

## **Chapter 7 Investor protection**

7.1 Arising from the LB incident, a major concern to the Subcommittee is whether investors in Hong Kong are adequately protected under the existing regulatory regime. This chapter examines the issue of investor protection in the light of the LB incident.

### **Policy on investor protection**

7.2 According to Prof CHAN Ka-keung, SFST, and Mr John TSANG, FS, the Administration attaches great importance to investor education and to protecting the interests of the investing public. At the policy level, investor protection has always been one of the Administration's core policy objectives. The Administration makes every effort to ensure that the financial regulators are sufficiently resourced and appropriately empowered to maintain and promote a fair, efficient, transparent and orderly financial market for the better protection of investors. The Subcommittee was informed by Prof CHAN Ka-keung that the Administration and regulators had stayed in close touch and exchanged views on issues related to investor protection and education on an ongoing basis.

### **The responsibilities of the regulators in investor protection**

7.3 In his testimony, Mr Joseph YAM, then MA, stated that one of MA's key focuses in the day-to-day regulation of the securities business of banks is investor protection, in particular the prevention and detection of mis-selling of financial products to investors. According to Mr YAM, although investor protection is not expressly stated in BO, it can be construed from the relevant provisions of BO that this is a function of

MA. Mr YAM also stated that MA's functions as specified in section 7(2) of BO are relevant to the protection of investors. Other provisions of BO touching upon investor protection include sections 58A, 71C, 71E(6) and 132A(9). The Subcommittee notes that as stipulated in section 7(1) of BO, the principal function of MA under BO is to promote the general stability and effective working of the banking system. One of the specific functions of MA set out in section 7(2)(g) of BO is that MA shall take all reasonable steps to ensure that any banking business, any business of taking deposits, or any other business, carried out by an AI is carried on (i) with integrity, prudence and the appropriate degree of professional competence; and (ii) in a manner which is not detrimental, or likely to be detrimental, to the interests of depositors or potential depositors.

7.4 The Subcommittee notes that SFC is the financial regulator with an explicit statutory remit for investor protection. One of SFC's regulatory objectives as specified in section 4(c) of SFO is to provide protection for members of the public investing in or holding financial products. Regarding the statutory functions of SFC, section 5(1)(i) of SFO requires SFC to promote understanding by the public of the benefits, risks and liabilities associated with investing in financial products; while section 5(1)(k) requires SFC to promote understanding by the public of the importance of making informed decisions regarding transactions or activities related to financial products and of taking responsibility therefor. As specified in section 5(1)(l) of SFO, SFC has the function to secure an appropriate degree of protection for members of the public investing in or holding financial products, having regard to their degree of understanding and expertise in respect of investing in or holding financial products. In pursuing its regulatory objectives and performing its functions, SFC is required under section 6(2)(a) and (b) of SFO to have regard to the desirability of maintaining the status of Hong Kong as a competitive international financial centre and the desirability of facilitating innovation in connection with financial products.

## **Investor protection and investor education**

7.5 As stated by Mr Martin WHEATLEY, then CEO/SFC, investor protection has always been and will remain SFC's first priority. This is done through regulation, enforcement<sup>1</sup> and education. According to Mr WHEATLEY, SFC fulfils its role of protecting investors by ensuring sufficient disclosure of product information in the offer documentation for the investor to make an informed investment decision. Intermediaries conducting the sale have the duty to ensure the suitability of an investment product for the particular customer.

7.6 The Subcommittee has noted that surveys on investors had been conducted by SFC<sup>2</sup>. One of these surveys was the Structured Product Investor Survey<sup>3</sup> conducted in 2006 which revealed, amongst others, that about 87.9% of the investors covered in the survey had bought unlisted structured financial products through banks. It was also found that investors' understanding of structured financial products needed strengthening. For example, nearly 30% of the investors had purchased these products with capital preservation as the objective, or they had perceived these products as low risk investments. Where sales representatives were involved, a significant number of investors did not recall having received advice from their sales representatives, while other investors noted difficulty in understanding sales representatives' explanations due to product complexity and the use of jargon<sup>4</sup>. As stated by Mr WHEATLEY, on the same day when the findings of this survey were released, SFC published a Dr Wise article on retail structured notes, issued a press release and another circular to issuers of unlisted structured products drawing their attention to the survey findings. To

---

<sup>1</sup> The work of SFC and HKMA in regulation and enforcement in respect of the securities business of RIs has been discussed in Chapters 3 and 4.

