

**IFPHK's Response to the Securities and Futures  
Commission (SFC) Consultation Paper on Consultation  
Paper on Proposed Enhancements to the Investor  
Compensation Regime and Related Legislative  
Amendments**

**June 2018**

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## **Institute of Financial Planners of Hong Kong (IFPHK) - Profile**

### **Background**

The IFPHK was established in June 2000 as a non-profit organization for the fast-growing financial industry. It aims to be recognized in the region as the premier professional body representing those financial planners that uphold the highest standards for the benefit of the public.

The IFPHK is the sole licensing body in Hong Kong authorized by Financial Planning Standards Board Limited to grant the much-coveted and internationally-recognized CFP<sup>CM</sup> certification and AFP<sup>TM</sup> certification to qualified financial planning professionals in Hong Kong and Macau.

It represents more than 6,800 financial planning practitioners in Hong Kong from such diverse professional backgrounds as banking, insurance, independent financial advisory, stockbroking, accounting, and legal services.

Currently there are more than 147,000 CFP certificants in 24 countries/regions; the majority of these professionals are in the U.S., Canada, China, Australia and Japan, with more than 4,700 CFP certificants in Hong Kong.

CFP<sup>CM</sup>, CERTIFIED FINANCIAL PLANNER<sup>CM</sup>,  CFP<sup>CM</sup>,  CERTIFIED FINANCIAL PLANNER<sup>TM</sup>, AFP<sup>TM</sup>, ASSOCIATE FINANCIAL PLANNER<sup>TM</sup>,  AFP<sup>®</sup> and  ASSOCIATE FINANCIAL PLANNER<sup>®</sup> are certification marks and/or trademarks owned outside the U.S. by Financial Planning Standards Board Ltd. The Institute of Financial Planners of Hong Kong is the marks licensing authority for the CFP marks and AFP marks in Hong Kong and Macau, through agreement with FPSB.

### **IFPHK's interest in this consultation**

The mission and vision of the IFPHK is to promote the importance of financial planning<sup>1</sup>. The IFPHK is the sole licensing body in Hong Kong authorized by the FPSB to grant the internationally recognized CFP<sup>CM</sup> Certification and AFP<sup>TM</sup> Certification to qualified financial planning professionals in Hong Kong and Macau.

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<sup>1</sup> [www.fpsb.org](http://www.fpsb.org). Financial planning refers to the process of setting, planning, achieving and reviewing life goals through the proper management of finances.

As the leading professional body for the welfare of the financial planning industry, the IFPHK actively responds to policy changes that affect the industry or the financial system as a whole. In 2009, we commented on the Securities and Futures Commission (SFC) proposal put forward in the wake of the Lehman Brothers Minibond Saga that suggested ways to better protect the investing public. In 2010, the IFPHK submitted a response to the consultation paper on establishing an Investor Education Council and a Financial Dispute Resolution Centre. In 2011, IFPHK supported the establishment of a Policyholder's Protection Fund. In 2014, the institute responded to the Consultation Document on developing an effective resolution regime in Hong Kong. We also submitted our comments on enhancements to Deposit Protection Scheme in the same year. For full list of IFPHK's submission, please refer to the IFPHK webpage. (<http://www.ifphk.org/ee/importance-of-advocacy>).

In light of the above, IFPHK wishes to comment on the proposals set out in the Consultation Paper.

#### **IFPHK's representation**

IFPHK was founded by 30 members (the 'Founding Members') to raise the standards of financial planners and highlight the importance of sound financial planning.

IFPHK currently has 35 Corporate Members, including banks, independent financial advisors, insurance companies and securities brokerages. With our Corporate Members providing a full spectrum of client services and products, the IFPHK is well positioned to understand the needs, concerns and aspirations of the financial planning community.

## **Executive Summary**

On 27 April 2018, the Securities and Futures Commission (“SFC”) today launched a two-month consultation on proposed enhancements to the Investor Compensation Regime (the “Consultation Paper”). The Investor Compensation Regime has been in place since 1 April 2003 when the Securities and Futures Ordinance came into effect. Deadline of submission is 27 June 2018.

