Follow-up to the hearing on 11 December 2009

Information (including relevant documents and records, if any) on the following issues

Q.1 Please provide the Financial Secretary (FS)'s views on the factors contributing to the financial market crisis of 2008 as detailed in the article "Origins of the Financial Market Crisis" by Anna J. Schwartz (issued to Subcommittee members via LC Paper No. CB(1)671/09-10(01) dated 14 December 2009), in particular Factor Two: Flawed Financial Innovations which reads: "Additional banking innovations, notably the practices of the derivatives industry, made mortgage lending problems worse, shifting risk that is the basic property of derivatives in directions that became so complex that neither the designer nor the buyer of these instruments apparently understood the risk they imposed and implicated derivative owners in risky contingencies they did not realize they were assuming."

1.1 After the onset of the financial crisis and collapse of the Lehman Brothers (LB) in mid-September 2008, there is no lack of analysis and discussions on the circumstances leading to and / or factors contributing to the financial market crisis of 2008. It may not be appropriate for the Administration to comment on the views and commentaries of individual academics.

Q.2 In the light of (a) the marketing material of a structured financial product at Annex 1 to the Appendix (the Appendix) to the Clerk to the Subcommittee's letter dated 11.12.2009, (b) the subscription instruction by an investor at Annex 2 to the Appendix and (c) the letter from the investor concerned at Annex 3 to the Appendix, is there any change in FS's views on the efficacy of the existing disclosure-cum-conduct based regulatory approach for authorization and sale of structured financial products? If yes, please provide the details; if no, the reasons.

2.1 Under the existing disclosure-cum-conduct based regulatory approach, SFC authorizes the prospectus and marketing materials of financial products, rather than the products themselves. SFC's authorization of the marketing material does not imply SFC's endorsement or recommendation of the product, and an appropriate warning to such an effect is included in each of the prospectus and marketing materials authorized by SFC. It follows that SFC's authorization does not mean that the financial products are suitable for all investors. Suitability

could only be determined at the point of sale when the particular circumstances of the investor were known.

2.2 As regards the Administration's understanding and position on the disclosure-cum-conduct based regulatory approach, please refer to paragraphs 9-11 of and paragraphs 5.1-5.10 of the Annex to my statement, in particular the following observations –

(a) the disclosure-cum-conduct based regulatory regime rests on two important pillars – (i) disclosure-based principles and (ii) suitability obligations that an intermediary has to discharge in recommending products or soliciting subscriptions from investors;

(b) in view of this regulatory approach, it follows that the role of intermediaries, as regulated by the regulators, is instrumental in ensuring the investment products that they sell are suitable for their customers;

(c) having regard to the market development since 2003, the regulators have constantly reviewed and stepped up their supervisory, regulatory, collaborative and investor education efforts to address the regulatory challenges and protect the investing public;

(d) the regulators have reviewed the appropriateness of this disclosure-cum-conduct-based regulatory regime following the Minibond Incident. In their Review Reports submitted to me in December 2008, both regulators have suggested retaining the disclosure-cum-conduct based regulatory regime, which could be further enhanced. They have come up with a slate of proposals, some of which either have been implemented or are currently under consultation;

(e) we also note that jurisdictions such as the UK, the US, Australia, Singapore, the Netherlands and Germany also adopt a similar regulatory approach; and

(f) it is against the above background and observations that the Administration considers that even the most stringent regulation cannot completely prevent market misconduct and fraud. If regulatory breaches are identified in the course of day-to-day supervision, enforcement actions by the regulators are necessary to serve punitive and deterrent effects.

2.3 While the **policy rationale** underlying the disclosure-cum-conduct-based regulatory regime aims to strike a balance between investor choice and protection (through authorization of product documentation and intermediaries' suitability assessment), the actual **implementation** of this regulatory regime is equally important to deliver such policy objective.

2.4 With regard to the documents (a) to (c) referred to in the question above, it may not be appropriate to base on a single case to form a view of the efficacy of the existing regulatory framework or for the Administration to comment on individual complaints, marketing materials and contract documents between an intermediary and an investor. As a matter of general principle, we trust that the regulators, on receipt of complaints, would deal with them in accordance with their established practices and procedures.

