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Hong Kong June 2018

SFC Consults on Proposed Enhancements to the Investor Compensation Regime and Related Legislative Amendments

Introduction

The Securities and Futures Commission (**SFC**) published a Consultation on Proposed Enhancements to the Investor Compensation Regime and Related Legislative Amendments[1] (**Consultation**) on 27 April 2018. The cut-off date for responding to the Consultation is 27 June 2018, and the SFC is hoping to finalise the proposals by mid-2018 and to introduce legislative amendments into the Legislative Council before the end of 2018.

In the Consultation, the SFC proposes to:

a) increase the compensation limit per investor from HK$150,000 to HK$500,000;

b) increase the trigger levels for the suspension and reinstatement of the investor compensation fund levies from HK$1.4 billion and HK$1 billion, to HK$3 billion and HK$2 billion, respectively;

c) extend the ICF regime to cover northbound trading under the Mainland-Hong Kong Stock Connect (but not southbound trading); and

d) empower the SFC to make interim compensation payments out of the ICF in exceptional circumstances where delay in payment may increase systemic concerns.

1 https://www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo=18CP4

The proposed enhancements require amendments to the following subsidiary legislation: the Securities and Futures (Investor Compensation-Claims) Rules (Cap 571T), the Securities and Futures (Investor Compensation-Levy) Rules (Cap 571AB), the Securities and Futures (Investor Compensation-Compensation Limits) Rules (Cap 571AC) and the Securities and Futures (Transfer of Functions-Investor Compensation Company) Order (Cap 571AD).

Current Investor Compensation Regime

The investor compensation regime provides that investors who suffer financial losses due to the default of a licensed intermediary or authorised financial institution may be compensated out of the Investor Compensation Fund (**ICF**).

Under the current regime, the ICF is funded by: (i) monies from the compensation funds of previous regimes; (ii) investment income; and (iii) transaction levies (**ICF levies**) payable by purchasers or sellers of securities or futures on the Stock Exchange of Hong Kong (**HKEx**) or on the Hong Kong Futures Exchange (**HKFE**).

Only losses in respect of securities or futures contracts that are listed or traded on the HKEx or the HKFE, and any related assets, are covered under the regime. In addition, the regime only covers losses attributable to the default of a dealing or financing intermediary or a person related to such an intermediary (for example, its employee). A dealing or financing intermediary is (i) an intermediary licensed for dealing in securities (Type 1 regulated activity) or for dealing in futures contracts (Type 2 regulated activity); (ii) an intermediary licensed for securities margining financing (Type 8 regulated activity); or (iii) an authorised financial institution which provides securities margin financing.

There is a compensation limit of HK$150,000 per investor per default. There are separate, independent limits for securities-related losses and for futures-related losses. This means that where there is default by an intermediary with both a securities business and a futures business, investors may claim up to HK$150,000 for any securities-related losses and an additional HK$150,000 for any futures-related losses. Investors cannot use the HK$150,000 limit for futures-related losses to offset securities-related losses that are greater than HK$150,000 (and vice versa).

Under the regime, ICF levies are suspended and reinstated when the net asset value of the ICF reaches HK$1.4 billion and HK$1 billion, respectively.

Proposed Enhancements to the Investor Compensation Regime

Increase the compensation limit

The SFC proposes to increase the compensation limit of HK$150,000 per investor per default to HK$500,000 per investor per default under the Securities and Futures (Investor Compensation-Compensation Limits) Rules (Cap 571AC). The reasons for this proposed compensation limit increase are as follows:

1. Hong Kong's markets have grown significantly over the past ten years in terms of market capitalisation, average daily turnover, number of listed companies and number of exchange participants. With this growth, the value of clients' assets held with intermediaries has also increased.

2. In general, the SFC aims for the compensation limit to attain a coverage ratio of around 80% (i.e. losses of approximately 80% of investors to be within the level of the compensation limit). Survey data suggests that a compensation limit of HK$5,000,000 would result in an average coverage ratio of around 83%.

3. The existing HK$150,000 compensation limit is lower than other comparable investor schemes. An increase to HK$500,000 would bring Hong Kong within the mid-range of comparable schemes – above Singapore (SGD50,000, equivalent to approximately HK$295,000), similar to the UK (GBP50,000, equivalent to approximately HK$547,000) and below the US (USD500,000, equivalent to approximately HK$3.9 million). It is also the same limit as applies under the Hong Kong Monetary Authority's Deposit Protection Scheme, under which certain bank deposits are protected, with a HK$500,000 compensation limit per depositor per bank.

Increase the trigger levels for levy suspension and reinstatement

Where the compensation limit is increased to HK$500,000, it will be necessary to increase the trigger levels for suspending and reinstating the ICF levies. The SFC proposes to increase the levy suspension level from HK$1.4 billion to HK$3 billion, and the levy reinstatement level from HK$1 billion to HK$2 billion. In determining the proposed new levels, the SFC has considered the following:

1. The trigger levels should reflect the aim of the mechanism for levy suspension and reinstatement – to make sure that the ICF is at a level sufficient to cover potential obligations, but without investors contributing more than is necessary.