Key proposals include increasing the compensation limit from \$150,000 to \$500,000 per investor per default and covering northbound trading under Mainland-Hong Kong Stock Connect. In addition, the SFC proposes to raise the trigger levels for suspending and reinstating the Investor Compensation Fund levies from \$1.4 billion to \$3 billion and from \$1 billion to \$2 billion respectively. This will not affect the levy suspension currently in place. Another proposal would empower the SFC to make interim compensation payments in exceptional circumstances where delays may raise or increase systemic concerns.<sup>2</sup>

The investor compensation fund (“ICF”) regime has been in place since April 2003. It provides a safety net for retail investors who suffer losses as a result of defaults of licensed intermediaries or authorised financial institutions that offer exchange-traded investment products in Hong Kong. Defaults cover insolvency, bankruptcy or winding up, breach of trust, misappropriation of funds, fraud or misfeasance – intentional incorrect action or advice.

This submission paper is based on the following principles in which IFPHK advocates:

### ***Aligning with international standard***

As an international financial centre, Hong Kong is not immune from international financial market and regulatory development. This has been illustrated by the financial crisis, where problems originating in one country quickly spread across the globe. In order to enable Hong Kong to continue to excel in its status as an international financial centre, it is essential that we keep abreast of the development of international standard. In response to crisis, temporary guarantee arrangements were established and the scope of existing arrangements was extended in various countries. Policy makers need to understand the effects of the various guarantee arrangements and to ensure internal consistency among them.<sup>3</sup> As such, the government shall take into account

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<sup>2</sup> SFC news on 27 April 2018

<sup>3</sup> Sebastian Schich and Byoung-Hwan Kim, Guarantee Arrangements for Financial Promises: How Widely Should the

international standard as well as local policy objectives when reviewing any guarantee arrangements.

### ***Enhancing consumer protection***

The IFPHK has always believed that qualified intermediaries and well-informed and educated consumers, together with a robust framework, should form the core pillars for protecting the investing public. As financial products get more complex and sophisticated, it is of utmost importance that investors/consumers are provided with proper and adequate protection under a sound and effective regulatory system. The IFPHK regards that the reputation of the financial planning industry has been unfairly tarnished after the financial crisis due to varying standards of sales practice and professionalism. Indeed, the confidence of consumers has not been restored after the crisis. According to the latest trust barometer report of Edelman, trust in financial services has been continuously declined in Hong Kong. A solid investor compensation scheme can help to restore investor's confidence to the financial system as a whole.

### ***Ensuring a level playing field across the financial service industry***

The IFPHK believes there is a need for implementing a consistent approach across the industry to establish a 'level playing field' among all financial planners/advisors in the different distribution segments. The IFPHK strongly believes that a consistent approach will significantly reduce any regulatory arbitrage that could potentially undermine the good intentions of protecting investors. Therefore, when reviewing the ICF Scheme, it is sensible to take into account other similar arrangement in Hong Kong such as Policyholder Protection Fund and Deposit Protection Scheme.

Based on the above principles, the IFPHK agrees on the proposals to:

- Raise the compensation limit to \$500,000;
- Raise the levy suspension and reinstatement levels to \$3 billion and \$2 billion respectively;
- Expand to cover losses relating to Northbound trading
- Empower the SFC to make interim payments

Apart from the above, we have addition comments for the SFC consideration:

- The SFC decided not to change the funding arrangement in this Consultation Paper. We noted that compensation funds are generally funded by market participants in other jurisdictions. To

align with international practice and to restore consumers' confidence, we urge the SFC to consider solely collect funding from the market participants.

- In view of rapid changing financial industry, it is important to implement a robust review system and mechanism that could quickly adjust the compensation limit and the scope of the ICF. The review system shall ensure that the fund is always affordable, fit for the policy objective and at the same time avoid any moral hazard.

In the nutshell, a solid investor compensation scheme is part of a resolution regime and is an important element of maintaining investor confidence. The resolution regime is a key part of the broader financial stability framework. An effective resolution regime helps to make supervision more effective.

## **The SFC Consultation**

On 27 April 2018, the Securities and Futures Commission (SFC) today launched a two-month consultation on proposed enhancements to the Investor Compensation Regime (the “Consultation Paper”). The Investor Compensation Regime has been in place since 1 April 2003 when the Securities and Futures Ordinance came into effect. Deadline of submission is 27 June 2018.

Key proposals include increasing the compensation limit from \$150,000 to \$500,000 per investor per default and covering northbound trading under Mainland-Hong Kong Stock Connect. In addition, the SFC proposes to raise the trigger levels for suspending and reinstating the Investor Compensation Fund levies from \$1.4 billion to \$3 billion and from \$1 billion to \$2 billion respectively. This will not affect the levy suspension currently in place. Another proposal would empower the SFC to make interim compensation payments in exceptional circumstances where delays may raise or increase systemic concerns.

