

Chapter 6 The handling and resolution of Lehman Brothers-related complaints under the existing regulatory regime

6.1 This chapter examines how the large number of complaints from investors of LB structured products were dealt with by HKMA and SFC under the existing regulatory regime.

Initial response of the Administration and regulators to LB-related complaints

6.2 The Subcommittee has noted that a large number of complaints were lodged with HKMA and SFC following the collapse of LB in September 2008, as investors realized that they had incurred significant losses on the LB structured products they had purchased. In its circular issued to all LCs and RIs on 19 September 2008, SFC urged all LCs and RIs to take a more proactive role in addressing investors' enquiries about their investments, and handle complaints in a timely and appropriate manner¹. On 22 September 2008, HKMA convened a meeting between representatives of investors and representatives of banks that had distributed LB structured products to facilitate communication among the relevant parties. HKMA had encouraged banks to be as transparent and forthcoming as possible in providing information to the affected investors². Both the distributing banks and HKMA set up dedicated hotlines to answer enquiries and receive complaints from investors of LB structured products³.

¹ Circular dated 19 September 2008 issued by SFC is available on SFC's website at <http://www.sfc.hk>. This circular was re-attached in a circular dated 23 September 2008 issued by HKMA to RIs which is available on HKMA's website at <http://www.hkma.gov.hk>.

² Press releases dated 21 and 22 September 2008 issued by HKMA are available on HKMA's website at <http://www.hkma.gov.hk>.

³ Press release dated 22 September 2008 and circular dated 23 September 2008 issued by HKMA are available on HKMA's website at <http://www.hkma.gov.hk>.

6.3 The Subcommittee has also noted that on various public occasions in September 2008, FS and SFST expressed concern and sympathy with the investors. They also assured the public that HKMA and SFC would deal with investors' enquiries and complaints expeditiously⁴. Meanwhile, FS had asked HKMA and SFC to submit a report to him before the end of 2008 on the issues identified in the course of their investigation into LB-related complaints so that the Administration might undertake a systematic review and consider, on a policy level, ways to further improve the regulatory framework⁵.

6.4 On 6 October 2008, the Administration announced that it had put up a "buy-back" proposal whereby the distributors of Minibonds would offer to buy back the Minibonds from the investors at the prevailing estimated value⁶. On 17 October 2008, the Task Force on Lehman Incident of the HKAB announced the decision of the distributing banks to accept the "buy-back" proposal⁷. However, due to the legal challenge raised by the US lawyers acting for the liquidator of LBHI in late November 2008 against the unwinding of the underlying collateral of Minibonds by the trustee⁸, the banks put on hold any "buy-back" action until the legal issues had been resolved.

⁴ For example, FS's speech at the luncheon of HKAB on 24 September 2008 and SFST's remarks on 27 and 30 September 2008 which are available on Information Services Department's website at <http://www.isd.gov.hk>.

⁵ FS's speech at the luncheon of HKAB on 24 September 2008 is available on Information Services Department's website at <http://www.isd.gov.hk>.

⁶ Remarks of FS and SFST made after a meeting with representatives of distributing banks on 6 October 2008 are available on Information Services Department's website at <http://www.isd.gov.hk>.

⁷ The Task Force on Lehman Incident of HKAB was formed on 2 October 2008 and comprised the banks that distributed LB-related structured products. Its purpose was to facilitate distributing banks' discussion of common issues in assisting affected investors who were holding outstanding LB structured products. Press releases issued by the Task Force are available on HKAB' website at <http://www.hkab.org.hk>.

⁸ In late November 2008, the legal advisers of Lehman Brothers Special Financing Inc. wrote to the trustee of Minibonds claiming that the proceeds from any sale of underlying collateral for the Minibonds should be paid to the swap counterparty (an LB entity) first before the issuer and investors of Minibonds. Given that the legal issues involved had not been clarified and addressed, the distributors found it impracticable to determine the market value of the Minibonds and therefore decided to put on hold the buy-back. Relevant documents and discussion on the "buy-back" proposal at the meetings of Panel on Financial Affairs held on 18 and 30 December 2008 are available on LegCo's website at <http://www.legco.gov.hk>.

6.5 At the special meeting of the House Committee held on 13 October 2008⁹, FS re-affirmed the responsibility of the Administration and the regulators in safeguarding the interest of investors. He also made it clear that the Administration would not use public money to compensate investors for their losses on LB structured products as this would be unfair to taxpayers. FS also said that the Administration should refrain from intervening too much into market operations, and should play the role of a facilitator in assisting the parties concerned to resolve the matter.