<sup>2</sup> Reports of about 10 investor surveys conducted during the period from 1999 to 2008 are available on SFC's website at <http://www.sfc.hk>.

<sup>3</sup> The report on Structured Product Investor Survey published in November 2006, as well as the relevant press release dated 28 November 2006, is available on SFC's website at <http://www.sfc.hk>.

<sup>4</sup> The summary of these findings is prepared on the basis of the press release dated 28 November 2006 available on SFC's website at <http://www.sfc.hk>.

follow up, SFC conducted a second round of themed inspections on investment advisers in 2006. This was done in parallel with HKMA's thematic examinations on selected RIs<sup>5</sup>.

7.7 The Subcommittee has been informed by Mr WHEATLEY that since 2003, the features and risks of specific types of products and the promotion of informed investing had been active in SFC's investor education work on unlisted structured financial products. SFC also disseminates information through its investor education portal to draw investors' attention to the nature and risks of investment in structured financial products<sup>6</sup>. The Subcommittee has noted from the evidence of Mr WHEATLEY that over 100 publicity initiatives, many of which focused on the investment risks of structured financial products, had been undertaken by SFC. Some examples are given in **Appendix 7(a)**.

7.8 According to Mr Joseph YAM, then MA, it was not appropriate for any regulator to issue public warnings related to individual institutions or specific products. However, he considered that regulators could give general warnings when financial markets experienced heightened volatility. The Subcommittee has noted from his evidence that during the period June 2006 to August 2008, Mr YAM had issued general warnings and urged caution with regard to developments in the global and local economies, in particular the impacts of the sub-prime problems and the ensuing credit crisis through his regular briefings at the Panel on Financial Affairs, his interviews with the media and media briefings. In addition, Mr Joseph YAM also informed the Subcommittee that during this period, he had published articles in his Viewpoint column<sup>7</sup> on the website of HKMA to alert the investing public of market

---

<sup>5</sup> Please see paragraph 4.37 of Chapter 4.

<sup>6</sup> SFC had operated an Electronic Investor Resource Centre (<http://www.eirc.hk>) which is now its designated portal for investor education (<http://www.invested.hk>).

<sup>7</sup> Viewpoint is a bilingual column published weekly on HKMA's website for disseminating messages about monetary and financial issues on-line to the community and in a timely manner. About 500 articles have been written by Mr Joseph YAM, then MA, from September 1999 to September 2009. These articles were carried in a number of local newspapers.

volatilities and financial innovation. For example, on 6 September 2007, he wrote about the impact of the sub-prime issue. On 28 February 2008, he highlighted the risks arising from financial innovation and warned that "investors could find themselves holding assets whose risk-return profile turns out to be different from what they believed". In the Viewpoint article published on 27 March 2008, Mr YAM emphasized the importance for investors to exercise due diligence over their investments, particularly when the structures of the financial instruments and the dynamics of the markets grew in complexity<sup>8</sup>. Some examples of Mr YAM's general forewarnings issued through various channels are given in **Appendix 7(b)**.

7.9 The Subcommittee has noted the proposed establishment of a cross-sectoral Investor Education Council (IEC)<sup>9</sup> to holistically oversee the needs of investor education and delivery of related initiatives. The IEC will be set up as a wholly owned subsidiary company of SFC and will leverage and enhance the current investor education initiatives undertaken by SFC, and on that basis offer expanded education programme across the financial services industry.

