

### **Chapter 3 Regulation of the conduct of securities business by banks**

3.1 Following the collapse of LB in September 2008, it became clear that here in Hong Kong, a wide range of LB structured products had been sold to a large number of investors, mainly through retail banks. This chapter examines how the securities business (the sale of structured financial products being one of such activities) conducted by banks are regulated, and sets out certain observations of the Subcommittee on the existing regime.

#### **Overview of the regulatory structure**

3.2 Under Hong Kong's regulatory regime, the legal status of an entity (for example, a bank, a securities broker or an insurance company) determines which regulator is responsible for overseeing both its prudential soundness and business conduct. The roles and responsibilities of the Administration and regulators under the existing regulatory structure are summarized in the ensuing paragraphs.

#### The Administration

3.3 FS and SFST are the principal officials of the Hong Kong Special Administrative Region Government charged with policy responsibilities in financial affairs. According to the "Responsibilities of the Financial Secretary and the Secretary for Financial Services and the Treasury" issued on 27 June 2003 by Mr TUNG Chee-hwa, then Chief Executive, FS is responsible for determining the policy objectives at a macro level in relation to the financial system, while SFST is responsible for formulating specific policies to achieve such objectives and overseeing their implementation through the regulatory authorities

and other organizations as appropriate. In addition, SFST has a specific responsibility for the efficient functioning of Hong Kong's financial system and is expected to safeguard the independence of the regulatory authorities in exercising their powers and discharging their functions in accordance with the relevant legislation.

3.4 According to the "Policy Objectives in Financial Affairs and Public Finance" issued by Mr Antony LEUNG, then FS, on 27 June 2003, the Administration should formulate specific policies to promote the efficient functioning of the financial system, and that policies concerning the regulatory regime should aim to provide a regulatory framework that promotes the stability of the financial system, provides an appropriate measure of protection to users of financial services and facilitates competition, and is consistent with the standards and practices of major international financial centres.

3.5 As regards the division of responsibilities between the Administration and the regulators, both Mr John TSANG, FS, and Prof CHAN Ka-keung, SFST<sup>1</sup>, have stated in their respective testimony to the Subcommittee that the Administration is not involved in the day-to-day regulation of the industry, but makes every effort to ensure that the regulators are sufficiently resourced and appropriately empowered to maintain and promote a fair, efficient and orderly financial market to protect investors and facilitate market development. Furthermore, the Administration also seeks to provide various platforms for effective exchanges among regulators and between them and the Administration on the regulatory trends and development; ensure that appropriate checks and balances are put in place; and keep the regulatory systems under monitoring and review in collaboration with the regulators.

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<sup>1</sup> Mr John TSANG and Prof CHAN Ka-keung were appointed FS and SFST respectively on 1 July 2007.

## The Monetary Authority and the Hong Kong Monetary Authority

3.6 The Exchange Fund Ordinance (Cap. 66) was amended in 1992 to empower FS to appoint a person to be the MA and to specify his functions. MA is also the Chief Executive of HKMA, which is the office of MA and comprises persons appointed to assist MA<sup>2</sup>. Mr Joseph YAM was appointed MA and held office from 1 April 1993 to 30 September 2009. Mr Y K CHOI held the post of DCE/HKMA overseeing all banking-related matters during the period from September 2007 to December 2009.

3.7 The principal function of MA under the Banking Ordinance (Cap. 155) (BO)<sup>3</sup> is to promote the general stability and effective working of the banking system. In this respect, MA's role focuses on prudential regulation of banks. Nevertheless, MA does have a role in overseeing the general way in which banks conduct their business from the standpoint of prudence and integrity with a view to deterring improper conduct that might adversely affect their customers and risk loss of confidence in institutions or affect stability or inhibit the effective working of the banking system<sup>4</sup>. The BO also requires MA, amongst others, to promote and encourage proper standards of conduct and sound and prudent business practices among authorized institutions (AIs). Since April 2003, MA has taken on the added responsibility to take all reasonable steps to ensure that AIs' business (including securities business) is carried on with integrity, prudence and the appropriate degree of professional competence<sup>5</sup>.

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<sup>2</sup> Section 5A(3) of the Exchange Fund Ordinance (Cap. 66).

<sup>3</sup> Section 7(1) of BO.