The Consultation Paper contains 7 questions which set out as follows:

1. Do you agree that the compensation limit should be increased to \$500,000? If not, please explain why?
2. Do you agree that the levy suspension and reinstatement levels should be raised to \$3 billion and \$2 billion respectively? If not, please explain why.
3. Do you have any other comments regarding the proposals discussed in paragraphs 9 to 14 in the Consultation Paper?
4. Do you agree that the ICF regime should be expanded to cover losses relating to Northbound trading? If not, please explain why?
5. Do you have any other comments regarding the proposals to adjust coverage to cater for Stock Connect?



6. Do you agree that the SFC should be able to make interim compensation payments in the exceptional circumstances described in paragraph 19 above? If not, please explain why.
  
7. Do you have any other comments regarding the proposals to provide flexibility for the SFC to make interim payments?

### **IFPHK's Submission**

The views expressed in this submission paper are not necessarily simply summaries of the views taken from the industry. They have undergone independent and critical analysis and consideration by the IFPHK as a professional body. As a result, not all the views collected by the IFPHK are recorded in this submission paper. Nor have all the views expressed in this paper been directly endorsed by the industry representatives or members consulted.

In considering the various proposals of the Consultation Paper, the IFPHK's comments are based upon the following principles and beliefs:

### **IFPHK's Principles**

#### ***Aligning with international standard***

Globalization and financial market integration have increased rapidly in the past decade. As an international financial centre, Hong Kong is not immune from international financial market and regulatory development. This has been illustrated by the financial crisis, where problems originating in one country quickly spread across the globe. In order to enable Hong Kong to continue to excel in its status as an international financial centre, it is essential that we keep abreast of the development of international standard.

In the aftermath of the financial crisis there was general recognition that in spite of supervisory measures, it is inevitable that some financial institutions will encounter serious financial difficulties which could seriously harm the confidence of consumers. Guarantee arrangements have become a policy intervention mechanism especially after the global financial crisis. Explicit deposit insurance arrangements have now become a standard feature of national financial systems. Insurance policyholder protection schemes are becoming more widespread in financial system around the world and are fairly common among advanced economies. In response to crisis, temporary guarantee arrangements were established and the scope of existing arrangements was extended<sup>4</sup>.

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<sup>4</sup> Sebastian Schich and Byoung-Hwan Kim, Guarantee Arrangements for Financial Promises: How Widely Should the Safety Net be Cast?, OECD Journal: Financial Market Trends Volume 2011 – Issue 1, 2011

However, this kind of protection schemes cannot be expanded without limit. Guarantees need to be limited and affordable. Policy makers need to focus on each individual guarantee and ensure that it is being used for the appropriate policy objective and it is effective in achieving such objectives.<sup>5</sup> As such, the government shall take into account international standard as well as local policy objectives.

### ***Enhancing consumer protection***

The IFPHK has always believed that qualified intermediaries and well-informed and educated consumers, together with a robust framework, should form the core pillars for protecting the investing public. As financial products get more complex and sophisticated, it is of utmost importance that investors/consumers are provided with proper and adequate protection under a sound and effective regulatory system. The IFPHK supports a regulatory system which would facilitate delivering better financial products and services to the benefit of members of the public, as well as protecting them. Hence, the effectiveness of consumer protection and a healthy balance of robust regulations and market development are the FPHK's areas of focus.

The IFPHK regards that the reputation of the financial planning industry has been unfairly tarnished after the financial crisis due to varying standards of sales practice and professionalism. The confidence of consumers has not been restored after the crisis. In 2016, a territory-wide study by the IFPHK with GfK finds that only 18 percent say their confidence in the markets has been fully restored after the 2008 Lehman Brothers incident.<sup>6</sup> According to the latest trust barometer report of Edelman, trust in financial services has been continuously declined in Hong Kong. Index dropped from 55% to 47% which represented general population distrust financial services institutions. Double-digit declines in informed public trust in financial services, Hong Kong's index decreased by 15% to 48%.<sup>7</sup> A solid investor compensation scheme can help to restore investor's confidence to the financial system as a whole.