### **"Treating Customers Fairly"**

7.10 In examining the issue of investor protection, the Subcommittee has noted that the Financial Services Authority (FSA) in the United Kingdom (UK) introduced a principle-based "Treating Customers Fairly" (TCF) initiative in recent years<sup>10</sup>. The Subcommittee further notes that pursuant to the TCF initiative, investors of a financial product should be

---

<sup>8</sup> All the Viewpoint articles cited are available on HKMA's website at <http://www.hkma.gov.hk>.

<sup>9</sup> The IEC is one of the proposals in the Securities and Futures (Amendment) Bill 2011 passed by LegCo on 25 April 2012. Documents related to the Bill are available on LegCo's website at <http://www.legco.gov.hk>.

<sup>10</sup> In July 2004, FSA issued a paper "Treating customers fairly – progress and next steps" which set out its plan to address the fair treatment of customers throughout the product life-cycle. The paper and other documents relevant to Treating Customers Fairly are available on FSA's website at <http://www.fsa.gov.uk>.

treated fairly throughout the product life-cycle, including product design, marketing, sale, after-sale and complaint-handling. The TCF defines six consumer outcomes which firms under the supervision of FSA are expected to deliver<sup>11</sup>. They are:

- (a) consumers can be confident that they are dealing with firms where the fair treatment of customers is central to the corporate culture;
- (b) products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly;
- (c) consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale;
- (d) where consumers receive advice, the advice is suitable and takes account of their circumstances;
- (e) consumers are provided with products that perform as firms have led them to expect, and the associated service is both of an acceptable standard and as they have been led to expect; and
- (f) consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint.

---

<sup>11</sup> The six outcomes are explained in FSA's paper "Treating customers fairly – towards fair outcomes for consumers" issued in July 2006, which is available on FSA's website at <http://www.fsa.gov.uk>.

7.11 In reply to the Subcommittee's question of whether consideration should be given to implementing a similar TCF initiative under the present regulatory regime governing banks' securities business in Hong Kong, Mr Joseph YAM considered that the nine principles (i.e. GP1 to GP9)<sup>12</sup> set out in the Code of Conduct are in line with the fundamental principles underlying the TCF initiative in UK. The Subcommittee notes that the TCF initiative has a wider coverage in that it extends to the design of a financial product which appears to be beyond the ambit of the Code of Conduct. It is further noted that in 2007, FSA issued a regulatory guide<sup>13</sup> setting out the responsibilities of providers and distributors of financial products for the fair treatment of customers. The regulatory guide requires, amongst others, providers of financial products to identify the target customers of their products and take steps to ensure that their products are suitable for these customers.

### **Professional investor**

7.12 The Subcommittee notes that under the existing regime, the investor population is not categorized and is broadly referred to as the investing public or investors. The only group identified and being treated differently from the rest of the investor population is "professional investors" which is defined in SFO to mean:

- (a) market professionals comprising specified entities set out in paragraphs (a) to (i) in Part 1 of Schedule 1 to SFO including investment banks, brokers and managers of authorized funds; and

---

<sup>12</sup> GP1 to GP9 are explained in paragraph 4.27 of Chapter 4.

<sup>13</sup> In July 2007, FSA issued a Regulatory Guide "The Responsibilities of Providers and Distributors for the Fair Treatment of Customers" and set out its view on the respective responsibility of providers and distributors under the Principles for Businesses to treat customers fairly during the product life-cycle or various stages of provisions of the service. The Guide is available on FSA's website at <http://www.fsa.gov.uk>.

- (b) high net worth investors who are persons (entities and individuals) who have been prescribed under the Securities and Futures (Professional Investor) Rules (Cap. 571D) as professional investors. These include high net worth individuals with a portfolio of not less than HK\$8 million (or the equivalent in foreign currency).