<sup>4</sup> The Joint Forum of the Basel Committee on Banking Supervision, the International Organization of Securities Commissions and the International Association of Insurance Supervisors noted in its April 2008 report on "Customer suitability in the retail sale of financial products and services" that "[h]ow financial firms approach the sale of financial products and services is at the core of consumer confidence in financial markets and subsequently, has implications for firms' financial soundness and financial system stability as well as investor protection" and "concerns about the impact of mis-selling are arguably an area where concerns about system stability and investor protection meet". Please see Exhibit 2 of SFC Review Report.

<sup>5</sup> Section 7(2)(g) of BO.

3.8 The commencement of the Securities and Futures Ordinance (Cap. 571) (SFO) and the Banking (Amendment) Ordinance 2002 (No. 6 of 2002) (BAO) brought the securities business of AIs under the regulatory regime of SFO. The arrangement is that HKMA is the frontline regulator of the securities business conducted by AIs. This is reflected in paragraph 8 of the letter dated 25 June 2003 issued by FS to MA<sup>6</sup> on "Functions and Responsibilities in Monetary and Financial Affairs", which specifies a number of responsibilities of MA, including that of co-operating with other relevant authorities in the supervision of business conducted by AIs other than their banking or deposit taking business, and developing the debt market in co-operation with other relevant authorities or organizations.

#### Securities and Futures Commission

3.9 The SFC was established on 1 May 1989 under the Securities and Futures Commission Ordinance (Cap. 24) which was repealed and consolidated into the SFO. SFC is the regulator of the securities and futures industry<sup>7</sup> in Hong Kong. The regulatory objectives of SFC as stated in SFO<sup>8</sup> include keeping the securities and futures industry fair, efficient, competitive, transparent and orderly; protecting the investing public; minimizing crime and misconduct in the markets; reducing systemic risks in the industry; and helping FS maintain financial stability in Hong Kong. In addition, when pursuing its regulatory objectives and performing its functions, SFC must have regard to the desirability of maintaining Hong Kong's status as a competitive international financial centre and of facilitating innovation in connection with financial products<sup>9</sup>. Mr Martin WHEATLEY was appointed CEO/SFC and held office from 23 June 2006 to 8 June 2011.

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<sup>6</sup> The letter was acknowledged and agreed to by Mr Joseph YAM, then MA.

<sup>7</sup> "Securities and futures industry" has the meaning as given to the expression in Schedule 1 to SFO.

<sup>8</sup> Section 4 of SFO.

<sup>9</sup> Section 6(2)(a) and (b) of SFO.

3.10 SFC regulates intermediaries<sup>10</sup> which include brokers and investment advisers through a licensing regime. These intermediaries must satisfy SFC's requisite criteria before they can be granted a licence to deal in securities or futures or to give investment advice. Their business must also comply with financial resources obligations and standards of conduct specified by SFC. Most of the regulatory requirements relating to the sale of securities and futures products by intermediaries are set out in SFC's Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (the Code of Conduct)<sup>11</sup> made by SFC under section 169 of SFO. SFC also issued the Frequently Asked Questions and Answers on Suitability Obligations in May 2007 (Suitability FAQ) to provide practical guidance to the intermediaries<sup>12</sup>.

### **Regulation of banks' securities business by the two regulators**

3.11 Under the current regime as described above, HKMA is the frontline regulator of banks in respect of all their business activities, including regulated activities<sup>13</sup>. The sale of structured financial products by banks to their customers falls within regulated activity Type 1, while the provision of investment advice is regulated activity Type 4. In performing its functions as a regulator over banks' regulated activities,

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<sup>10</sup> Where banks conduct securities and futures business, the banks must be registered with SFC as registered institutions. Their compliance with the rules and requirements of SFC are overseen by HKMA.

<sup>11</sup> First issued in February 1994 and revised from time to time, principally in April 2003 when the SFO came into effect. Further revisions to the Code of Conduct were made in June 2010 to give effect to measures to enhance investor protection. Please also see paragraph 4.27 of Chapter 4.

<sup>12</sup> Please see paragraphs 4.29 and 4.30 of Chapter 4.

<sup>13</sup> Prior to 1 June 2011, there were 9 types of regulated activity under SFO. Type 1: dealing in securities; Type 2: dealing in futures contracts; Type 3: leveraged foreign exchange trading; Type 4: advising on securities; Type 5: advising on futures contracts; Type 6: advising on corporate finance; Type 7: providing automated trading services; Type 8: securities margin financing; Type 9: asset management. The amendments to Schedule 5 to SFO, which came into force on 1 June 2011, added a new Type 10: providing credit-rating services.