Complaints of the investors of LB structured products

6.6 At the special meeting of the House Committee on 13 October 2008, Mr Joseph YAM, then MA, informed members that HKMA had received over 9 000 complaints¹⁰. The number rose to 19 699 by December 2008¹¹. As reported in the SFC Review Report, at the end of November 2008, SFC received 8 055 complaints, 7 712 of which were made against distributing banks¹².

6.7 The Subcommittee notes that since mid October 2008, HKMA has published on its website statistics on the number of LB-related complaints it received and the progress of its investigation into these complaint cases. The information is usually updated on a weekly basis and the statistics have varied over time in the light of progress. According to the statistics published by HKMA at the end of September 2009 (about one year after the collapse of LB), the number of LB-related complaints received by HKMA stood at 21 712¹³.

⁹ The opening remarks by FS at the special meeting of the House Committee on 13 October 2008. The verbatim transcript of the meeting is available on LegCo's website at <http://www.legco.gov.hk>.

¹⁰ Please see footnote 2 of Chapter 1.

¹¹ Please see footnote 3 of Chapter 1.

¹² Paragraph 17.2.1 of SFC Review Report.

¹³ Complaints statistics concerning Lehman-related investment products (up to 30 September 2009) are available on HKMA's website at <http://www.hkma.gov.hk>.

6.8 As pointed out in the SFC Review Report published in December 2008, the most common allegations made by investors of LB structured products against banks included the following¹⁴:

- (a) the frontline staff proactively induced the complainants to turn their matured fixed deposits into investments in LB structured products;
- (b) the frontline staff failed to consider the complainants' risk profile and personal circumstances when selling the products, particularly in the case of retirees, elderly persons, less educated and risk averse customers;
- (c) the frontline staff did not provide explanation on product features and risks at the point of sale. Some even misrepresented that the products, in particular Minibonds, were risk-free and similar to time deposits; and
- (d) the distributing banks did not respond to the complainants' enquiries and complaints.

6.9 When testifying to the Subcommittee, many investors of LB structured products made similar complaints against the distributing banks regarding the sale of LB structured products to them. The above allegations were also found in many written submissions received by the Subcommittee. Many investors indicated in the written submissions that they did not know whether to approach HKMA or SFC for filing complaints.

6.10 As stated by some investors, they had also lodged their complaints with the Consumer Council (CC) and the Commercial Crime Bureau (CCB) of the Hong Kong Police, as they considered that they had

¹⁴ Paragraph 17.2.2 of SFC Review Report.

been misled by the banks to purchase the LB structured products. According to available information, CC had received about 12 000 LB-related complaints¹⁵. After assessing the complaints, CC referred the majority of suspected mis-selling cases to HKMA for follow-up action. Meanwhile, the Consumer Legal Action Fund (CLAF) received 156 applications from investors of LB structured products to pursue their claims¹⁶. Given the large number of applications for assistance, CLAF decided to bring to court a small number of representative cases that would serve to clarify important legal principles and establish precedents for better consumer protection in future. The CLAF granted assistance to three cases involving four investors¹⁷.

6.11 According to the information of the Police, CCB had received about 3 100 complaints relating to the sale of LB structured products since September 2008. The majority of these complaints were categorized as "misleading investor" cases. There were 39 cases related to "forgery" and one related to "conspiracy to defraud"¹⁸. It is known to the Subcommittee that prosecution had been taken against four bank employees in connection with their sale of LB structured products. On 15 November 2010, one bank employee was ordered to perform community services after pleading guilty to an offence of forgery in relation to the sale of Minibonds¹⁹. Three other bank employees had been charged under section 107 of SFO²⁰. Among them, two employees were acquitted after trial on 18 February 2011 and 25 May 2011

¹⁵ CC's Annual Reports 2008-2009 and 2009-2010 available on CC's website at <http://www.consumer.org.hk>.

¹⁶ According to CC's Annual Report 2009-2010 available on CC's website at <http://www.consumer.org.hk>, CLAF received 156 applications from affected investors of LB structured products after the collapse of LB.

¹⁷ According to CC's Annual Report 2010-2011 available on CC's website at <http://www.consumer.org.hk>, one assisted investor had accepted a settlement offer from the bank. The other two assisted cases had commenced legal proceedings against the banks concerned in the District Court.

¹⁸ Press release dated 29 March 2012 issued by the Police is available on its website at <http://www.police.gov.hk>.

¹⁹ Please see the judgement of the case HCMA 527 of 2010 available on Judiciary's website at <http://www.judiciary.gov.hk>.

