

Investor Compensation Company Limited¹

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Summary

With the enactment of the Securities and Futures Ordinance (“SFO”) on 1 April 2003, a new compensation arrangement has taken effect. The Investor Compensation Company Limited (“ICC”) began operations on that date and has the responsibility to process claims against the Investor Compensation Fund (“ICF”) and make payments from the ICF in the event of defaults³ by covered intermediaries⁴ in relation to products traded on the Stock Exchange of Hong Kong Limited (“SEHK”) and the Hong Kong Futures Exchange Limited (“HKFE”).

The purpose of the new arrangement is to provide a measure of compensation primarily for retail investors trading within the Hong Kong securities and futures market. The compensation limit is set at a maximum of HK\$150,000 per investor per default case.

The mission of the ICC is to effectively and efficiently administer investors’ claims against the ICF under the SFO.

Introduction

With the enactment of the SFO, the ICC was set up and established under section 79(1) of the SFO to administer and manage the ICF established under

the SFO. The ICC is a wholly owned subsidiary of the Securities and Futures Commission (“SFC”) and officially commenced operation on 1 April 2003 at the same time as the SFO became effective. The objective of the ICF is to provide a secure and cost-effective measure of compensation per retail investor in relation to products traded on the Hong Kong Exchanges and Clearing Limited (“HKEx”). It is also intended that the new compensation arrangements could help improve investor confidence and enhance stability in the market.

The ICF has replaced the previously set up Unified Exchange Compensation Fund (“UECF”) and the Commodity Exchange Compensation Fund (“CECF”) and the Dealers’ Deposit Scheme for non-exchange intermediaries and registered dealers for defaults which occur on or after 1 April 2003. Default cases which occur before 1 April 2003 continue to be processed under the UECF and CECF schemes.

Mission of the ICC

The main mission of the ICC is to effectively and efficiently administer investors’ claims against the ICF under the SFO.

[1] This article was prepared in January 2004. It has the same factual basis and origin as the article “New Investor Compensation Arrangement” written by Mrs. Irene Tang published in the SFC Quarterly Bulletin Winter 2002 Issue No. 50.

[2] Mr. John Lau is currently the General Manager of the ICC.

[3] Legislation now extends the meaning of “Default” to include bankruptcy, winding up, insolvency, breach of trust, defalcation, fraud, or misfeasance by a specified person, its employee or associated persons.

[4] Covered intermediaries now go beyond exchange participants and brokers and include all licensed and registered persons authorized to deal in securities and futures contracts on the Stock Exchange of Hong Kong and the Hong Kong Futures Exchange and licensed margin financiers.

Compensation Arrangement

Key features of the new compensation arrangement are as follows:

- 1) A single Fund to cover products trading at the SEHK and HKFE.
- 2) Investors may claim compensation from the ICF if pecuniary losses are suffered as a result of a default committed by the specified person or its associated person in relation to securities or futures traded on HKEx.
- 3) The scheme covers defaults by
 - a) Intermediaries licensed or registered for dealing in securities or futures contracts;
 - b) Intermediaries licensed for securities margin financing; or
 - c) Authorized financial institutions who provide securities margin financing
- 4) The total amount of compensation that can be awarded as a result of a single default is limited to HK\$150,000 per claimant in relation to trading at the SEHK.
- 5) The total amount of compensation that can be awarded as a result of a single default is limited to HK\$150,000 per claimant in relation to trading at the HKFE.
- 6) "Default" is defined in the Securities and Futures (Investor Compensation - Claims) Rules. It means that a specified person (an intermediary or an authorized financial institution), its employee or its associated person is in bankruptcy, winding up or insolvency or has committed breach of trust, defalcation, fraud or misfeasance, which occurs on or after 1 April 2003.
- 7) Money for the ICF comes originally from the UECF and the CECF. In addition, the ICF receives a levy on exchange transactions. The current levy on securities transactions is 0.002% each payable by buyers and sellers. For futures contracts, it is HK\$0.5 per side of a contract or HK\$0.1 per side of a mini contract. Income is also derived from investment return of the ICF itself.
- 8) The objective of the ICF is to protect retail investors, hence the following investors cannot claim against the ICF:
 - i) a licensed corporation
 - ii) an authorised financial institution
 - iii) a recognised exchange company, a recognised exchange controller, or a recognised clearing house
 - iv) an authorised automated trading services provider
 - v) an authorised insurer
 - vi) a manager or operator of an authorised collective investment scheme
 - vii) an employee or an associate of the defaulting intermediary which is a corporation
 - viii) the Government or an overseas government
 - ix) a person acting as a trustee or custodian of the above corporations

Securities and Futures (Transfer of Functions – Investor Compensation Company) Order

The responsibilities and functions of the ICC emanate from the SFC under the SFO and are listed out in the Securities and Futures (Transfer of Functions – Investor Compensation Company) Order ("Order") as summarized below.

Securities and Futures Ordinance (Cap 571)

<u>Item</u>	<u>Provision</u>	<u>Description</u>
1.	Section 236(1)	Maintaining the compensation fund.
2.	Section 237(2)	Borrowing money for the purpose of the compensation fund.
3.	Section 238(1)	Management and administration of the compensation fund, including the determination of a claim for compensation.
4.	Section 239	Opening accounts at authorized financial institutions and paying into or transferring to such accounts all amounts received by the Investor Compensation Company forming part of the compensation fund.
5.	Section 240(1)	Keeping proper accounts of the compensation fund.
6.	Section 240(2)	Maintaining separate accounts and sub-accounts.
7.	Section 240(5)	Appointing an auditor to audit the accounts of the compensation fund.
8.	Section 241	Investing money which forms part of the compensation fund.
9.	Section 242(1)	Making payments out of the compensation fund and determining the order of such payments.