HKMA follows the standards and requirements that are stipulated and applied by SFC to its licensed intermediaries<sup>14</sup>.

### Relevant legislation

3.12 The existing legislative framework, established by BAO and SFO, commenced operation on 1 April 2003. Prior to the enactment of these two Ordinances, banks, as AIs, were exempted from regulation by SFC in respect of their conduct of securities business. The relevant Bills were introduced with the objectives to develop a regulatory regime that provides adequate protection to investors, minimizes regulatory overlap and regulatory cost; and enforces a set of consistent regulatory standards between the then exempted AIs (i.e. the entities that were to become "registered institutions" (RIs)) and intermediaries licensed by SFC<sup>15</sup>. After their enactment, relevant provisions in BO and SFO empower MA to supervise the regulated activities of RIs according to the standards applied by SFC on its licensees, and subject banks to the sanctions for breaches of relevant rules and requirements as applicable to licensed intermediaries in the securities industry.

### Regulatory functions of MA and SFC

3.13 When a bank intends to carry on regulated activities, it is required under section 119 of SFO to apply to SFC for registration. SFC will refer the application to HKMA for advice, and in deciding whether or not to register the bank, SFC must have regard to HKMA's advice on the fitness and properness of the bank, and may rely wholly or partly on such advice. The Subcommittee notes from the testimony of Mr Joseph YAM, then MA, that there had not been a case where HKMA and SFC had disagreed on the eligibility of an AI to be registered as an RI.

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<sup>14</sup> An exception, for example, is the Securities and Futures (Financial Resources) Rules as banks are already subject to HKMA's Capital Adequacy Rules, which imposes more stringent requirements on financial adequacy.

<sup>15</sup> The LegCo Brief dated 10 November 2000 on the Banking (Amendment) Bill 2000 and the Securities and Futures Bill which is available on LegCo's website at <http://www.legco.gov.hk>.

3.14 Every RI must appoint at least two executive officers (EOs) for supervising each of its regulated activities<sup>16</sup>. The appointment of EOs is subject to the consent of MA on being satisfied that they are fit and proper and have sufficient authority in the institution<sup>17</sup>. Individuals engaged by RIs to carry out regulated activities (including the sales staff) are not required to be licensed by SFC, but as required by section 114 of SFO, must be registered with HKMA under section 20 of BO as relevant individuals (ReIs)<sup>18</sup>. HKMA does not license or approve ReIs as such, but requires the senior management of each RI to ensure that their ReIs meet the relevant requirements specified in SFC's Fit and Proper Guidelines, Guidelines on Competence and Guidelines on Continuous Professional Training. If MA considers that an EO or an ReI is no longer fit and proper, he may, after consultation with SFC under section 71C(4) or section 58A(1) of BO, withdraw or suspend consent to the appointment of the EO or remove or suspend the particulars of the ReI from the public register respectively. As a result of such disciplinary action, the person should cease to undertake any regulated activities on behalf of the RI.

3.15 In this connection, the Subcommittee has noted from the Guidelines on Competence issued by SFC in March 2003 that the minimum academic qualification requirement for ReIs is "passes in English or Chinese, and Mathematics in Hong Kong Certificate of Education Examination or equivalent". Some members enquired whether an ReI possessing only the minimum academic qualification would be competent enough to explain the product features and information in the prospectuses to customers. Mr Joseph YAM said that as there were also requirements on industry qualification and regulatory knowledge in addition to academic qualification, he considered the competence requirements on ReIs adequate and reasonable. Mr Martin

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<sup>16</sup> Section 71D of BO.

<sup>17</sup> Section 71C(2) of BO.

<sup>18</sup> EOs and ReIs may be seen as the counterparts of "responsible officers" and "licensed representatives" in licensed corporations regulated by SFC.

WHEATLEY advised that the academic/industry qualifications and regulatory knowledge specified in the Guidelines are the minimum entry requirements. SFC would expect RIs to provide sufficient additional training to the ReIs to enable them to perform their duties.