Q.3 Given that as at 7 December 2009, HKMA took disciplinary action in respect of one LB-related non-Minibond complaint case only, what are the bases for FS to hold the view that HKMA has conducted its investigations expeditiously?

3.1 According to HKMA, of the 21,762 Lehman related complaints received by HKMA, 13,114 have been resolved by the Minibond Settlement Scheme reached among SFC, HKMA and the distributor banks as announced on 22.7.2009, which is a result of the enforcement actions on the part of both HKMA and SFC. 2,772 cases have been closed as there was insufficient prima facie evidence found after preliminary assessment or no sufficient grounds and evidence found after detailed investigations. 820 cases are currently undergoing the disciplinary process. Together with the one case where disciplinary action has been taken, 76.8% of the investigations on the complaints received have been concluded. HKMA has indicated that it will complete basically all investigations in relation to the remaining Lehman related complaints by end March 2010.

3.2 HKMA is duty-bound to ensure investigative and disciplinary actions are taken fairly and in accordance with the relevant statutory requirements. After 22.7.2009, HKMA has redeployed its enforcement resources to non-Minibond cases and has pledged to press ahead with the investigative and disciplinary actions as far as practicable fairly and expeditiously.

3.3 My remarks about the HKMA's investigation work at the hearing on 11.12.2009 were made against the above circumstances and understanding.

Q.4 Please provide a detailed explanation of the respective accountability arrangements in place for HKMA and SFC and the related checks and balances.

4.1 In studying the accountability arrangements of the two regulators, it is important to note the nature and status of the regulators, their corporate governance arrangements, the checks and balances imposed upon them, as well as their relationship with the Administration and Legislative Council (LegCo) under the regulatory structure, which aim at striking a balance between protecting the public interest and ensuring the regulators' independence in performing their day-to-day regulatory functions.

4.2 As stated in paragraph 2.3 of the Annex to my statement, the Administration is responsible for providing an appropriate economic and legal environment for the maintenance of the status of Hong Kong as an international financial centre. Consistent with the policy and legislative intents underlying the statutory regulatory system and international practices, the Administration leaves the day-to-day regulatory functions to the regulatory agencies. We perform our function by appointing the regulators, making sure that the regulators are independent and vested with the necessary powers and resources; and equipped with the necessary professional expertise to discharge their statutory duties and perform their regulatory functions. W20(C)

4.3 Consequent to the recommendations of the "Report of the Securities Review Committee" (SRC Report) published in 1988, the Administration has entrusted its responsibilities as regards the regulation of the securities and futures industry to SFC. Specifically, the SRC recommended the Administration to establish a new regulatory body, which became SFC, along a number of important principles, such as (a) SFC should be a statutory body outside the civil service; and (b) all the statutory regulatory powers should be vested in SFC in order to ensure its independence. Under the regulatory arrangements of banks' securities business as enshrined in the relevant statutes, HKMA also exercises its statutory functions and discharges its regulatory duties independently, and is not required to report to the Administration in respect of its day-to-day frontline regulatory activities.

4.4 In addition, the regulators are subject to a number of checks and balances as stated in paragraph 3.3 of the Annex to my statement to ensure that the regulators exercise their statutory powers and functions flexibly, effectively, independently and in a proper and appropriate manner, namely, (a) the powers, functions and responsibilities of SFC and HKMA are set out in the Securities and Futures Ordinance (SFO) and the Banking Ordinance (BO); (b) the regulators' powers to update and adjust

existing regulatory requirements and introduce new ones through the promulgation of codes, guidelines and subsidiary legislation are subject to market consultation and negative vetting by LegCo as appropriate; and (c) there are other well-established checks and balances including (i) the independent Securities and Futures Appeals Tribunal chaired by a full-time judge; (ii) judicial review over the regulators' decisions in the performance of their functions; and (iii) the oversight by the Office of the Ombudsman, Independent Commission Against Corruption and the Director of Audit, etc.

4.5 Furthermore, as the statutory regulator of the securities and futures markets in Hong Kong, SFC places great importance on corporate governance. It strives to enhance its accountability and the transparency of its work. In this regard, SFC's management board ensures independent supervision of the Commission's executive functions. Likewise, the Exchange Fund Advisory Committee (and its Governance Sub-Committee) monitors the performance of HKMA and makes recommendations on remuneration and human resources policies, and on budgetary, administrative and governance issues.