Securities and Futures (Investor Compensation-Claims) Rules (Cap 571 sub. leg. T)

<u>Item</u>	<u>Provision</u>	<u>Description</u>
10.	Section 3	Publishing a notice inviting claims.
11.	Section 4(4)	Determining whether a claim not lodged within the time limit provided in section 4(3) is barred.
12.	Section 5(2)	Accepting a claim lodged otherwise than in accordance with section 5(1).
13.	Section 6	Requiring records to be produced.
14.	Section 7	Making a determination.
15.	Section 8	Issuing a notice of determination.
16.	Section 9	Paying compensation.
17.	Section 10	Arranging for insurance, surety, guarantee or other financial arrangements.

The Order provides the basis for the transfer of the above functions from the SFC to the ICC if deemed appropriate at some stage. Most of the claims processing functions have been transferred from the

SFC to the ICC, and further transfer of fund management and investment functions may happen in the future.

Organization and Management

The management of the ICC rests with the Board of Directors. The Board currently has ten directors and they are appointed by the SFC, comprising staff members from the SFC, the HKEx securities and futures industry professionals, lawyers, accountants and people representing public interest. The current Chairperson is Ms. Anna H.Y. Wu, SBS, JP.

Operational Structure

Since defaults are not a regular event, the volume of claims received by the ICC may swing from a very low trough to a very high peak during different periods.

In order to reduce operational expenses, the ICC has adopted a structure that offers maximum flexibility, with most of its operations outsourced to external suppliers and vendors. The ICC relies on the effectiveness and efficiency of its partners, suppliers and vendors to deliver their services as arranged beforehand, which contemplates the possibility of a high volume of claims in the event of defaults arising. The benefit of this operating structure is that staffing level of the ICC is able to be kept to a minimum with only three full time employees; the General Manager, the Market Communications and Public Relations Manager and an Administrator.

In view of the limited internal staffing level of the ICC, the current arrangement with our claims processing service provider is that only the first 30 claims within a financial period from 1 April to 31 March of next year are to be handled by the ICC internally. Once there are more than 30 claims within a financial year, from the 31st claim onwards the claims are to be handled by the ICC's appointed claims processing partner.

However, if there was a default which is likely to result in more than 30 claims, for example because the defaulting intermediary has dozens or hundreds of clients who may file a claim, the entire claims processing for all claims relating to the same intermediary default incident will be handled by the ICC's appointed claims processing partner, notwithstanding that there are remaining quota left from the annual limit of 30 claims that should be processed by the ICC internally. This arrangement is to ensure consistency and efficiency such that all claims relating to the same default are treated by exactly the same process.

Claim Procedures

- 1) The ICC does not charge any fees relating to claims against the ICF from the claimants.
- 2) Claims have to be submitted within before or specified date which is at least 3 months of the ICC issuing a Notice of Claim relating to a named defaulting person. If no Notice of Claim is issued, claims must be submitted within 6 months of the investor first becoming aware of the default.
- 3) When submitting a claim form to the ICC or its appointed agent, claimants need to submit copies of documents that the defaulting person has given or sent to him/her about his/her investments and account position. These might include the client's account agreement, latest account statement, contract notes, proof of payment and deposit receipts for securities etc.

The more evidence is submitted, the easier it will be to process the claim. If the required documents cannot be produced at the first instance, or if further information is required, ICC or its appointed agent may contact the claimant for an explanation of events or submission of further materials.

It is important that claimants should keep the ICC updated of any subsequent changes in the information submitted, such as change of address, contact phone number or amendments to the amount of claims, etc.

- 4) The ICC and/or its appointed claims processing partner will process claims received as quickly as possible. However, the determination process depends very much on the complication of the default and the legal process involved. Delay may also occur if claimants cannot provide the full supporting documentation. The ICC will make payments to the allowed claimants as soon as practicable following the determination.
- 5) When the ICC makes a determination that the claim should be allowed, disallowed or allowed in part, it will inform, as soon as practicable, claimants of its decisions by issuing a Notice of determination. The Notice of determination is normally posted to the address of the claimant as reported in the claim form.
- 6) If the claim is disallowed in full or is only allowed in part, the claimant will be given a reasonable opportunity of being heard before the ICC issues him/her the notice of determination. Reasons for disallowance or allowance in part will also be given in the notice of determination.
- 7) If claimants are dissatisfied with the determination, he/she can lodge an appeal with the Securities and Futures Appeals Tribunal within 3 months after the service of the Notice of determination. They should contact the ICC regarding appeals.

Action Plan

Most of the effort in 2003 had been towards setting up the operational infrastructure of the ICC as an entirely new company in a start up situation; such

as hiring the appropriate staff, evaluating and appointing partners, suppliers and vendors, establishing a new office, establishing operational procedures and so on. Much work remains to be done in 2004 and beyond.

Awareness development

The ICC is still relatively new to the public and it is considered necessary that our profile should be enhanced with some publicity that explains to the public and other stakeholders about our existence, mission and functions. It is intended that the ICC should maintain a relatively low key strategic position whilst creating public awareness in the investment community, especially amongst retail investors so that in the event of defaults, the public would know where to turn and possibly file a claim with the ICC.

Managing the ICF

The UECF and the CECF should eventually roll into the ICF after all the claims emanating from defaults arising before 1 April 2003 have been dealt with. Total value of the UECF, the CECF and the ICF accumulated so far exceeds HK\$1 billion. Until there is any change in legislation, the investor compensation levy will continue to be charged on transactions traded at the SEHK and the HKFE. ■■

Contact Details

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