²⁰ Under section 107 of SFO, it is a criminal offence for a person to make a fraudulent or reckless misrepresentation for the purpose of inducing another person to invest in securities.

respectively²¹. The prosecution offered no evidence on the charge against the remaining employee on 2 August 2011²². On 29 March 2012, the Police announced that after seeking legal advice from the Department of Justice and reviewing the evidence available, it had curtailed the investigation into cases relating to the sale of LB structured products except five cases in respect of suspected forgery which were still under investigation. The Police have informed the complainants concerned accordingly²³.

Investigation of LB-related complaints by the regulators

6.12 The Subcommittee has noted that in order to deal with the large volume of LB-related complaints that arose after the collapse of LB, HKMA and SFC had agreed on a set of specifically designed procedures. Under these procedures, HKMA would, in accordance with its powers under BO and SFO, conduct preliminary investigation into each complaint to ascertain whether there was prima facie evidence to support referral to SFC. According to HKMA, irrespective of whether the cases had been referred to SFC, HKMA would continue its investigation of individual complaints so as to ascertain whether disciplinary action should be taken against individual ReIs and EOs in relation to their sale of LB structured products. HKMA has published on its website weekly statistics on the progress in processing the complaints received.

6.13 As informed by SFC, upon receipt of referrals from HKMA concerning alleged mis-selling of LB structured products by banks, SFC would commence investigation into the RIs concerned by adopting a top-down investigatory approach. Under this top-down approach, SFC would not look into each complaint individually, but would review the

²¹ Please see the reasons for verdict of the cases DCCC 526 of 2010 and DCCC 527 & 1272 of 2010 available on Judiciary's website at <http://www.judiciary.gov.hk>.

²² Please see press reports of the case DCCC 1295 of 2010 in local newspapers dated 3 August 2011.

²³ Press release dated 29 March 2012 issued by the Police is available on its website at <http://www.police.gov.hk>.

distributing bank's systems and controls over its selling process, and would examine key issues including²⁴:

- (a) the management controls;
- (b) the due diligence process;
- (c) the training and supervision of sales staff;
- (d) the record keeping; and
- (e) the procedures used at the point of sale, especially the way in which suitability was determined.

6.14 According to SFC, the top-down investigatory approach described above would enable it to form views about the respective positions of the largest number of complainants in the shortest time-frame, and to identify whether there was a systemic problem in the sale of LB structured products that had to be remedied²⁵. As informed by SFC, its investigatory process involved compelling the production of relevant documentation, interviewing witnesses/suspects and analyzing the evidence obtained.

6.15 The Subcommittee notes that under the existing regime, where an RI was found to have failed to comply with the regulatory requirements, SFC may consider imposing sanctions under SFO, which include public and private reprimands, revocation or suspension of the registration of the RI, fines up to HK\$10 million or three times the total profit gained or loss avoided by the misconduct in question²⁶. In cases where SFC contemplates the exercise of its disciplinary power, section 201(3) of SFO also permits SFC to agree to other means of resolving

²⁴ Paragraph 18.2 of SFC Review Report.

²⁵ Paragraph 18.3 of SFC Review Report.

²⁶ Sections 196(1)(i) and (ii), and 196(2) of SFO.

complaints where it considers it appropriate to do so in the interest of the investing public or in the public interest. Nevertheless, neither SFC nor MA is empowered under the existing legislation to order the payment of compensation to individual customers, even if their complaints against the RIs are substantiated.

6.16 According to the evidence of Mr Joseph YAM, then MA and Mr Y K CHOI, then DCE/HKMA, given in June 2009, HKMA had received 21 226 complaints regarding LB structured products sold through RIs. More than 20 000 preliminary assessments had been carried out by HKMA, and 482 cases had been referred to SFC²⁷. According to HKMA, the objective of such referral was to speed up SFC's top-down investigation of the RIs concerned, to help SFC focus on possible areas of concern, and to identify any systemic failure at the RI level. Meanwhile, HKMA would continue its investigation into individual ReIs and EOs involved in these cases.

6.17 When taking evidence from Mr Joseph YAM and Mr Y K CHOI from April to June 2009, the Subcommittee was informed that HKMA's target was to conclude work on at least 70% of the LB-related complaints by March 2010. SFC, on the other hand, had not announced any time-frame for completion of its work on the LB-related complaints. As stated by Mr Martin WHEATLEY, then CEO/SFC, at the hearing on 26 June 2009, SFC did not provide general updates of its investigation, although Mr WHEATLEY had repeatedly stated to the Subcommittee that SFC was making the best endeavours to expedite its investigation work while observing the necessary legal and procedural requirements. In response to members' questions at the hearing on 23 June 2009 concerning the progress of investigation, Mr WHEATLEY informed the Subcommittee that SFC had commenced investigation into all 19 banks that distributed LB structured products, and that SFC would not need to

²⁷ Complaints statistics concerning Lehman-related investment products (up to 11 June 2009) are available on HKMA's website at <http://www.hkma.gov.hk>.

await receipt of complaint cases from HKMA in order to open and complete investigations. He said that instead of handling the complaints individually, SFC would look at the controls and processes of RIs with a view to achieving settlements that could deal with all the complaints.