7.13 In this connection, the Subcommittee has noted that since the Companies (Amendment) Ordinance 2004 (No. 30 of 2004) came into effect on 3 December 2004, the authorization requirements in respect of offer documentation were exempted under the CO prospectus regime if an offer of investment was made to professional investors only<sup>14</sup>. Certain requirements in the Code of Conduct would, subject to the fulfilment of certain conditions, also be waived regarding professional investors<sup>15</sup>. Nevertheless, irrespective of whether a client is a professional investor, where the transaction involved derivative products such as Minibonds, an intermediary must comply with the provisions under paragraph 5.3 on "Know your client: derivative products" of the Code of Conduct, and satisfy itself that the client understands the nature and risks of the products and has sufficient net worth to be able to assume the risks and bear the potential losses of trading in the products<sup>16</sup>.

7.14 The Code of Conduct also requires intermediaries to take necessary steps to ascertain that a high net worth investor is knowledgeable and has sufficient experience in the relevant products and markets, and that he has chosen and confirmed in writing to be treated as a professional investor. The intermediary is also required to confirm

---

<sup>14</sup> Please see paragraph 4.16 of Chapter 4 on the offer of investment products by private placement. The latest legislative amendments that disapply the "safe harbour" provisions under CO on the offer of structured products are set out in Appendix 4(b).

<sup>15</sup> Paragraph 15.5 of the Code of Conduct.

<sup>16</sup> A new paragraph 5.1A was added to the Code of Conduct with effect from 4 September 2011. Henceforth, except where a client is a professional investor, the intermediary is required to assess the client's knowledge of derivatives and characterize the client based on his knowledge of derivatives. Where a client without knowledge of derivatives wishes to purchase a derivative product, the intermediary is required to warn the client about the transaction and provide appropriate advice to the client on the suitability of the transaction for the client.



annually that the client continues to meet the requirements to be categorized as a professional investor<sup>17</sup>.

## **Observations**

7.15 The Subcommittee has identified and examined a number of issues relating to investor protection in the light of the LB incident, and made certain observations as set out in the ensuing paragraphs.

### Financial innovation and investor protection

7.16 As explained in paragraph 7.4 above, SFO sets out the regulatory framework for the regulation of the securities market in Hong Kong, with the key objectives to, inter alia, provide protection for members of the public investing in or holding financial products. In pursuing its regulatory objectives, SFC must have due regard to the desirability of maintaining the status of Hong Kong as a competitive international financial centre and the desirability of facilitating innovation in connection with financial products.

7.17 An issue of concern to the Subcommittee is the potential conflict between financial innovation and investor protection; and whether financial innovation and market development had been pursued over the years at the expense of investor protection. Mr Martin WHEATLEY, then CEO/SFC, has stated that investor protection has always been and will remain SFC's first priority, and that this is done through regulation, enforcement and education. In response to the Subcommittee's questions at the hearing on 26 March 2010, Mr WHEATLEY said that SFC is required to strike a proper balance between

---

<sup>17</sup> Paragraphs 15.3 and 15.4 of the Code of Conduct. In June 2011, new paragraphs 15.3A and 15.3B were added to the Code of Conduct under which the intermediary is required to undertake separate assessment prior to treating an existing Professional Investor as a Professional Investor in a different product type or market, and to undertake a new assessment if the Professional Investor has ceased to trade in the relevant product or market for more than two years.

the need for investor protection and the promotion of market development, and that investor protection would never be sacrificed in order to develop the market. Although there is no ranking of the regulatory objectives specified in SFO, Mr WHEATLEY pointed out that in practice, SFC had always put investors' interest first, and this was so reflected in various issues of SFC's Annual Report<sup>18</sup>.

7.18 In examining the initiatives to facilitate market development, the Subcommittee has noted that one such initiative was the enactment of the Companies (Amendment) Ordinance 2004 (No. 30 of 2004) to facilitate the offer of shares or debentures on a repeat or programme basis by introducing a "dual prospectus" structure for programme offerings<sup>19</sup>. The said Ordinance, which came into effect on 3 December 2004, also excluded from the definition of "prospectus" documents containing or relating to offers and invitations that fell within the "safe harbours" set out in the Seventeenth Schedule to CO<sup>20</sup>.

