

17th November 2010~~Private and Confidential~~

Your Ref: CB1/HS/1/08

BY HAND

Clerk to Subcommittee
Legislative Council Secretariat
3rd Floor, Citibank Tower
3 Garden Road, Central
Hong Kong

Attn: Miss Polly Yeung

Dear Sirs,

**Re: Subcommittee to Study Issues Arising from Lehman Brothers-related
Minibonds and Structured Financial Products (the "Subcommittee")**

I refer to your letter dated 10 November 2010 referring to the order made by the Chairman of the Subcommittee at the Subcommittee's hearing on 9 November 2010 (the "Hearing") that I provide written answers to certain questions as set out in the Appendix to your letter.

I set out below my response to those questions. Unless otherwise stated, I shall adopt the same defined terms as I have used in my witness statement dated 15 October 2010 (the "Witness Statement").

1. **Under the repurchase agreement reached in December 2009 by Hong Kong Monetary Authority, Securities and Futures Commission (SFC) with Dah Sing Bank, Limited (DSB) and Mevas Bank Limited concerning the sale of certain Equity Index-linked Fixed Coupon Principal Protected Notes (PPNs) issued by Lehman Brothers (LB), all individual customers who purchased Lehman PPNs from DSB on or after 5 August 2008 were eligible for the repurchase offers. Please confirm which series of LB-related PPNs were distributed by DSB on and after 5 August 2008.**
 - 1.1 LMP0008 to LMP0023 and LMP0025 as listed in Appendix 2(a) of my Witness Statement were distributed by the Bank on or after 5 August 2008.
2. **It is noted from Appendix 67 of W44(C) that out of 1 867 complaint cases in relation to Minibonds and 796 complaint cases in relation to LB-related non-Minibonds products that had been settled, 1 743 and 445 cases were settled under the Minibonds repurchase agreement announced on 22 July 2009 and the resolution on LB-related PPNs announced on 23 December 2010 respectively. In addition, 112**

Minibonds-related complaint cases and 324 LB-related non-Minibonds complaint cases were settled by the enhanced complaint handling procedures. Please provide:

- (a) **a breakdown of these 112 and 324 settled cases relating to Minibonds and LB-related non-Minibonds respectively showing the settlement amount as percentages of the investment amount; and**

2.1 Please see enclosed as Appendix 2.1.

- (b) **without disclosing details of individual cases, a breakdown of the broad reasons that led to DSB's approval of settlement of these cases.**

2.2 Generally speaking, the assessment of whether a complaint case should be settled under the enhanced complaint handling procedures is conducted based on an evaluation of a number of factors, including the strengths of the evidence collected from the relevant staff members and complainants under the complaint handling process, and other relevant circumstances (such as personal circumstances of the complainant).

3. **As specified in page 1 of the "Instruction for Bonds/Notes Purchase Order" form under Appendix 31(i) of W44 (C), there were three boxes under "Documentation Checklist" for the customer to confirm whether he/she had received (i) Bonds/Notes Issue and Programme Prospectus, (ii) Investment Product Explanation Memorandum and (iii) SFC Leaflet – Invest Wisely.**

- (a) **Of all the duly signed order forms for purchase of Minibonds from DSB during the Relevant Period between April 2003 and 15 September 2008, please advise on the number of such forms in which the customers concerned had not ticked the boxes to confirm receipt of document(s) (i) and/or (ii).**

3.1 Please see enclosed as Appendix 3.1.

3.2 25 transactions of Minibond Series 5 and 6 used an earlier version of purchase order form which did not have boxes to be ticked. However, customers had acknowledged that they had read the terms and conditions and application procedures set out in the prospectus by signing the order form.

3.3 We have 2,139 order forms where the box for "Investment Product Explanation Memorandum" was ticked and 736 order forms where the box for "Investment Product Explanation Memorandum" was not ticked. By way of explanation, the "Investment Product Explanation Memorandum" was

required to be signed only with respect to the following two groups of customers, namely (i) vulnerable customers (being customers who were over the age of 65, visually impaired, or illiterate); and/or (ii) customers who would like to invest in products that did not match their investment experience, or where there was a mismatch in terms of the customers' liquidity requirements and the period of commitment / tenor with respect to the investment product in question. Thus, these transactions, which did not fall under the aforementioned situations, were not required to sign the Investment Product Explanation Memorandum and therefore the boxes would not have been ticked.

(b) Please advise whether the complaint cases relating to the order forms in (a) had been settled by DSB.

3.4 All complaint cases relating to the order forms in (a) had been settled by the Bank.

4. **According to Appendix 72 of W44 (C), among the cases that DSB had reached an agreement with customers through mediation, the lowest amount settled as a percentage of the investment amount was 39%. For complaints settled by means other than mediation, please advise on the number of cases settled with an amount less than 39% of the original investment and the lowest percentage of the settlement amount.**

4.1 The number of cases settled, other than through mediation, with amount less than 39% of the original investment amount is 190 and the lowest percentage of the settlement amount is 10%, which relates to complaints made by 3 ineligible corporate customers. It should be noted that for Minibonds cases, all the customers thereof were ineligible customers.