Disciplinary actions

6.18 The Subcommittee has noted that as a result of the investigation of LB-related complaints, HKMA took disciplinary action against two ReIs in connection with their sale of LB structured products. In November 2009, HKMA announced that it would suspend the particulars of an ReI from the register maintained by HKMA for three months. In May 2010, the particulars of another ReI were suspended from the aforesaid register for five months²⁸. At the time of preparing this report, no further disciplinary sanction has been announced by HKMA.

6.19 At the time when the Subcommittee took evidence from Mr Y K CHOI, it noted that as at 12 November 2009, a total of 822 cases were under disciplinary consideration by HKMA²⁹. In response to questions about the progress of any disciplinary action contemplated by HKMA, Mr Y K CHOI explained that before MA could impose disciplinary sanction and make public announcement, he must observe the due process to ensure fairness and give the subjects of investigation an opportunity to be heard. He said that the enforcement process might last for more than six months as the following procedural steps were involved:

- (a) issuance of Notice of Intention to Impose Disciplinary Sanction (NID) to the regulated person,

²⁸ The relevant press releases issued by HKMA on 20 November 2009 and 14 May 2010 are available on HKMA's website at <http://www.hkma.gov.hk>.

²⁹ Complaints statistics concerning Lehman-related investment products (up to 12 November 2009) are available on HKMA's website at <http://www.hkma.gov.hk>.

- (b) representation made by the regulated person, normally within 30 days upon the issuance of the NID,
- (c) review and consideration on the representation by HKMA,
- (d) consultation with SFC,
- (e) issuance of Notice of Disciplinary Decision (NDD),
- (f) appeal to the Securities and Futures Appeals Tribunal (SFAT) by the regulated person for a review of MA's decision within 21 days after the NDD had been served,
- (g) review and decision made by SFAT, and
- (h) MA imposing disciplinary sanction subject to the decision of SFAT or withdrawal of appeal by the regulated person.

6.20 The Subcommittee has continued to keep in view the progress of the disciplinary process of HKMA in relation to LB-related complaints, and noted that up to 29 March 2012, a total of 25 cases were under disciplinary consideration³⁰. According to HKMA, these were cases in respect of which proposed disciplinary notices were being prepared after detailed investigation by the HKMA.

Disputes resolution mechanism

6.21 On 31 October 2008, HKMA announced that to assist distributing banks of LB structured products and individual investors to settle their disputes, it had engaged the Hong Kong International

³⁰ Complaints statistics concerning Lehman-related investment products (up to 29 March 2012) are available on HKMA's website at <http://www.hkma.gov.hk>.

Arbitration Centre to provide mediation and arbitration services under the Lehman Brothers-related Products Disputes Mediation and Arbitration Scheme. Participation in the Scheme is voluntary and the consent of both the investor and the distributing bank is required for mediation/arbitration to proceed. HKMA would pay the investor's share of the fee for (i) investors whose complaints had been referred to SFC, or (ii) investors whose complaints had resulted in a finding against an ReI or EO³¹.

6.22 The Subcommittee has noted that in the HKMA Review Report and SFC Review Report submitted to the FS in December 2008, the regulators had recommended that the Government should explore the need and feasibility of setting up an independent dispute resolution mechanism to provide a simple and efficient channel to settle disputes between investors and financial intermediaries. After a public consultation exercise conducted in early 2010, the Administration announced in December 2010 the decision to establish the Financial Dispute Resolution Centre (FDRC) by mid 2012. Approval had also been obtained from the Finance Committee of LegCo in June 2011 to create a new commitment of HK\$92 million for supporting the establishment of the FDRC and its operating costs for the first three years of operation. The FDRC is incorporated as a limited company by guarantee to administer a financial dispute resolution scheme for settling monetary disputes between individual customers and financial institutions regulated by HKMA and SFC by way of primarily mediation and, failing which and if the claimant so wishes, arbitration. The Government appointed the Board of Directors and the Chief Executive Officer of the FDRC on 1 March 2012 to spearhead the preparatory work for its operation by mid 2012³².

³¹ Information on the Scheme is available on HKMA's website at <http://www.hkma.gov.hk>.

³² The press release dated 1 March 2012 is available on Information Services Department's website at <http://www.isd.gov.hk>.