4.6 In short, the regulators are accountable to the public, Administration and LegCo for the effective discharge of their statutory functions and independent exercise of their regulatory powers. In particular, the regulators are accountable to LegCo through a number of channels: (a) answering questions raised by LegCo Members; (b) briefing the LegCo Financial Affairs Panel and relevant Bills Committees; and (c) submitting papers and reports on the implementation of the regulatory systems to LegCo.

Q.5 The written questions at Annex 4 to the Appendix to the Clerk to the Subcommittee's letter dated 11.12.2009 on questions raised by Hon Leung Kwok-hung

Q.5(1-2) **關於權力來源:** 你在陳述書聲稱財政司只是「負責訂定與金融體系有關的宏觀政策目標，而財經事務及庫務局局長則負責制訂具體政策及監管HKMA及SFC執行有關政策」。在那一條條例有賦予財經事務及庫務局局長權力去管這兩個監管機構？財經事務及庫務局局長如有失職，最終是否由財政司負責？

5(1-2).1 There is no legislative provision related to SFST's power to oversee the implementation of the financial regulatory policies through the regulators. In fact, the Administration's role in respect of the actual implementation of the regulatory arrangements of the securities industry is limited as reflected in

the statutes, in light of our regulatory philosophies which were (a) mapped out after public discussion and LegCo's scrutiny; (b) reflected in the relevant statutes; and (c) on par with those in other major financial markets.

5(1-2).2 The Government must abide by the law and be accountable to LegCo: it shall implement laws passed by the Council and already in force; it shall present regular policy addresses to the Council; it shall answer questions raised by members of the Council; and it shall obtain approval from the Council for taxation and public expenditure.

5(1-2).3 On the working relationship between statutory agencies and the principal officials, due regard would have to be given to the relevant statutory provisions that establish the agencies. Statutory agencies are required under the statute under which they are established to act independently in certain aspects. In general, subject to the relevant legislative provisions, statutory agencies enjoy a high degree of autonomy in their day to day operations.

5(1-2).4 Please refer to the document "Responsibilities of the FS and SFST" issued on 27.6.2003, which delineates the responsibilities of FS and SFST regarding the responsibilities for, inter alia, the monetary and financial affairs. The document states that SFST has a specific responsibility for the efficient functioning of our financial system. Where this requires regulation, the regulatory authorities shall exercise their powers and discharge their functions independently in accordance with the respective statutes. SFST is expected to safeguard that independence. Please also refer to paragraphs 4.1-4.6 above. **A22**

Q.5(3) MOU是否一份影響宏觀政策的文件?

5(3).1 According to the Memorandum of Understanding (MOU) between SFC and HKMA, its aims include (a) to replace and supersede the previous MOU signed in 1995; (b) to set out the roles and responsibilities of the two regulators respectively under the regulatory regime in respect of the securities industry as enshrined in the BO and SFO, which came into force in 2003; (c) to achieve the regulatory objective that all intermediaries carrying out securities business in Hong Kong are subject to consistent regulatory measures irrespective of whether they are supervised by SFC or HKMA; as well as (d) to strengthen cooperation between the two regulators (Part I of the MOU refers). **S1-Appendix 10**

5(3).2 According to Part III of the MOU, the two regulators recognize a number of overriding principles, including that (a) the MOU does not modify or supersede any law or regulation and (b) the MOU does not detract from the statutory functions of SFC and HKMA. Therefore the MOU does not affect the macro policy adopted for regulating regulated activities in Hong Kong.

5(3).3 The MOU is one of the undertakings made by the regulators to the Administration and LegCo to enhance mutual communication and bilateral coordination before the existing regulatory arrangements in respect of banks' securities business were put in place, and a piece of public document available in the public domain. As stated at paragraph 8.2 of the Annex to my statement, at the Bills Committee on the Securities and Futures Bill in December 2000, SFC indicated that they were updating an MOU with HKMA with a view to aligning the regulatory standards applied in frontline supervision and enforcement. The updated MOU was subsequently signed on 12 December 2002; published on the internet 13 December 2002; and a copy of the MOU was submitted to LegCo on 17 January 2003.