7.19 According to Mr WHEATLEY, these measures were not intended to, and did not, adversely affect SFC's regulatory standard applied to issuers and its regulatory function to secure an appropriate degree of protection for the investing public. In the view of the Subcommittee, the above change, which had simplified the requirements on prospectuses, had the effect of facilitating the issuance of certain series of Minibonds and LB-CLNs for public offer. Product issuers were also able to make use of the "safe harbour" provisions under the Seventeenth Schedule to CO to issue LB-ELNs without the need for a prospectus<sup>21</sup>. In the view of the Subcommittee, these measures might have contributed

---

<sup>18</sup> Please see SFC's Annual Report 2004-05, 2006-07, 2007-08 and 2008-09, which are available on SFC's website at <http://www.sfc.hk>.

<sup>19</sup> Please see paragraph 4.8 of Chapter 4.

<sup>20</sup> Please see paragraphs 4.16 and 4.17 of Chapter 4 on investment products offered by private placement.

<sup>21</sup> Minibonds and LB-CLNs were structured notes issued in a series under a programme and therefore the "dual prospectus" approach applied. Programme prospectus was not required for every series of the products. LB-ELNs were distributed by banks making use of the "safe harbour" provisions in the Seventeenth Schedule to CO and therefore authorization of the offer documentation by SFC was not required.

to the proliferation of structured financial products, including LB structured products. The Subcommittee has noted that according to the information published by SFC<sup>22</sup>, a total of 147 retail structured notes, with an aggregate issue size of HK\$9.75 billion, were issued during the 12-month period ending June 2006, as compared to 31 retail structured notes, with an aggregate issue size of HK\$7.45 billion, issued during the 12-month period ending June 2004.

### Sale of LB structured products in Hong Kong

7.20 Noting that LB structured products had been widely sold to retail investors in Hong Kong, some members of the Subcommittee have enquired whether overseas regulatory authorities had adopted a more stringent approach to prohibit such products from retail sale and as a result, prevented investors from suffering heavy losses. According to the findings in the HKMA Review Report, there did not appear to be absolute restriction on the sale of structured financial products to the retail public in the overseas jurisdictions reviewed by HKMA. The UK, US, Australia, Singapore, the Netherlands and Germany adopted a broadly similar approach based on (i) disclosure by product issuers in public offers; (ii) licensing of financial intermediaries; and (iii) requirements on the intermediaries to treat customers fairly, assess their suitability for products recommended to them, and disclosure of adequate product information to enable the customers to make informed investment decisions. Some jurisdictions required the issuers of products to identify the target market and the types of customers for whom the product was likely to be unsuitable<sup>23</sup>.

7.21 The Subcommittee has also noted from the findings in the SFC Review Report that Minibonds were also sold in Singapore. Other LB structured products were sold in Singapore, Taiwan and Indonesia. In

---

<sup>22</sup> Please see SFC Research Paper No.34 published in September 2006 which is available on SFC's website at <http://www.sfc.hk>.

<sup>23</sup> Paragraph 7.2 of HKMA Review Report.

Europe, examples included the product with the name "Zertifikate", sold by banks to around 60 000 small investors in Germany. Certain Principal Protected Notes issued by LB were sold in US<sup>24</sup>.

7.22 In response to the Subcommittee's question, Mr Joseph YAM said that according to his understanding, there was no prohibition on the sale of LB structured products in US. As stated by Mr Brian HO at the hearing on 21 July 2009, the Securities and Exchange Commission in US had authorized the prospectuses of LB structured products for offers to the public. According to the evidence given by the top management of two banks that had distributed LB-ELNs through private placement, the reason why the LB-ELNs distributed by way of private placement in Hong Kong could not be distributed in US was because they were issued under the EMTN Programme which had not been registered in US. The Subcommittee is not aware of any absolute prohibition on the sale of LB structured products to retail investors in overseas jurisdictions.