Settlement agreements entered into by SFC, MA and RIs

6.23 On 22 July 2009, SFC, HKMA and the 16 Minibonds-distributing banks jointly announced that they had reached an agreement in relation to the repurchase of Minibonds from eligible customers. Thereafter, during the period from December 2009 to July 2011, SFC and HKMA announced further agreements with the following banks to make repurchase offers of outstanding LB structured products which included LB-CLNs and various structured notes distributed through private placement³³:

- (a) DSB and Mevas Bank Ltd;
- (b) DBSHK;
- (c) SCBHK; and
- (d) CHKL.

The agreements were entered into by SFC and MA with the banks in question pursuant to section 201 of SFO. Further details on the five settlement agreements are given in **Appendix 6(a)**. According to the settlement agreement reached with 16 distributing banks of Minibonds, each of them were required to make a further payment to eligible customers once the collateral was recovered and paid to the distributing banks. On 28 March 2011, the distributing banks and the Receivers of the collateral securing certain series of Minibonds announced a collateral recovery agreement, details of which are set out in **Appendix 6(b)**.

6.24 The Subcommittee has taken note of the following matters arising from the five settlement agreements:

³³ The relevant press releases and related information on all the five settlement agreements are available on SFC's website at <http://www.sfc.hk>.

- (a) The repurchase offers were made by the distributing banks without admission of liability.
- (b) There were different eligibility criteria for the repurchase offers made under the five settlement agreements. According to the information in the relevant press releases issued by SFC announcing these agreements, it was estimated that a majority (ranging from 64% to 95%) of the customers of the banks holding outstanding LB structured products were eligible for the offers under these agreements.
- (c) With the exception of the settlement agreement in respect of LB-CLNs, the other settlement agreements only provided for offers amounting to partial repayment of the investment principal to eligible customers.
- (d) SFC set out its concerns raised in the course of its investigation into the distributing banks regarding their sale of LB structured products. These included concerns over the overall monitoring of the sales process, the appropriateness of the risk rating assigned to the LB structured products and the adequacy of the suitability assessments conducted with customers.
- (e) Under most of these settlement agreements, the distributing banks were required to implement ECHP to handle complaints from customers who did not accept the repurchase offers or who were not eligible for the offers.
- (f) SFC and HKMA would not take any enforcement/disciplinary action against the banks and their employees in relation to the sale of the LB structured

products covered by the agreements except for acts of a criminal nature. HKMA would continue to handle complaints of ineligible customers or customers who rejected the repurchase offers.

6.25 The SFC's approach in considering whether to exercise its power under section 201 of SFO in any contemplated or actual disciplinary case was the subject of members' questions at the hearings on 23 June, 26 June and 3 August 2009³⁴. In response, Mr Martin WHEATLEY said that in negotiating and entering into agreements pursuant to section 201 of SFO, SFC would seek outcomes that:

- (a) provide reasonable remediation arising from the consequences flowing from any regulatory concerns that have been identified;
- (b) ensure any systems and control deficiencies are rectified and that measures are put in place to reduce the chance of re-occurrence; and
- (c) provide a deterrent or lesson to other market participants.

6.26 The Subcommittee notes that according to the press releases issued on the settlement agreements, both SFC and HKMA welcomed the agreements as reasonable and practical resolutions since eligible customers would be able to recover a reasonable amount of their investment without incurring the costs and associated risks of separate legal proceedings. They considered that the same outcome could not have been achieved through disciplinary action against the distributing banks and their employees. However, the Subcommittee has also

³⁴ As at 3 August 2009, the only agreement reached with distributing banks pursuant to section 201 of SFO in relation to their sale of LB structured products was the settlement agreement reached with 16 distributing banks of Minibonds.

received submissions from some investors of LB structured products expressing the following dissatisfaction over these agreements:

- (a) The affected investors had not been consulted on the terms of the agreements reached by the regulators with the distributing banks.
- (b) As the LB structured products had been mis-sold to them by banks, the investors considered that they should be compensated in full.
- (c) Under the agreement announced by SFC, HKMA and 16 Minibonds distributing banks on 22 July 2009, certain investors were arbitrarily designated as "experienced investors"³⁵ and excluded from the repurchase offers. Given that such designation is not found in existing legislation, it was unfair and unjustifiable to exclude these investors from the repurchase offers.
- (d) It was unfair that under another settlement agreement for LB-ELNs announced on 1 March 2011, the repurchase offer price would be reduced by 5% (or 10%) of the investors' total assets held at the bank (Available Assets). At the initial period after the announcement of the agreement, there was ambiguity over what constituted Available Assets³⁶.