5. **With regard to the settled cases in respect of purchase of LB-related structured financial products from DSB, please advise on:**

(a) the number of investors, if any, who had been invited by DSB to assist in the bank's internal investigation on complaint cases notwithstanding that their respective cases had already been settled; and

5.1 As explained in paragraph 64.4 of my Witness Statement, under the enhanced complaint handling procedures, our Complaint Investigation Team would conduct a complete review on all documentation and evidence made available from the Bank internally as well as from the complainant to assess the complaint case. Contacts would be made by the Bank with the complainant for him / her to explain his / her concerns and to present any evidence in relation to his / her complaint before the Panel Review Team / Senior Management would make a final determination.

5.2 As the steps referred to in paragraph 5.1 above were taken before settlement agreements were reached between the Bank and the customers concerned, the Bank did not consider it necessary to re-invite the relevant customers to re-review their complaint cases after settlement. However, the Bank will respond to any further questions or concerns raised by customers post settlement in a fair and reasonable manner in the circumstances.

(b) a breakdown of the number of bank staff (i) against whom the bank had taken disciplinary action and/or (ii) who had subsequently left employment as a result of internal investigation.

5.3 The Bank had not taken any formal disciplinary action against any staff. We are not aware of any staff that had left our employment as a direct result of our internal investigation into LB-related complaint cases.

6. As specified in page 1 of the "Instruction for Private Placement Notes Purchase Order" form under Appendix 31(i) of W44 (C), there were four boxes under "Documentation Checklist" for the customer to confirm whether he/she had received (i) Private Placement Notes – Letter of Undertaking (Copy), (ii) Indicative Terms and Conditions, (iii) SFC Leaflet – Invest Wisely, and (iv) Investment Product Explanation Memorandum.

(a) Of all the duly signed order forms for purchase of PPNs from DSB during the Relevant Period, please advise on the number of such forms in which the customers had not ticked the boxes to confirm receipt of document(s) (i)/(ii)/(iv) or any combination of them, and

6.1 Please find enclosed as Appendix 6.1.

6.2 We have 122 order forms where the box for "Investment Product Explanation Memorandum" was ticked and 465 order forms where the box for "Investment Product Explanation Memorandum" was not ticked. With respect to Investment Product Explanation Memorandum, please refer to paragraph 3.3.

(b) Please advise whether the complaint cases relating to the order forms in (a) had been settled by DSB.

6.3 All complaint cases relating to the order forms in (a) had been settled by the Bank.

7. Please advise whether there were cases in which the customer concerned had not indicated that he had any investment experiences in "Structured Products" in response to question 13 of the Risk Assessment Questionnaire (Appendix 36 of W44 (C)), but who had purchased PPNs from DSB by signing the "Instruction for Private

Placement Notes Purchase Order" form (Appendix 31(i) of W44 (C)), on which one of the pre-printed items being declared by the customer was "I/We declare and confirm that I/we have experience in trading the related structured product(s)". If yes, please advise whether DSB would consider providing a settlement for such cases.

7.1 Except for one complaint case whereby the complainant was an experienced investor, all complaint cases in relation to PPNs purchased from the Bank had been settled.

8. The attached written questions 1 to 19 raised by Hon LEUNG Kwok-hung.

8(1) The Bank did not receive any notification from the HKMA not to sell LB related structured financial products prior to the collapse of LB.

8(2) The Companies Ordinance provides, at the Seventeenth Schedule, that certain offers, including, amongst other offers:

(a) an offer to not more than 50 persons and containing a statement specified in Part 3 of the Eighteenth Schedule of the Companies Ordinance (the "50 Offer Rule"); and

(b) an offer in respect of which the minimum denomination of, or the minimum consideration payable by any person for, the shares or, in the case of debentures, the minimum principal amount to be subscribed for purchased, is not less than HK\$500,000 (or its equivalent in another currency and containing a statement specified in Part 3 of the Eighteenth Schedule of the Companies Ordinance (the "Minimum Denomination Rule").

be excluded from the definition of a "prospectus" under the Companies Ordinance. These offers therefore do not need to comply with the provisions of the Companies Ordinance governing the content of prospectuses.

8(3) During the Relevant Period, the Bank had distributed LB-related structured financial products through private placement under both the 50 Offer Rule and the Minimum Denomination Rule explained in paragraphs 8(2) above in accordance with the requirements under the Companies Ordinance. There was no violation of the Companies Ordinance in relation to the distribution of LB-related structured financial products by the Bank.

8(4) As explained in paragraph 8(2) above, the sale of LB-related structured financial products of not more than HK\$500,000 by way of private placement was allowed under the 50 Offer Rule.

Therefore the fact that customers had purchased LB-related structured financial products of not more than HK\$500,000 by way of private

placement was allowed under the 50 Offer Rule and was not, in itself, a basis for settlement.