### ***Ensuring a level playing field across the financial service industry***

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<sup>5</sup> Sebastian Schich and Byoung-Hwan Kim, Guarantee Arrangements for Financial Promises: How Widely Should the Safety Net be Cast?, OECD Journal: Financial Market Trends Volume 2011 – Issue 1, 2011

<sup>6</sup> The Value of Financial Planning and Awareness of CFP Certification: A Global Financial Planning Survey Hong Kong Results, FPSB and GfK, 2016

<sup>7</sup> 2018 Edelman Trust Barometer

The IFPHK believes that the failure to implement a consistent approach across the industry could result in significant negative consumer and industry consequences. The IFPHK is frequently urged by industry professionals to highlight the need for implementing a consistent approach across the industry to establish a 'level playing field' among all financial planners/advisors in the different distribution segments. We have already expressed our views in our responses to various consultation documents. The IFPHK strongly believes that a consistent approach will significantly reduce any regulatory arbitrage that could potentially undermine the good intentions of protecting investors. Therefore, when reviewing the ICF Regime, it is sensible to take into account other similar arrangements in Hong Kong such as Policyholder Protection Fund and Deposit Protection Scheme.

### ***Questions raised in the Consultation Paper***

#### ***Raising the compensation limit***

The SFC proposes raising the compensation limit from \$150,000 to \$500,000 because (a) the total value of client assets held with the securities intermediaries has increased by more than 50% from \$598 billion to \$918 billion over the last three years, (b) the target coverage ratio is about 80% and as such if the compensation limit were raised to \$500,000, the average coverage ratio would rise to around 83% and (c) the current \$150,000 compensation limit is low compare to international standard.

#### ***Question 1:***

**Do you agree that the compensation limit should be increased to \$500,000? If not, please explain why.**

#### **IFPHK Responses**

In accordance to the aforementioned IFPHK's principles (e.g. aligning with international standards, ensuring a level playing field, etc), we support to increase the compensation limit. In deciding the appropriate compensation limit, it is useful to take into account the amounts of other jurisdictions. The proposed compensation limit of \$500,000 is the same as the amount of the Deposit Protection Scheme. It is also higher than the limit of our major competitor Singapore and at similar level to the one of UK. Thus, IFPHK thinks the proposed limit is appropriate. Nonetheless, the amount is still

below of those in the US and Canada, the SFC may consider take this opportunity to set a higher limit. Alternatively, the SFC may consider implement a mechanism that could more robustly adjust the compensation limit.

### ***Raising the trigger levels for levy suspension and reinstatement***

Consequential to raising the compensation limit to \$500,000, it will be necessary to raise the trigger levels for suspending and reinstating the ICF levies. The SFC proposes raising the levy suspension level from the current \$1.4 billion to \$3 billion, and the levy reinstatement level from the current \$1 billion to \$2 billion. In setting the new levels, the SFC have taken into account (a) objective of ICF, (a) the pay-outs in past default cases, (c) estimating potential obligations in order for the ICF to withstand the immediate impact of more significant defaults, and (d) trigger levels should be sustainable for some time. As of end of February, the size of the ICF was about \$2.36 billion.

### ***Question 2:***

**Do you agree that the levy suspension and reinstatement levels should be raised to \$3 billion and \$2 billion respectively? If not please explain why.**

### **IFPHK Responses**

The existence of a sufficient amount of funds for consumer protection ensures the visibility of a safety net and thus contributes to the maintenance of public confidence in the industry<sup>8</sup>. The current level of the ICF Regime is not apparently inadequate. Similar to response in Question 1, IFPHK agree to raise the levy suspension and reinstatement levels to \$3 billion and \$2 billion to ensure sufficient coverage of the fund. We also consider the estimating approach as reasonable.

### ***Other consideration***

The SFC also reviewed the funding of the ICF more generally. In particular, the SFC has considered whether there should be any change to the current arrangement whereby ICF levies are charged on a transaction basis and paid by buyers and sellers of securities or futures. Compensation funds of other jurisdictions are generally funded by market participants. After

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<sup>8</sup> Sebastian Schich and Byoung-Hwan Kim, Guarantee Arrangements for Financial Promises: How Widely Should the Safety Net be Cast?, OECD Journal: Financial Market Trends Volume 2011 – Issue 1, 2011

considering that the current ICF has worked well in imposes a minimal cost on investors and provides an effective and quick means for building up a reserve, and the whole funding mechanism is relatively straightforward and inexpensive to administer, the SFC will not introduce amendments to the funding arrangement at this stage.