³⁵ "Experienced investors" refers to those investors who in the three years preceding their first purchase of Minibonds, executed five or more transactions in Leveraged Products, Structured Products or a combination of these products. This category of investors is not eligible for the repurchase offer announced on 22 July 2009. Please see the relevant press release dated 22 July 2009 which is available on SFC's website at <http://www.sfc.hk>. According to the Minibonds collateral recovery agreement subsequently announced on 28 March 2011 by the distributing banks and the Receivers of collateral, all note-holders (including the customers previously classified as "experienced investors") of the relevant series of Minibonds were able to recover from the collateral 70% to 93% of their original investment. Please see Appendix 6(b).

³⁶ After discussions with the regulators, the concerned bank announced that investment linked assurance scheme products and insurance products would not be regarded as Available Assets for the purpose of calculating the repurchase price.

Observations

6.27 Arising from its examination of how LB-related complaints were handled and resolved by the regulators under the existing regulatory regime, the Subcommittee has made a number of observations.

Lodging of complaints

6.28 The Subcommittee is deeply concerned about the predicament faced by the aggrieved investors, and notes that some of them have staged protests and demonstrations for months. The Subcommittee also appreciates that many investors were confused as to which authority they should approach for seeking assistance or lodging their complaints against RIs. Quite a number of them had filed complaints with HKMA, SFC, CC and the Police. To a certain extent, this might reflect the serious and complicated nature of the LB-related complaints, and the lack of clarity on whether HKMA or SFC should take lead responsibility in handling such complaints. The Subcommittee considers that since most of the investors had purchased the LB structured products through banks, HKMA, being the frontline regulator of banks, should have proactively advised the aggrieved investors to lodge their complaints with HKMA. This would also enable HKMA to better gauge the extent of the problem.

Progress of complaints investigation

6.29 All along, the Subcommittee has considered it incumbent upon the regulators to take all necessary measures to expedite the investigation of LB-related complaints, as the aggrieved investors would be in a stronger position to seek remedies if the regulators find mis-selling on the part of the RIs. The Subcommittee did not find it helpful when HKMA only aimed at completing enforcement work on at least 70% of the complaints by the end of March 2010 (which was some 18 months from

the collapse of LB in September 2008). It has asked HKMA to advance the target date to, say, the end of 2009.

6.30 According to Mr Joseph YAM and Mr Y K CHOI, HKMA had difficulty in recruiting the personnel with the necessary knowledge in structured financial products, familiarity with the regulatory requirements and investigative experience. Taking into account the lead time for on-the-job training, the man-days required for information gathering, analysis of evidence and preparation of reports and the need to observe the due process, HKMA maintained that its target of completing work on 70% of the complaints by the end of March 2010 was realistic.

6.31 As the Subcommittee has noted in paragraph 6.16 above, HKMA had only completed preliminary assessments on the bulk of the 20 000 complaints and referred less than 500 cases to SFC by June 2009. However, following the eligible customers' acceptance of the repurchase offers under various settlement agreements announced since July 2009, resulting in SFC and HKMA not taking any enforcement/disciplinary action against the RIs in the cases of these customers, the number of outstanding LB-related complaints dropped considerably. According to the statistics of LB-related complaints published by HKMA on a weekly basis, by the end of March 2010 (i.e. HKMA's previous target date for completion of work on 70% of the complaints), investigation of over 99% of the 21 547 complaint cases had been completed. Out of these cases, 13 060 cases were resolved under the Minibonds repurchase agreement announced on 22 July 2009³⁷. By 29 March 2012, a total of 15 769 cases out of 21 851 complaint cases had been resolved under different settlement agreements reached pursuant to section 201 of SFO³⁸. Another 3 370 cases had been resolved through the ECHP put in place by various banks. 2 467 cases were closed due to insufficient prima facie

³⁷ Complaints statistics concerning Lehman-related investment products (up to 31 March 2010) are available on HKMA's website at <http://www.hkma.gov.hk>.

³⁸ Complaints statistics concerning Lehman-related investment products (up to 29 March 2012) are available on HKMA's website at <http://www.hkma.gov.hk>.

evidence or disciplinary grounds³⁹. Disciplinary sanctions had been imposed in respect of two cases⁴⁰ while disciplinary action was pending on 25 cases. Investigation into another 168 cases had been completed and the decision on these cases was pending. There remained 50 cases that were still under investigation by HKMA. The Subcommittee considers that it was the various agreements, rather than the investigation into each and every complaint case by the regulators, that had been instrumental in bringing about the resolution of outstanding LB-related complaints.