- 8(5) As explained in paragraph 8(1) above, the Bank did not receive any notification from the HKMA not to sell LB related structured financial products prior to the collapse of LB.
- 8(6) Please refer to paragraphs 8(4) above. It is not appropriate for us to comment on an individual case.
- 8(7) Please refer to paragraphs 8(4) above.
- 8(8) Please refer to paragraphs 8(4) above. The Bank strives to ensure that customers are treated fairly in the process and that the Bank makes a fair and reasonable decision as to whether to compensate customers in light of the circumstances of each case. The Bank has not engaged in any dilatory tactics in considering and resolving customers' complaints.
- 8(9) Please refer to paragraphs 8(4) and 8(5) above. Please refer to paragraphs 64.1 to 64.4 of my Witness Statement for the Bank's policies and procedures on handling and investigating complaints lodged by customers who have purchased investment products from the Bank.
- 8(10) Please refer to paragraphs 8(4), 8(5) and 8(8) above.
- 8(11) As a matter of practice, the Bank expects sales staff to explain to the customers the features and risks of the structured financial products and ensure that customers are aware of the risks of the products when making informed investment decisions. We required our sales staff to explain to the customers the risks involved and the customers should sign a set of forms used during the selling process to confirm their understanding of the risks involved before proceeding with the transaction. Please see the Bank's Branch Operations Guidelines for Bond/Notes Services, a copy of which was enclosed as Appendix 31(i) of my Witness Statement.

Training was also provided to sales staff to ensure that they were familiar with the selling process and the products, and that they fully understood their compliance obligations during the selling process. Please see training materials enclosed at Appendix 6.4 of my 8 November 2010 Letter.

- 8(12) At the time of the distribution of Minibonds Series 35 and Series 36, information in relation to the collateral of Minibonds Series 35 and 36 were disclosed in the issue prospectuses and marketing materials, which were prepared by the issuer and the co-ordinating dealer and authorised by the SFC.

The collateral for both Minibonds Series 35 and Series 36 consisted of synthetic collateralised debt obligations (Synthetic CDOs). According to the issue prospectuses of both Minibonds Series 35 and Series 36, irrespective of its composition, the collateral must meet the following criteria as at the date of purchase:

- (i) be rated AAA by Standard and Poor's and/or AAA by Fitch, Inc., Fitch Ratings, Ltd. and their subsidiaries and any successor or successors thereto (Fitch) and/or Aaa by Moody's;
- (ii) not be subject to any negative Credit Watch of Standard and Poor's, negative Rating Watch of Fitch or review for possible downgrade on Moody's Watchlist;
- (iii) have a maximum maturity not later than the maturity date of the notes;
- (iv) be acceptable to Lehman Brothers Special Financing Inc. as a funding source for the issuer's obligations under the swap arrangements; and
- (v) the CDO will not be an asset-backed securities CDO. The CDO will not be linked to asset-backed or mortgage-backed securities.

8(13) Yes.

8(14) Synthetic CDO refers to synthetic collateralised debt obligations. Generally and academically speaking, a synthetic CDO is a financial arrangement used to manage credit risk. It is a form of collateralised debt obligations in which the underlying credit exposures are undertaken by using a credit default swap. A synthetic CDO is typically entered into between two or more counterparties. One counterparty typically pays a premium to another party in exchange for a payment if certain events related to the underlying reference securities occur.

The investment risks of a synthetic CDO depends on how the CDS, the CDOs and their tranches are defined. Generally speaking, investors are exposed to the credit risk of the counterparty that transacts the credit default swap with the issuer, the credit risk of the companies underlying the reference security, as well as the credit risk of the issuer. As a secondary market for the synthetic CDOs may not exist, investors may also assume liquidity risk. In addition, investors also take on the uncertainty of level of recovery and diversification risk.

Finally, it should be noted that different synthetic CDO products have different features and risks and commercial arrangement.

- 8(15) We required and trained our sales staff to provide customers with, and explain to them, the prospectus and relevant materials of the investment products before or during the selling process. The prospectus and marketing materials for Minibonds contained explanation of, amongst other risks, risks relating to the collateral.
- 8(16) Please see our responses at paragraph 8(15) above.
- 8(17) Please see our responses at paragraph 8(15) above. In addition, we note that the identity of the swap counterparty and the swap guarantor were disclosed in the prospectus.
- 8(18) The Bank does not have specific information in relation to the return of the CDOs for Minibonds Series 36 which will be subject to market fluctuation. There were specified limitations on the selection of collateral which were set out in the prospectus of Minibonds Series 36 and explained in paragraph 8(12) above.
- 8(19) Throughout the Relevant Period, the Bank had in place a product due diligence process which required involvement / approval from different departments, and which evolved with the then prevailing regulatory requirements and industry benchmarks.

Whilst the product risks to customers had been considered during the due diligence process, the Bank did not keep detailed written record of all those considerations.

Please see Appendix 7.2 of my 12 November 2010 letter to the Subcommittee for certain sample emails that documented enquiries made by the WMT with the issuers / arrangers.

Should you have any enquiries to the above, please do not hesitate to contact our Mr. Derek Chan or Mr. Richard Li.

Yours faithfully,



Wong Hon-hing Derek
Managing Director and Chief Executive
Dah Sing Bank, Limited

Encl.