3.16 MA is vested with the powers under section 180 of SFO and section 55 of BO to oversee the regulated activities of RIs. The ongoing supervisory activities of HKMA include on-site inspections, off-site review of information submitted by RIs and handling and investigation of complaints against RIs. Where investigation reveals suspected non-compliance with the Code of Conduct or other regulatory requirements, HKMA would refer the case to SFC for consideration of appropriate disciplinary sanctions under SFO, which include revoking/suspending the registration of the RI, issuance of prohibition orders, private or public reprimands and imposition of fines. SFC may only carry out an investigation into an RI where it has reason to inquire whether the RI is guilty of misconduct or is not fit and proper, and after consultation with MA under section 182(4) of SFO. Before exercising any disciplinary power against RIs and their staff, SFC has to consult MA under section 198(2) of SFO.

3.17 As stated by Mr Y K CHOI, then DCE/HKMA, HKMA had, since 2000, adopted the practice of holding prudential meetings<sup>19</sup> with the boards of directors of local banks once a year to the extent possible. The year 2000 also saw the de-regulation of interest rates rules<sup>20</sup>. The Subcommittee has noted from Mr CHOI that at the prudential meetings, HKMA might provide a peer group comparison to enable the bank concerned to understand its position in the market in terms of its financial position and sources of income. On whether these meetings might have in any way encouraged or exerted pressure on banks to become more aggressive in pursuing non-interest income, Mr Y K CHOI informed the

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<sup>19</sup> In general, HKMA staff at the rank of Division Head, Executive Director or Deputy Chief Executive responsible for banking supervision would conduct the prudential meetings.

<sup>20</sup> The first phase of the de-regulation of interest rates rules took effect on 3 July 2000.



Subcommittee that while HKMA would draw the bank's attention to any potential risk of over-reliance on a particular source of income, it was for individual banks to decide on their business activities. Noting that from 2007 to 2008, HKMA had held 37 prudential meetings with local banks' senior management or board of directors, the Subcommittee sought clarification on whether these prudential meetings were only concerned with the banks' capital adequacy. As advised by Mr Y K CHOI, the prudential meetings also included various facets of the internal controls and operations of banks, including their conduct of securities business.

#### Memorandum of Understanding between SFC and HKMA

3.18 A revised Memorandum of Understanding (MoU) was signed between SFC and HKMA in December 2002<sup>21</sup> setting out their respective roles and responsibilities under each major functional aspect of regulating the securities business of banks, as well as the arrangements in relation to the exchange of relevant information and notification or referral matters. The regulatory objective is to ensure that all intermediaries, whether banks or securities brokers, carrying out the same regulated activities are subject to consistent regulatory measures. The division of responsibilities between SFC and HKMA as set out in the MoU is at **Appendix 3(a)**.

3.19 The Subcommittee notes that since the last revision of the MoU in 2002 to tie in with the enactment of the SFO and BAO, no major revision has been made, except that the side-letter to the MoU to streamline communication and co-operation on enforcement matters was revised in April 2007. According to Mr Joseph YAM and Mr Martin WHEATLEY, then CEO/SFC, regular MoU meetings were held between HKMA and SFC to discuss operational issues related to the regulated

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<sup>21</sup> The revised MoU signed by the two regulators on 12 December 2002 replaced the previous one signed on 23 October 1995.

activities of RIs. During that period, both regulators did not see a need to revise the MoU.

#### Other high-level forum for exchange of views

3.20 The Council of Financial Regulators (CFR) and the Financial Stability Committee (FSC) were set up in 2000 to provide a high-level forum for financial regulators to consider and exchange views on systemic and cross-market issues.

3.21 Chaired by FS and comprising representatives from HKMA, SFC, Office of the Commissioner of Insurance (OCI), Mandatory Provident Fund Schemes Authority and the Financial Services and the Treasury Bureau (FSTB), the CFR is charged with the objective of contributing to the efficiency and effectiveness of regulation and supervision of financial institutions, the promotion and development of the financial markets and the maintenance of financial stability in Hong Kong<sup>22</sup>. According to Mr John TSANG, FS, from April 2003 to July 2007, the regulation of the securities business conducted by banks had been reported and discussed at CFR meetings on a number of occasions. For instance, CFR noted in October 2003 that HKMA had been liaising with SFC on the implementation of SFO and BAO. It also noted in July 2007 the implementation of the MoU between SFC and HKMA in supervising the regulated activities of banks.

