enable the Compensation Company to exercise its subrogated rights against the Member of the Exchange Company or against any other person concerned; or
 - (c) for the purpose of enabling criminal proceedings to be brought against any person concerned in the default if the default involves allegations of a criminal offence.
- (2) Where any claimant required to produce information or documentation under subsection (1) fails to produce it, the Compensation Company may, if it is satisfied that the information or documentation is in the possession of or available to the claimant, disallow the claim until such time as the claimant produces the information or documentation.

7. Determination of claims, date of default, amount of loss, amount of compensation allowed

- (1) The Compensation Company will determine whether to allow or disallow a claim under these Rules and its decision shall be final. It will use its best efforts to determine claims as soon as practicable and within 6 months of receipt, but shall not be bound to do so.
- (2) After the Compensation Company has determined a claim, it will forthwith notify the claimant in writing of its determination and also notify the Commission and the Exchange Company.
- (3) If the Compensation Company determines to disallow a claim in whole or in part, it will give reasons for that determination to the claimant in the notice under subsection (2).
- (4) If the Compensation Company determines to allow a claim in whole or in part it will specify in the notice under subsection (2) the following:
 - (a) the date of default;
 - (b) the amount of the claimant's loss as calculated under these Rules; and

- (c) the amount of compensation allowed under these Rules.
- (5) The Compensation Company may include compensation payment with the notice of determination or may specify in the notice how compensation will be made. The Compensation Company may make one or more partial compensation payments if it determines that it is necessary or appropriate to do so, including compensation made under Rule 10.
- (6) No interest shall be payable in relation to the amount of a claimant's loss or the compensation made to a claimant under these Rules.

8. Calculation of amount of loss

The Compensation Company shall determine the amount of a claimant's loss due to the default of the Member of the Exchange Company as of the date of default. The amount of loss may be specified as a dollar amount, as an amount or quantity of securities or other property, or a net amount reflecting any indebtedness of the claimant to the defaulting Member of the Exchange Company.

9. Compensation limits

The Compensation Company may set limits to the compensation payable under these Rules. Compensation limits must be approved by the Commission and published by it in the Gazette. A description of any limits to the compensation payable under these Rules will also be made available by the Compensation Company as an addendum to these Rules.

10. Return of securities to claimants

- (1) Subject to the compensation limits under these Rules, where the Compensation Company determines that the amount of loss of a claimant under these Rules includes securities in which the claimant has a proprietary interest, the Compensation Company may, if the claimant so requests and to the extent that securities can be purchased in a fair and orderly market, purchase securities to deliver to the claimant in satisfaction or partial satisfaction of the allowed claim.
- (2) If a claimant elects to receive securities under subsection (1) the claimant shall specify the account of a participant of the Central Clearing and Settlement System to receive delivery of any securities.
- (3) If the claimant is indebted in any way to the defaulting Member of the Exchange Company, the Compensation Company may require the claimant to pay any such indebtedness to the Compensation Company prior to any purchase and delivery of securities under subsection (1).
- (4) Where a claimant requests a return of securities under subsection (1) and the amount of the claimant's loss is greater than the limits of compensation under these Rules, the claimant may request a return of such securities as the

claimant may specify and the Compensation Company may take that request into account if it purchases and delivers securities to the claimant.

- (5) In making compensation under this Rule, the Compensation Company may take all its related costs and expenses into account in determining whether the compensation limit has been reached in relation to the claimant.

11. Rules subject to any insurance arrangement

The Compensation Company may arrange for insurance, surety, guarantee, or any other financial arrangements as it in its discretion deems to be necessary or appropriate to enable it to meet its obligations under these Rules. These Rules shall be subject to any such insurance, surety, guarantee, or other financial arrangement a copy or description of which shall be made available to the public at the offices of the Compensation Company.

12. Subrogation of the Compensation Company

- (1) On the Compensation Company making any compensation to a claimant under these Rules -
 - (a) the Compensation Company shall be subrogated to the extent of that compensation to all the rights and remedies of the claimant in relation to the loss caused by the default on which the claim was based; and
 - (b) the claimant shall have no right in bankruptcy or winding up or by legal proceedings or otherwise to receive in respect of the loss any sum, securities or other property out of the assets of the Member of the Exchange Company concerned or any dealing partnership in which he is a partner, or where the loss was caused in whole or in part by the default of a servant, director, or partner of the Member of the Exchange Company, the assets of that person until the Compensation Company has been reimbursed the full amount of the compensation made.
- (2) A claimant shall cooperate as may reasonably be required by the Compensation Company to enable it to pursue its subrogated rights under subsection (1) and such cooperation may be required as a condition to the payment of any compensation.

13. Claim to be submitted as proof of debt in winding up or bankruptcy

If a claimant so requests on the claim form submitted to the Compensation Company, the claim will be submitted on behalf of the claimant as a proof of debt in any winding-up or bankruptcy proceeding in respect of the defaulting Member of the Exchange Company.

14. Provision where the assets of the Compensation Company are insufficient to meet claims

If the Compensation Company determines that the assets available to it are insufficient to enable the satisfaction under these Rules of all claims that it has allowed, the amount available to the Compensation Company shall be apportioned among the claimants as the Compensation Company shall determine in its discretion and any claim, so far as it remains unsatisfied, shall be charged against further receipts of the Compensation Company and satisfied when there is sufficient assets again available to the Compensation Company.

15. Discharge of claims

Where the Compensation Company has made compensation to a claimant in accordance with these Rules, the rights of the claimant against the Compensation Company in relation that claim shall be absolutely discharged. However, the Compensation Company may in its discretion determine to provide further assistance to the claimant. This may include, for example, relinquishing its subrogated rights against the defaulting Member of the Exchange Company in exchange for a release and a repayment by the claimant of the compensation paid to the claimant to enable the claimant to receive a return of the claimant's securities or other property in a bankruptcy or winding up proceeding concerning the defaulting Member of the Exchange Company.

16. Annual report, accounts, and estimates of the Compensation Company

The Compensation Company will prepare an annual report, annual accounts, and estimates of its income and expenditure as required by section [...]. A copy of these will be provided to the Exchange Company at the same time as they are provided to the Commission.

17. Rules of the Compensation Company

These rules and any amendments to them must be approved by the Commission under section [...]. Where the Compensation Company submits any of these Rules or amendments thereto or any amendments to the constitution of the Compensation Company to the Commission for approval it will copy such submission at the same time to the Exchange Company.

18. Immunity

Section [...] provides that, without prejudice to the generality of section 56(1) of the Securities and Futures Commission Ordinance (Cap. 24), no liability shall be incurred by a recognized investor compensation company or any person acting on behalf of the recognized investor compensation company, in respect of anything done in good faith in the performance or purported performance of any of its functions under its rules or [...].

Addendum: Compensation Limits

The limit of compensation to any claimant under these Rules in relation to a defaulting Member of the Exchange Company shall be \$[...]. The limit shall be calculated with reference to the total costs and expenses of making compensation to the claimant as calculated by the Compensation Company and notified to the claimant.

[...] Represents areas where new legislation will be proposed.