Q.5(4) **你是否認識什麼叫「一業兩管」與什麼叫「雙峯制」？**

5(4).1 The term "dual regulatory approach" (commonly known as "一業兩管") is used by some as a shorthand to refer to the current regulatory framework in respect of regulated activities in Hong Kong as enshrined under the SFO and the BO (i.e. HKMA is the front-line regulator of banks' regulated activities while SFC is responsible for regulating licensed corporations as well as setting the standards, through rules, codes and guidelines issued under the SFO, with which intermediaries should comply in carrying on their regulated activities); whereas the "Twin Peaks Approach" is one of the broader regulatory philosophies which is based on the principle of regulation by objective and refers to a separation of regulatory functions between two regulators: one that performs prudential supervision (ensuring the safety and soundness of institutions) and the other that focuses on conduct-of- business regulation.

Q.5(5) **這兩個制度是否宏觀政策範疇?**

5(5).1 Both approaches are regulatory arrangements that would result in the best and effective use of regulatory resources to achieve the

regulatory objectives.

Q.5(6) **MOU應否由財政司審批？**

5(6).1 According to Part IX of the MOU, either SFC or HKMA may request the other party to agree to make an amendment to the MOU or invite consultation with the other party regarding the need for any amendment or supplement to the MOU. As set out in 5(3).2, the MOU does not modify or supersede any law or regulation, and also, does not detract from the statutory functions of SFC and HKMA. Therefore the MOU does not affect the macro policy adopted for regulating regulated activities in Hong Kong. This is also the rationale that the MOU does not require the Administration's involvement. In line with the existing regulatory philosophies and the division of labour between the Administration and the regulators (paragraphs 5-7 of my statement refer), the Administration should not be involved in the preparation of the MOU.

Q.5(7) **當金管局在調查銀行銷售結構性投資產品是否出現違規時，開立檔案的權力是由金管局負責，是削弱了SFC的權力？**

Q.5(8) **金融局無形中擁有對涉嫌違規銀行是否進行懲處的酌情權，這是否已削弱了SFC 的權力?**

5(7-8).1 Under the current regulatory arrangements in respect of banks' securities business in Hong Kong, both HKMA and SFC have the statutory power of investigation. SFC has statutory power under the SFO to investigate and impose sanction on any banks or its staff or management engaged in the conduct of regulated activity. SFC is the only regulator that has the statutory power to discipline banks. Both SFC and HKMA have the power to open an investigation.

Q.5(9) **HKMA 的監管方式是以指導為主，SFC是以懲罰為主，對不對?**

5(9).1 Under the current regulatory regime, SFC, which is responsible for the SFO and the related regulations, develops the standards and regulatory requirements for regulated activities applicable to all banks and other intermediaries. HKMA is the front-line regulator of banks in respect of their conduct of regulated

activities and performs its regulatory functions according to standards that are consistent with those applied by SFC to its licensed persons. One of the purposes of the MoU signed in December 2002 is to achieve the regulatory objective that all intermediaries carrying out regulated activities in Hong Kong are subject to consistent regulatory measures, irrespective of whether they are supervised by SFC or HKMA. To ensure consistency in interpretation of the SFC's standards, the two regulators have been maintaining close communication and co-ordination. There are established consultation arrangements between the two regulators under the SFO, the BO and the MOU, which cover various aspects over the regulation of banks' conduct of regulated activities, including making of regulatory standards, applications for registration, and investigations and disciplinary actions. Furthermore, the Administration and LegCo were assured that banks would be subject to the day-to-day front-line supervision by HKMA, using the regulatory standards set by SFC, e.g. Codes of Conduct. These undertakings were recorded in the relevant Bills Committee records.

5(9).2 Over the years, the regulators have diligently delivered their undertakings by taking a number of measures such as the MOU, working group meetings, close day-to-day communication, staff secondment and cross fertilization of training resources, as set out in paragraph 4.3 of the Annex to my statement and the statements of the regulators.

5(9).3 The Administration also noted that the regulators have proactively and vigorously enhanced their supervisory, regulatory and investor education efforts to address the regulatory challenges and protect the investing public, such as issuing circulars and FAQs to the intermediaries and taking enforcement actions against cases of suspected misconduct.