Disciplinary actions

6.32 According to the information published by HKMA on its website, the number of cases under disciplinary consideration grew significantly from 822 in November 2009 to more than 2 800 in July and August 2010⁴¹. However, the Subcommittee has noted that since September 2010, there has been a downward trend in the number of such cases. The Subcommittee has observed that the drop was hardly the outcome of completion of investigation and enforcement action, but one of the results of various settlement agreements reached by SFC, MA and the distributing banks under which HKMA and SFC would not take enforcement/disciplinary action against the RIs and their employees in relation to the sale of LB structured products covered by those agreements.

6.33 Notwithstanding the steps required to be taken by HKMA to ensure fairness to the subjects of investigation as mentioned in paragraph 6.19 above, the Subcommittee finds it inexplicable that by the end of March 2012, over 40 months after the collapse of LB, only two ReIs had

³⁹ As stated by HKMA, investigation into these cases may be re-opened if more information is available. Please see Note 3 of the Complaints statistics concerning Lehman-related investment products (up to 29 March 2012) available on HKMA's website at <http://www.hkma.gov.hk>.

⁴⁰ Please see paragraph 6.18 of this chapter.

⁴¹ Complaints statistics concerning Lehman-related investment products (up to 8 July 2010 and 12 August 2010) are available on HKMA's website at <http://www.hkma.gov.hk>.

been sanctioned by MA while the disciplinary outcomes/decision relating to about 200 LB-related cases were still pending. The Subcommittee cannot but doubt the efficacy of the disciplinary process.

Transparency of investigation or enforcement actions

6.34 The Subcommittee notes that since mid October 2008, HKMA has published on its website statistics on its progress of investigating into LB-related complaints against RIs distributing LB structured products. Individual RIs were not named in the statistics which were usually updated on a weekly basis. SFC however has not published on a regular basis information relating to its investigation work. The Subcommittee finds this unsatisfactory and considers that SFC should have adopted a similar or comparable practice as that of HKMA to achieve at least the same level of transparency in respect of its investigation into LB-related complaints.

6.35 The Subcommittee recognizes that there are secrecy provisions under BO and SFO⁴² which constrain MA and SFC respectively in disclosing information obtained in the course of performing their statutory functions. Nevertheless, given the widespread public concerns engendered by the LB incident, the Subcommittee considers that public expectation can be better met if information on the progress of investigation or enforcement actions can be published by the regulators as far as permissible under existing legislation.

6.36 The Subcommittee also considers that the complainants have every right to know the progress and outcome of investigation into their complaints. Where HKMA decides not to proceed further with a complaint, the Subcommittee is of the view that HKMA should provide the complainant with an explanation of the reasons for its decision.

⁴² Section 120(1) of BO and section 378(1) of SFO.

Individual settlement agreements between investors and RIs

6.37 It is noted that some investors had negotiated directly with the distributing banks for settlement of their complaints⁴³. The Subcommittee had sought clarification from Mr Joseph YAM on whether it was in order for RIs to enter into settlement agreements with individual investors which contained provisions requiring the investor to withdraw the complaints he/she had lodged with SFC, HKMA and other regulatory agencies. In this regard, Mr Joseph YAM referred to a circular issued by HKMA on 5 March 2009 requiring RIs to ensure that fair and reasonable arrangements were in place for settling LB-related complaints. He stated that HKMA's investigation into any case would not be closed due to the investor's withdrawal of the relevant complaint. Even if a complainant was not willing to provide information to HKMA for the purpose of its investigation, HKMA would make all reasonable efforts to gather relevant information and evidence from other sources. Notwithstanding such explanation, the Subcommittee is of the view that investors' right of lodging complaints with regulators should be upheld and it is not fair in principle if an RI required a complainant to withdraw the complaint lodged with the regulators as a condition for settlement.

Disputes resolution mechanism

6.38 The Subcommittee has noted with concern the absence of a simple, speedy and affordable disputes resolution mechanism through which aggrieved investors of LB structured products could seek remedies.

6.39 As discussed in Chapter 5, there is no evidence that direct negotiations between individual investors and the RIs had produced fruitful settlement outcomes in great numbers⁴⁴. As pointed out in

⁴³ Please see paragraphs 5.102 to 5.114 of Chapter 5 for discussion on RIs' handling of customers' complaints relating to LB structured products.

⁴⁴ Please see paragraph 5.108 of Chapter 5.

paragraph 6.31 above, the vast majority of the 21 851 complaint cases had in fact been resolved as a result of the various settlement agreements pursuant to section 201 of SFO. The Subcommittee has also found that the Lehman Brothers-related Products Disputes Mediation and Arbitration Scheme, which was launched by HKMA in November 2008 specifically for LB-related cases, had not been widely used by aggrieved investors and the distributing bank. According to the evidence given by the top/senior management of the six banks, only two of the banks had made use of the mediation service under this Scheme⁴⁵. The Subcommittee considers that a thorough independent review of the Scheme should be made as soon as practicable so that the experience gained or the lessons learnt can throw light on the operation of the FDRC.