#### Investor education

7.23 The Subcommittee has observed that there is no lack of investor education initiatives taken by SFC and HKMA over the years. However, the LB incident has called into question the effectiveness of these initiatives, in particular whether the key messages had reached those individuals who needed them most. As the majority of the topical articles issued by SFC and HKMA are posted online, they might not be accessible to elderly and less educated persons. Greater use should be made of radio and TV broadcasts as they are the main channels through which these individuals obtain information.

7.24 In addition to the dissemination of information and general advice, the Subcommittee believes that any investor education initiatives must unequivocally convey the message that any investment decision is a

---

<sup>24</sup> Paragraph 14.3 of SFC Review Report.

decision of the investor, and that he should not invest in products that he does not know or understand.

### Suitability assessment in investor protection

7.25 The Subcommittee has noted that ensuring the suitability of a product for the investor is a cornerstone for investor protection. As discussed in Chapter 5<sup>25</sup>, there is divergence in the evidence given by the management and frontline staff of the six banks and by the investors on whether and how suitability assessment had been conducted at the point of sale. The Subcommittee has found that each of the six banks had put in place practices and procedures requiring their staff to observe proper standards of conduct when selling LB structured products (as well as other products) to customers. One bank, for example, required the completion of a product-specific suitability questionnaire in addition to assessing the risk tolerance level of the customer<sup>26</sup>. The senior management of another bank raised concern about the need for relevant training and proper suitability assessment as a result of an enlarged customer base for certain LB structured products to be distributed by the bank through private placement<sup>27</sup>.

7.26 Notwithstanding the above, the evidence given by the investors on how they had acquired LB structured products has reflected that individual banks had not been resolute and effective in implementing the very procedures laid down by them, and in ensuring that proper conduct at the point of sale was maintained in all cases. The Subcommittee is concerned that where there was a conflict between strict observance of regulatory requirements and the need to maximize business earnings, individual banks had not given due priority to investors' interest in all cases.

---

<sup>25</sup> Please see paragraphs 5.59 to 5.60 of Chapter 5.

<sup>26</sup> Please see paragraph 5.50 of Chapter 5.

<sup>27</sup> Please see paragraph 5.54 of Chapter 5.

### Responsibility for investor protection

7.27 The Subcommittee has no doubt that the Administration and regulators have a vital responsibility in investor protection and must take effective measures to prevent unfair treatment of investors. However, the Subcommittee must also point out that one should not expect the Administration and the regulators to provide a risk-free investment environment for investors. Investors must also exercise a reasonable degree of vigilance and due diligence. In the light of the LB incident, the Subcommittee finds it equally important for investors to take responsibility in protecting their own interest. When being offered certain structured financial products with above-average return, investors, in particular those who are not familiar with financial products or who do not follow market conditions closely, should question and find out why such products would carry a much higher rate of return than, for example, what they would receive on placing plain fixed deposits with the bank. It is essential for investors to recognize the fact that the return on an investment is proportionate to the risks it carries.

7.28 The evidence given by investors of LB structured products<sup>28</sup> clearly shows that there are individuals who, due to their personal circumstances such as age, lack of education or financial illiteracy, have difficulty in comprehending LB structured products no matter how much information or explanation is provided, not to mention making an informed investment decision in relation to these products. To protect these vulnerable individuals, reliance on suitability assessment at the point of sale alone would not suffice. The Administration and the regulators should consider additional measures to prevent the sale of similar structured products to these individuals.

---

<sup>28</sup> Please see paragraphs 5.46 and 5.52 of Chapter 5.

### Fair treatment for customers

7.29 The Subcommittee considers that investor protection cannot be achieved if the product originator or promoter is most keen on product innovation but least minded to treat prospective customers fairly; and if the intermediaries conducting the sale of structured financial products have not fulfilled their obligations (such as undertaking product due diligence, conducting KYC and suitability assessment). As noted by the Subcommittee, the relevant prospectuses and termsheets of certain LB structured products (e.g. Minibonds, LB-CLNs and LB-ELNs) contained statements to the effect that the products were not suitable for everyone, or were only suitable for the more experienced and knowledgeable investors<sup>29</sup>. When selling LB structured products, intermediaries are required to ensure suitability of the product in question for the particular customer.