**Question 3:**

**Do you have any other comments regarding the proposals discussed in paragraphs 9 to 14 above? (i.e. proposals to adjust compensation limit and the levy suspension and reinstatement levels)**

**IFPHK Responses**

The IFPHK provides additional comments on the following areas:

Funding arrangement

A funding arrangement is essential to provide a mechanism for the recovery of the net costs arising in any resolution from surviving institutions, once it is apparent precisely how much needs to be recouped<sup>9</sup>. As stated in the Consultation Paper, the SFC decided not to change the funding arrangement at this time. We note that compensation funds are generally funded by market participants in other jurisdictions. To align with international practice and to effectively restore consumers' confidence, we urge the SFC to consider solely collect funding from the market participants.

Robust regular review

Whilst the Investor Compensation Fund regime is reviewed regularly, the compensation limit has not been revised since its establishment in 2003. We understand that any enhancements in the Investor Compensation Fund require amendments to various subsidiary legislations which make timely adjustment difficult. In view of rapid changing financial service industry, it is important to implement a regular review system and a mechanism that could quickly adjust the compensation limit. The review system shall ensure that the fund is always affordable, fit for the policy objective and at the same time avoiding any moral hazard.

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<sup>9</sup> Sebastian Schich and Byoung-Hwan Kim, Guarantee Arrangements for Financial Promises: How Widely Should the Safety Net be Cast?, OECD Journal: Financial Market Trends Volume 2011 – Issue 1, 2011

### ***Adjusting coverage to cater for Stock Connect***

The ICF regime is intended to protect investors against default by intermediaries in Hong Kong. However, the regime currently only covers losses relating to securities or futures traded on the SEHK or HKFE. It does not cover losses relating to securities traded on the Shanghai Stock Exchange or the Shenzhen Stock Exchange under Stock Connect (Northbound trading). As such, the SFC proposes expanding the scope of the ICF regime to cover losses relating to Northbound trading.

However, the SFC do not propose to expand the scope of the ICF regime to cover trading on securities listed on other overseas markets (such as the US and UK), and Mainland investors trading SEHK securities

### ***Question 4:***

**Do you agree that the ICF regime should be expanded to cover losses relating to Northbound trading? If not, please explain why?**

### **IFPHK Responses**

The ICF regime is established to pay compensation to investors of any nationality who suffer pecuniary losses as a result of default of a licensed intermediary or authorized financial institution in relation exchange-traded products in Hong Kong<sup>10</sup>. The ultimate purpose of the fund is to provide protection to local investors. Hence, we think it is sensible to include Northbound trading into the ICF.

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<sup>10</sup> Investor Compensation Fund website

**Question 5:**

**Do you have any comments regarding the proposals to adjust coverage to cater for Stock Connect?**

**IFPHK Responses**

We have no further comments on the proposals. Referring to our response in Question 3, a robust review framework shall be in place in order to allow the ICF Regime to promptly react to rapid changes in the financial services industry.

***Providing flexibility for the SFC to make interim payments***

Currently, compensation can only be paid after ascertaining all the relevant details of a claim, including the amounts due to and from the investor. It is proposed to enable the SFC to make interim payments in exceptional circumstance only where:

- (a) there is uncertainty as to any amount payable to a claimant by the defaulting intermediary (or vice versa), and hence to the amount of compensation payable, and time is needed to resolve such uncertainty;
- (b) circumstances which pose or may pose a systemic risk in the securities or futures industry or to the financial stability of Hong Kong; and
- (c) it is in the interest of the investing public or in the public interest not to delay payment of compensation

The proposals do not intend that the power to make interim payments be exercised in all, or even most, cases. Rather, the power is intended to be exercised with caution and restraint, and only in exceptional circumstances.

The SFC also proposes that where any compensation payment is made, and it is later discovered that the amount paid exceeds the total that should have been paid to the claimant, the SFC should



be able to receive the excess paid. If there is a delay in the return of any excess, a late repayment fee (not exceeding 5% of the amount of the excess that remains to be repaid) should be imposed.

***Question 6***

**Do you agree that the SFC should be able to make interim compensation payments in the exceptional circumstances described in paragraph 19 above? If not please explain why.**

**IFPHK Responses**

Legal procedure might take a long time. In order to benefit consumers, it is reasonable to empower the SFC to make interim compensation payments. The Deposit Protection Board also has interim payment arrangement. Where appropriate, the Board will make an interim payment to a depositor before the entire amount of the depositor's compensation can be ascertained.

***Question 7***

**Do you have any other comments regarding the proposals to provide flexibility for the SFC to make interim payments?**

**Other comments**

No further comments