3.22 The FSC, chaired by SFST, comprises representatives from HKMA, SFC and OCI. It is tasked to monitor the functioning of the financial system of Hong Kong, including the banking, debt, equity, insurance and related markets; deliberate on issues with possible cross-market and systemic implications, formulate and co-ordinate

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<sup>22</sup> Please see the Terms of Reference of CFR which is available on FSTB's website at <http://www.fstb.gov.hk>.

responses; and reporting to FS as necessary<sup>23</sup>. The Subcommittee has noted that since August 2007, regulators had started to report the implications triggered by the US sub-prime problems on Hong Kong's financial market.

### **Growth in the securities business conducted by banks**

3.23 The Subcommittee notes from the information of HKMA that the income from the securities business conducted by banks only amounted to some HK\$8.35 billion, or 7% of their total income in 2003<sup>24</sup>. Subsequent years saw a significant growth in banks' securities business such that their securities-related income tripled from HK\$13.964 billion in 2005 to HK\$44.435 billion in 2007. Over the same period, the ratio of income from banks' securities business to their total income doubled from 9% to 18%<sup>25</sup>. According to the evidence of Mr Joseph YAM, the notional value of structured financial products sold by banks rose from HK\$406.7 billion in 2003 to HK\$746 billion in 2005, and reached HK\$2,529.6 billion in 2007.

3.24 In explaining this phenomenal growth, Mr Joseph YAM informed the Subcommittee that the demand from retail customers for financial planning and wealth management services had increased since 2004, probably due to the prevailing benign investment and low interest rate environment. Banks responded to this demand by diversifying into non-interest business activities including securities business with a view to offering their customers greater choice and easier access to other investment options. In this connection, the Subcommittee notes that the Hong Kong dollar six-month time deposit rate was less than 1% during

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<sup>23</sup> Please see the Terms of Reference of FSC which is available on FSTB's website at <http://www.fstb.gov.hk>.

<sup>24</sup> Paragraph 4.9 of HKMA Review Report.

<sup>25</sup> Paragraph 4.9 of HKMA Review Report.

January 2004 to May 2005; 1.12% to 2.92% during June 2005 to February 2008; and less than 1% from March 2008 onwards<sup>26</sup>.

## **Observations**

3.25 In considering the current regulatory structure, the Subcommittee has the following observations.

### Perception of the crisis at the higher level of government

3.26 In examining the responses of the regulators and the Administration to the rapid deterioration in market conditions preceding the collapse of LB, the Subcommittee notes that there were discussions at FSC on the implications of the US sub-prime problems on the Hong Kong market. As indicated in the exchanges between MA and the Chairman of the Hong Kong Association of Banks (HKAB)<sup>27</sup> on 12 September 2008, the principal concern was on the impact of the market crisis on the soundness and stability of the local banking sector and financial system, as well as the banks' exposure to investment banks such as LBHI. The Subcommittee considers this justified and understandable from a prudential regulation point of view. However, it is concerned that during these high-level exchanges, it appears that very little attention had been given to the fact that a large number of retail investors in Hong Kong had assumed the credit risks of LB through their purchase of LB structured products. In fact, the Subcommittee has noted from the responses of Prof CHAN Ka-keung, SFST, at the hearings on 20 and 24 February 2009 that he only became aware of Minibonds after the collapse of LB in September 2008. The Subcommittee cannot but doubt whether

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<sup>26</sup> HKMA Statistical Bulletin which is updated on a monthly basis and available on HKMA's website at <http://www.hkma.gov.hk>.

<sup>27</sup> HKMA sent an email to FS on 12 September 2008 providing a summary record of MA's bi-weekly meeting with the Chairman of HKAB on that day, which specifically discussed banks' exposure to investment banks such as LB in terms of both credit risk and their dealings with LB in the over-the-counter markets.

the authorities had a reasonable grasp of the predicament of the investing public in the event of the collapse of LB.

### Regulatory foresight

3.27 The Subcommittee has sought to ascertain whether each of the two regulators had proactively looked at the possible implications of the increased exposure of local retail investors to structured products in the few years preceding the collapse of LB.