7.30 Based on the evidence given by witnesses from the six banks, the Subcommittee has found that not all the banks had specified the target customers to whom LB structured products would be sold. Customers were sold LB structured products subject to being assessed as suitable for acquiring such products in accordance with the banks' relevant requirements and procedures<sup>30</sup>. However, the evidence given by many of the investors revealed that the LB structured products sold to them were not in line with their investment experience, objectives and risk appetite<sup>31</sup>.

7.31 The Subcommittee has also noticed from the evidence of the investors of LB structured products that many of them were long-time customers of the banks, and had placed considerable trust in the banks and their staff<sup>32</sup>. The Subcommittee considers that banks enjoy

---

<sup>29</sup> Please see paragraph 2.17 of Chapter 2.

<sup>30</sup> For more details, please see paragraphs 5.41 to 5.64 of Chapter 5.

<sup>31</sup> Please see paragraphs 5.46 and 5.52 to 5.53 of Chapter 5.

<sup>32</sup> Please see paragraph 5.46 of Chapter 5.

proximity to their customers by virtue of their branch networks and banking services. In principle, the Subcommittee does not have any objection for banks to promote their securities business (e.g. sale of structured financial products). However, it believes that individual banks should implement effective measures to ensure that their customers were fairly treated, and not to take unfair advantage of long-time customers' trust in them by selling financial products which were not suitable or comprehensible to these customers. In this context, the Administration and the regulators are urged to study whether product issuers and RIs (as well as other intermediaries conducting securities business) should be required to implement appropriate measures to deliver the desired outcomes for treating customers fairly during the product life-cycle, broadly similar to the requirements contemplated under the TCF initiative of FSA in UK.

#### Investor types

7.32 One key issue that has emerged from the LB incident is whether the Administration or the regulators should require intermediaries to restrict the sale of derivative products such as LB structured products to those investors who are conversant with financial market products. A related question is whether the investor population should be categorized so that certain products can only be sold to specified categories of investors. As the Subcommittee has noted in paragraph 7.12 above, the only distinct investor type is "professional investor" as defined under SFO. The rest of the investor population is not categorized, although the investment knowledge, market experience and risk tolerance may vary widely among these investors.

7.33 In examining the offer documentation of LB structured products, the Subcommittee has noted that the termsheets of several LB-ELNs contained reminders to prospective investors that the issuer, the guarantor and the dealer of the notes consider that "the notes are only



suitable for highly sophisticated investors who are able to determine themselves the risk of an investment linked to shares". According to the termsheet of one LB structured note<sup>33</sup> which was linked to the performance of a basket of market indices and distributed by way of private placement, prospective investors should be experienced with respect to derivatives, particularly options and options transactions.

7.34 In this context, the Subcommittee has noted that according to the guidance issued by the National Association of Securities Dealers (NASD) in US in September 2005, individual investors who wish to acquire structured financial products are required to have an account approved for options trading, given the similar risk profile of many structured products and options<sup>34</sup>. The Subcommittee sees merits in using certain tangible "qualifications" such as the past or current investment activity of the investor as a requirement in determining whether certain financial products can be sold to the investor in question.

---

<sup>33</sup> Termsheet of Lehman Brothers 2.5 years USD Market Leader, Monthly Auto-call Principal Protected Note produced by the management of one of the six banks.

<sup>34</sup> NASD Notice to Members 05-59 dated September 2005. NASD was the predecessor of the Financial Industry Regulatory Authority, which is currently the largest self-regulatory organization in US operating under the oversight of the Securities and Exchange Commission and responsible for regulating all securities firms that do business with the public, including with respect to professional training, testing and licensing of registered persons, arbitration and mediation. Broker-dealers in US cannot conduct business until they are members of a self-regulatory organization.