2. Since the establishment of the ICF in 2003, there have only been several relatively large-scale intermediary defaults.

3. In light of the 2008 global financial crisis, there has been an increased emphasis on potential systemic risks. Thus, it is insufficient to only take into account past pay-outs, and the ICF must be in a position to hold out in the case of defaults which may pose systemic risk. As the ICF may also be financed by borrowing, the SFC considers it unnecessary and extreme for the ICF to be at such a level to fund default of the largest intermediaries (likely to be banks with large numbers of clients). Therefore, the SFC proposes to consider the two largest non-bank/non-bank-related intermediaries – the SFC estimates the potential pay-out if either were to default, and then averages these estimates over a period of around five years.

4. Changes to the suspension and reinstatement levels should be sustainable for a reasonable period, given any change requires legislative amendments, and frequent changes may lead to increased costs and burdens on the market. Thus, potential future growth in client assets should be considered when determining the new levels.

As the ICF levies have been suspended since December 2005 and the ICF was valued at HK$2.36 billion at the end of February 2018 (between the proposed HK$2 billion suspension level and HK$3 billion reinstatement level), there is a question as to whether the ICF levies should be reinstated or the suspension should remain in force. The SFC's view stated in the Consultation is that the current suspension should continue until the ICF falls below HK$2 billion.

The SFC has examined whether there should be any amendments to the existing arrangement whereby ICF levies are charged on a transaction basis and paid by buyers and sellers of securities or futures. In other jurisdictions, market participants typically finance compensation funds; however, schemes in each jurisdiction have a different scope and coverage. Under the current system in Hong Kong, investors are subject to a minimal cost of 0.002% of the transaction value. The arrangement in Hong Kong is also an effective and reasonably quick method to increase a reserve to protect retail investors, and is relatively straightforward and inexpensive to administer. Given that the current arrangement has worked well, the SFC does not consider it necessary to make any amendments at this time.

Adjusting coverage to cater for Stock Connect

The Stock Connect schemes provide mutual market access allowing Hong Kong and international investors to make northbound investments in certain stocks listed on the Shanghai Stock Exchange and the Shenzhen Stock Exchange (**Northbound trading**) and allowing mainland investors to invest southbound in stocks listed in Hong Kong through the Shanghai Stock Exchange and the Shenzhen Stock Exchange (**Southbound trading**). The Stock Connect comprises the Shanghai-Hong Kong Stock Connect launched in November 2014 and the Shenzhen-Hong Kong Stock Connect launched in December 2016.

The current ICF regime only covers losses relating to securities or futures traded on the HKEx or HKFE. Although the aim of the regime is to protect investors against default by intermediaries in Hong Kong and securities traded on the Shanghai Stock Exchange and the Shenzhen Stock Exchange under Stock Connect must be routed through Hong Kong intermediaries, losses from Northbound trading are not covered. The SFC thus proposes to include losses relating to Northbound trading under the ICF regime.

In relation to Hong Kong investors trading listed securities on other overseas markets, the SFC in the Consultation differentiates between trading on overseas markets through intermediaries that are regulated in overseas markets and trading conducted through Hong Kong-regulated intermediaries under Stock Connect. The SFC also differentiates between Southbound trading and Northbound trading, with the former being conducted through Mainland regulated intermediaries. Other overseas markets and Southbound trading are not subject to ICF levies, however investors trading securities on the Shanghai Stock Exchange and the Shenzhen Stock Exchange under Stock Connect would be liable to pay such levies.

Providing flexibility for the SFC to make interim payments

Compensation payments may only be made after all details of a claim have been obtained. In certain circumstances, a delay in making compensation may pose a threat to the stability of the wider market. It is proposed that the SFC should be empowered to make interim payments only where:

a) there is uncertainty as to any amount payable to a claimant by the defaulting intermediary (or vice versa), and hence the amount of compensation payable, and time is needed to resolve such uncertainty;

b) circumstances exist, in Hong Kong or elsewhere, which pose or may pose a systemic risk in the securities or futures industry or to the financial stability of Hong Kong; and

c) as a result of those circumstances, it is in the interest of the investing public or in the public interest not to delay payment of compensation until the uncertainty is resolved.

The SFC is to exercise its power only in exceptional circumstances, and with caution and restraint.

In addition, it is proposed that if any compensation paid (whether or not as an interim payment) to a claimant from the compensation fund is later found to be greater than the amount of compensation payable to the claimant, the claimant must repay the excess to the SFC. Where there is a delay in the return of any excess, the SFC may impose on the claimant a late repayment fee (not exceeding 5% of the amount of the excess that remains to be repaid).

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