3.28 As informed by Mr Martin WHEATLEY, SFC has since 2005 warned investors on the increasing complexity of structured products available in the market and emphasized the need for professional advice relating to product suitability<sup>28</sup>. In March 2006, SFC published a document entitled "Regulatory Challenges and Responses" in which one of the challenges identified was the increased exposure of retail clients to complex and structured products<sup>29</sup>. The Subcommittee has noted from the Structured Product Investor Survey conducted by SFC in June 2006 that around half of those who purchased unlisted retail structured products did not fully understand the nature of these products, and that most investors (87.9%) bought these products through banks. SFC also conducted two rounds of themed inspections of selling practices of investment advisers in 2004 and 2006<sup>30</sup>. The second round was in parallel to HKMA's thematic examinations on the investment advisory activities of RIs.

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<sup>28</sup> For example, in the July 2005 issue of Dr Wise, there was an article titled "Dr Wise – should you invest in structured notes?". In 2005, Dr Wise was a monthly column written by SFC and was available on the website of the SFC-operated Electronic Investor Resource Centre at <http://www.eirc.hk>. Dr Wise is now incorporated in the InvestEd Intelligence, a bi-monthly e-newsletter available at <http://www.invested.hk>.

<sup>29</sup> The paper "Regulatory Challenges and Responses" released on 29 March 2006 is available on SFC's website at <http://www.sfc.hk>.

<sup>30</sup> Further information on the two rounds of themed inspections conducted by SFC is given in Chapter 4.

3.29 Mr Joseph YAM has drawn the Subcommittee's attention to a survey conducted by HKMA from December 2007 to early 2008 to gather information on RIs' sale of retail credit-linked notes with sub-prime mortgages as underlying collateral, or with collateral that might include CDOs. Mr YAM has pointed out that although credit-linked notes only accounted for a small market share and the number of complaints about the sale of such products was low, HKMA had stepped up its regulatory effort on such products. To enhance uniform and prudent treatment among RIs, HKMA, through emails or telephone calls, advised eight RIs, which adopted a "medium" or "low" risk rating for retail credit-linked products without full principal protection, to rate such products as "high" risk. As a result, all except one RI (which had already decided not to sell such products by then) had revised the risk ratings for such products to "high" by February 2008. At the hearing on 20 February 2009, when being asked whether this course of action had exceeded MA's regulatory role under a disclosure-based system<sup>31</sup>, Prof CHAN Ka-keung responded that in his view, MA's move had not exceeded his regulatory role under the policy of the Administration.

3.30 Some members of the Subcommittee questioned whether HKMA and SFC had considered issuing any forewarnings to alert investors of the possible failure of LB. In response, Mr Joseph YAM and Mr Martin WHEATLEY said that while HKMA and SFC had kept a close watch on the developments as the global financial crisis unfolded, it was neither appropriate nor possible for any regulator in Hong Kong to forewarn with precision whether a certain financial institution in US, such as LB, might or might not fail, as this was often the outcome of high-level policy considerations and decisions of US authorities. For example, when responding to members' questions at the hearings on 17 April, 8 and 15 May 2009, Mr Joseph YAM pointed out that the failure of LB could

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<sup>31</sup> For discussion on the disclosure-based system, please see Chapter 4.

hardly be foreseen, given that some financial institutions such as Bear Stearns had been rescued by US authorities.

### Regulation of brokers and banks conducting regulated activities

3.31 One of the key objectives of SFO and BAO is to provide consistency in regulatory standards for both the securities and banking sectors when they conduct the same regulated activities<sup>32</sup>. In this regard, the Subcommittee has examined whether securities brokers and RIs have been subject to a consistent extent of regulation by their respective regulator.

3.32 Unlike SFC which maintains a licensing regime for intermediaries engaged in securities business, HKMA regulates RIs and requires the bank management to ensure the fitness and properness of their ReIs before entering the latter's names in the public register maintained by HKMA. The Subcommittee is concerned that under the existing regime, HKMA does not regulate ReIs directly but relies on the management of individual banks to ensure that their ReIs comply with relevant requirements when conducting regulated activities. Given the keen competition for business, such as the sale of structured financial products, banks might not have exercised the necessary vigilance over their sales staff, also rendering it difficult for HKMA to detect at an early stage any non-compliance by bank staff.