Agreements pursuant to section 201 of SFO

6.40 As observed in paragraph 6.31, the various settlement agreements entered into by the regulators and the distributing banks pursuant to section 201 of SFO had been instrumental in resolving the bulk of outstanding LB-related complaints. Investors were given an option to settle their cases with the distributing banks without having to wait for the outcome of investigation into their respective complaints or to engage in lengthy negotiation or litigation with the banks.

6.41 The Subcommittee is concerned that some investors were designated as "experienced investors" and excluded from the Minibonds repurchase offers announced on 22 July 2009. Some members questioned the rationale and fairness of such designation which is not found in existing legislation. According to the testimony of Mr Martin WHEATLEY, then CEO/SFC, the definition of "experienced investors" had set a very high benchmark of demonstrated experience in purchasing structured financial products (namely five or more transactions within the three years prior to the first purchase of Minibonds). Accordingly, such

⁴⁵ Please see paragraph 5.111 of Chapter 5.

an investor had to be a person with very recent experience and familiarity with products like Minibonds. SFC therefore considered it reasonable for "experienced investors" to be treated differently from inexperienced investors in the Minibonds repurchase offers. The Subcommittee has noted that according to the information available to HKMA at that time, approximately 25 000 customers were eligible for the Minibonds repurchase offers. Out of 1 098 customers who were not eligible for the repurchase offer, 879 were "experienced investors"⁴⁶. Although "experienced investors" and other ineligible customers were able to obtain remediation based on assessment of the merits of individual complaint cases through the ECHP, the Subcommittee considers it unfair and unjustifiable to draw certain lines which are arbitrary and lack legal basis to exclude certain investors from the repurchase offers.

Power to compel payment of compensation

6.42 The Subcommittee notes that before SFC exercise its power under section 201 of SFO and enters into any agreement, two statutory pre-conditions must be met. Firstly, SFC must be contemplating the exercise of its disciplinary power against the person concerned. Secondly, SFC must be satisfied that the agreement to be entered into is one that is appropriate in the interest of the investing public or in the public interest⁴⁷.

6.43 In the light of the above, it is clear to the Subcommittee that when contemplating to enter into an agreement pursuant to section 201 of SFO in relation to the LB-related complaints, SFC must have already gathered evidence from its investigation which enabled it to exercise disciplinary power against the RIs. Under the existing legislation, while SFC may impose penalties for breaches of regulatory requirements under SFO, neither SFC nor MA has the power to order the RIs to make

⁴⁶ "Experienced investors" in respect of relevant series of Minibonds were able to recover part of their original investment from the collateral. Please see footnote 35 of this chapter and Appendix 6(b).

⁴⁷ Section 201(3) of SFO.

payment of compensation to the affected investors. As explained by Mr WHEATLEY at the hearings on 26 June and 3 August 2009, banks might make voluntary offers if they felt that SFC had a strong case that they had failed in their duties and breached the Code of Conduct. They might realize that providing an equitable solution would be in their interests. However, the making of such offers was a voluntary action on the part of the RIs.

6.44 The Subcommittee notes that the agreements pursuant to section 201 of SFO are often the compromise reached after long-drawn negotiation, as reflected in the length of time taken to reach the five settlement agreements with the RIs in question, and the terms of such agreements, such as the repurchase price which fell short of the principal amount and/or the exclusion of certain investors from the repurchase offers. Another issue of concern is the decision of SFC and HKMA not to pursue enforcement/disciplinary action against the RIs in question and their employees in respect of the cases covered by the settlement agreements. The Subcommittee believes that the regulators' not pursuing enforcement/disciplinary action might be a crucial condition without which the settlement agreements with distributing banks could not have been reached. In this regard, the Subcommittee is seriously concerned that these agreements can lead to the impression that a regulated person who has failed to comply with regulatory requirements can escape sanction so long as the person is willing to come to a monetary settlement with the complainants.

6.45 The Subcommittee considers that if the regulator responsible for enforcement is also vested with appropriate powers to order the payment of compensation where the findings so justify, the existing system of handling and resolving LB-related complaints can be enhanced. In particular, the regulator needs not consider discontinuing their enforcement actions in deserving cases in return for a settlement deal with the regulated persons. Payment of compensation and consideration

of disciplinary action (where required) may proceed in parallel. The Subcommittee would however emphasize that even if a regulator is empowered to order the party guilty of misconduct to pay compensation, the entitlement of aggrieved investors to compensation and the amount payable would still depend on the circumstances of individual cases. The exercise of the power by the regulator to order payment of compensation may also be the subject of litigation.