Q.5(10) **你在回答提問2時指出:「證監會和金管局已推行多項措施，以期劃一前線監督及執法工作所採用的監管標準...」(第2.2節)，但為何在賠償時，同樣是購買雷曼迷債的苦主，新鴻基投資的客戶可得到十足賠償，而向銀行購買迷債的客戶，在被重新定義為不屬於經驗投資者，只獲六成回購？**

Q.5(11) **為何同是購買結構性金融產品，例如「股票掛勾票據」(ELN)及星展Constellation的投資者未在回購協議之內，至今無人理睬？**

5(10-11).1 As explained at the hearing on 11.12.2009, the Administration's role in respect of the settlement agreement among HKMA, SFC and the 16 Minibond distributor banks as announced on 22.7.2009 concerning the repurchase of Lehman Brothers Minibonds was limited (please also refer to paragraphs 12.1 – 12.3 of the Annex to my statement).

5(10-11).2 The Administration is not a party to the settlement agreement. In view of these, the Administration is not in a position to comment on the specifics of the settlement agreement.

Q.5(12) **在最近多次聽證會當中，證監會都最終承認以往以《公司條例》為本，要求這些結構性投資產品披露相關資訊供投資者參考是存在問題，因為這些要求適用於例如上市公司發行公司債券集資，但結構性投資產品的發行人主要是特別目的公司(special purpose vehicle)，可供參考數據十分有限。證監會在2005年已經知悉這問題，並在2006年9月公布《公司條例》招股章程改革措施的諮詢總結文件中指出:**

"The SFC acknowledges that a derivative issuer could not reasonably be expected to give the same level of information on the underlying asset as the issuer of the underlying asset itself when it engages in fund-raising"

(諮詢總結2006摘要/第5節/(a)/建議5) S17

但為何至今三年多，在迷債事件發生和今次立法會聽證會指出此漏洞之後，才在上月提出修法？須知在過去三年多，這些結構性投資產品在香港以幾何級數上升，早一日修訂，受害人便得以顯著減少。

Q.5(13) **你認為證監在此是否存在失職？**

Q.5(14) **你在2007年7月1日上任以來，監管機構有沒有向你提及上述情況，你有否提出過上述的問題及作出建議？**

5(12-14).1 The Administration and regulators have kept the local market developments, inter alia, under close and constant monitoring and review. Apart from noting that the regulators have continued to enhance their supervisory, regulatory and investor education efforts, the Administration is also aware of the SFC's drive to continue reviewing and reforming the public offering regime to create a legal framework that accommodates the financial

market's needs in the 21st Century and caters for issuers and investors alike.

5(12-14).2 Specifically, SFC published a consultation paper in 2005 on reform initiatives relating to the CO prospectus regime. As indicated in the Consultation Conclusions published in 2006, the overall consultation process has not been completed and there was no timetable for implementation of the proposals. As stated in CEO/SFC's statement, after the publication of the consultation conclusions in September 2006, SFC undertook a substantial amount of work including soft-consulting various stakeholders on the detailed logistics and technical aspects of certain proposals to reduce any process risk associated with the implementation of these proposals. SFC had completed an initial draft of the draft drafting instructions before mid-September 2008. The Administration was kept abreast of the progress of this proposed initiative. S17

5(12-14).3 Regardless of the different regulatory reform proposals contained in the SFC's Consultation Paper in 2005, the SFC's Consultation Conclusions in 2006 and the latest proposals in the SFC's consultation paper released in October 2009, it is important to note that all these regulatory reforms are based on the disclosure-cum-conduct based regulatory regime, which both SFC and HKMA have recommended for its retention in their review reports submitted to me in December 2008.

Q.5(15) **我曾多次要求證監會交出十份以往按《公司條例》審批表格所審查的結構性投資產品，以評估《公司條例》是否合適監管這些產品，但證監會一直未有交出，你可否運用作為財政司的權力，要求證監會交出十份表格，方便專責小組的調查工作？**

5(15).1 As stated in paragraph 2.4 of the Annex to my statement, the Administration is not involved in the day-to-day regulation of the securities industry, nor individual regulatory actions / decisions. The Administration does not have in possession the documents referred to in the question and does not consider it appropriate to accede to the request to use FS' powers for this purpose. If the SC considers it necessary and appropriate, the SC may consider following up on this request with the regulator direct. W20(C)

16 December 2009