3.33 The Subcommittee has noted that during the 65 months from April 2003 to September 2008 before the collapse of LB, HKMA handled 178 cases of suspected mis-selling of investment products by RIs. Among them, nine cases had been referred to SFC for appropriate action. SFC took enforcement actions in three of these cases<sup>33</sup>. MA suspended

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<sup>32</sup> The LegCo Brief dated 10 November 2000 on the Banking (Amendment) Bill 2000 and the Securities and Futures Bill which is available on LegCo's website at <http://www.legco.gov.hk>.

<sup>33</sup> Please see the press releases issued by SFC on 10 April and 4 May 2007, 24 August 2007 and 4 August 2008 which are available on SFC's website at <http://www.sfc.hk>.

the registration of one ReI from the public register for one month for breaches of requirements under the Code of Conduct<sup>34</sup>. During the same five-year period, 430 licensed intermediaries were disciplined by SFC for breaches of the Code of Conduct following disciplinary inquiries. Of these, 23 intermediaries had their licences revoked, 164 had their licences suspended and 54 were prohibited from applying for a licence<sup>35</sup>. In total, 102 were fined and 188 were publicly reprimanded. The highest fine imposed was HK\$38 million. The Subcommittee has noted with concern the relatively few enforcement actions taken against ReIs during these years. In the light of the large number of complaints alleging mis-selling of LB structured products, it is questionable whether the few enforcement actions were indicative of a high level of compliance, or a lack of effective enforcement actions in the past five years or so.

#### The exercise of regulatory powers by MA and SFC

3.34 The securities business of banks is currently regulated by HKMA and SFC in accordance with relevant provisions under SFO and BAO. The Subcommittee has noted the statutory powers vested with each regulator and the requirement that a regulator should consult the other on specified regulatory matters. In short, SFC does not oversee the regulated activities of RIs on a day-to-day basis, and must rely on MA to do it by exercising his powers under BO and SFO. MA is vested with the powers under BO to suspend or remove consent/registration for EOs and ReIs of RIs, but does not have the statutory power to impose disciplinary sanctions on them in respect of their conduct of regulated activities under SFO. This power is vested with SFC which may discipline RIs, their EOs and ReIs in accordance with the provisions under SFO. However, the regulators are required to consult each other before exercising disciplinary power over an RI, an EO or an ReI.

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<sup>34</sup> Please see the press release issued by HKMA on 4 June 2007 which is available on HKMA's website at <http://www.hkma.gov.hk>.

<sup>35</sup> Some persons/companies had more than one sanction imposed on them by SFC.



Notwithstanding their powers to impose sanctions on RIs under the relevant legislation, neither MA nor SFC has the power to order RIs to compensate customers even if investigation shows that their complaints against the RIs are substantiated<sup>36</sup>. The Subcommittee considers that such division of regulatory powers between MA and SFC is not conducive to effective regulation of RIs, especially in enforcement matters.

### Need for review of the regulatory arrangement

3.35 As the current regulatory arrangement has been in place since April 2003, the Subcommittee is of the view that a review should have been conducted to ascertain whether it has been effective and whether any improvement is required to meet changing needs. According to the evidence of Mr Martin WHEATLEY, he wrote to Mr Henry TANG, then FS, in February 2006 stating his views on the viability of putting the securities business of banks under the same regulator as brokers. In the same paper, he reflected the views of some securities brokers that banks had been favourably treated by HKMA as bank employees had rarely been disciplined by HKMA in carrying out regulated activities. The brokers also felt that the regulatory field was tilted against them as their representatives were required to be licensed while ReIs were not. The broad conclusion in Mr WHEATLEY's paper was that quite a number of hurdles would need to be overcome before any change of the current structure could be considered. There is no further evidence available to the Subcommittee of any discernible work done to critically examine the regulatory arrangement.

3.36 The Subcommittee considers that FS and SFST, being the principal officials with policy responsibility in financial affairs, should have closely monitored the implementation of the regulatory arrangement

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<sup>36</sup> The absence of statutory power on the part of the regulators to order payment of compensation is discussed in Chapter 6.

for banks' securities business, and taken the lead in initiating a comprehensive review in a timely manner. The differences in enforcement outcomes as described in paragraph 3.33 above and the views submitted by Mr Martin WHEATLEY in February 2006 should have alerted the Administration of the need for a critical examination of the existing system to identify and address issues of concern. This did not appear to have taken place until after the collapse of LB in September 2008 when FS asked HKMA and SFC to submit reports to him on their observations and lessons learned from their investigation into LB-related complaints.