## Chapter 8 Concluding observations and recommendations

8.1 In the preceding chapters, the Subcommittee has analyzed the evidence according to the themes relevant to the Subcommittee's study, and stated its observations on issues of concern. This chapter sets out the Subcommittee's concluding observations and recommendations on the basis of the foregoing analysis and observations.

# CONCLUDING OBSERVATIONS

## The regulatory structure

(Please refer to paragraphs 3.11 to 3.12, 3.31 to 3.34)

8.2 Since the commencement of SFO and BAO in April 2003, HKMA, being the frontline regulator of banks, has taken on the added responsibility of supervising the regulated activities carried on by banks in accordance with the standards and requirements set and applied by SFC to its licensed intermediaries. Unlike SFC which maintains a licensing regime for intermediaries, HKMA does not regulate ReIs directly but relies on the bank management to ensure compliance of their ReIs with regulatory requirements. The LB incident has exposed the inefficacy of the current regulatory structure, as manifested in the following facts:

(a) HKMA had not detected and rectified at an early stage the non-compliance by RIs and their staff with regulatory requirements in their sale of investment products; and

(b) during the five years or so preceding the collapse of LB, relatively few enforcement actions had been taken by HKMA against ReIs.

## Policy role of the Government

(Please refer to paragraphs 3.3 to 3.5, 3.20 to 3.22, 3.35 to 3.36)

8.3 One of the objectives of enacting SFO and BAO is to bring the securities business of banks under the regulatory regime of SFO so that both the banking and securities sectors would be subject to consistent regulation in respect of their securities business. Given the importance of the new regulatory framework put in place since April 2003, the Subcommittee considers that the Administration should have taken a proactive role in initiating a comprehensive review of the effectiveness of the regulatory arrangement and whether the policy objectives can be met. The fact that no comprehensive review has been carried out means that many existing weaknesses have been left to subsist for years and remained unaddressed.

## Regulation of the distribution of LB structured products by RIs

8.4 The twin pillars of "disclosure under the CO prospectus regime" and "regulation of intermediaries' conduct at the point of sale" were separately administered by two different regulators. SFC is responsible for the disclosure regime to ensure sufficient disclosure of information in the product documentation; while HKMA is responsible for supervising RIs in their conduct of regulated activities. Through its examination of the LB incident, the Subcommittee has come to the view that this system suffered from the following deficiencies that rendered it ineffective:

<u>CO prospectus regime</u>

(Please refer to paragraphs 4.5 to 4.10, 4.12 to 4.17, 4.19 to 4.25, 7.6)

(a) Since about 2005, there had been increased exposure of retail investors to structured financial products sold through banks. The public offer of most of these products was regulated under the CO prospectus regime. However, the CO prospectus regime was intended to

cater for equity or traditional debt capital-raising issues, not structured financial products structured as "debentures" (such as Minibonds). The matters required to be disclosed under the Third Schedule to CO, although very detailed and exacting, were not specifically directed at structured financial products. Little detailed guidance was provided on disclosure specific to structured financial products.

(b) Prospectuses were often lengthy and difficult to read. The information had not been disclosed in a manner which could effectively apprise prospective investors of key product features and risks.

(c) Some HK$6.2 billion worth of LB structured products had been sold to about 6 000 investors by way of private placement[1], under which the offer documentation and marketing materials did not require authorization by SFC. The fact that a sizable portion of LB-related product documentation could make use of the exemptions under CO and avoid oversight by SFC was incongruent with the objective of a disclosure regime emphasizing SFC's role to ensure sufficient disclosure, and undermined the usefulness of such a regime.

Regulation of conduct at the point of sale
(Please refer to paragraphs 4.26, 4.32 to 4.49)

(d) The current arrangements, under which HKMA relies on the management of RIs to ensure compliance of their ReIs instead of regulating them directly, had not been conducive to the early detection of mis-selling of structured financial products.

[1] Please see Appendix 2(b) of Chapter 2.

(e) Prior to the collapse of LB, both HKMA's day-to-day regulation and thematic examinations had not detected serious failure in compliance. This is in sharp contrast to the large number of complaints about mis-selling after September 2008. The ongoing regulatory process of HKMA had largely been ineffective in detecting non-compliance in RIs' sale of investment products.

(f) HKMA is responsible for supervising RIs, detecting and conducting initial investigation into non-compliance. However, the power to impose sanctions on RIs for breaches of regulatory requirements rests with SFC and can only be exercised after consultation with MA. The division of regulatory powers between the two regulators has given rise to operational complexities which are not conducive to effective complaints handling and enforcement.

## Compliance with regulatory requirements by RIs

8.5 The Subcommittee has found that there were deficiencies in compliance with regulatory requirements in the sale of LB structured products, as set out in the following paragraphs.

Product due diligence
(Please refer to paragraphs 5.7 to 5.22)

(a) There was little evidence that RIs had reviewed in what aspects the LB structured products were considered suitable for different risk categories of investors.

(b) There were instances of inappropriate risk ratings being assigned to LB structured products, such as non-principal protected LB-CLNs being rated as a product of low-to-medium risk.

(c) There was little evidence that the risk ratings of LB structured products had been subject to continuous reviews.

Staff training and guidance
(Please refer to paragraphs 5.24, 5.32 to 5.34, 5.37 to 5.40)

(d) The "basic" academic[2] qualification for ReIs stipulated in the Guidelines on Competence are no longer adequate in enabling ReIs to discharge their duties to their clients in the light of the changes and developments in the financial markets.

(e) The training materials (supplied by the co-ordinating distributor) used by some RIs contained misleading information to the effect that Minibonds was authorized by SFC for offer to ordinary investors. It did not appear that these RIs had conducted their own independent review of such materials. However, the training materials were likely relied upon by sales staff in understanding the product. Not all sales staff and bank management had understood correctly what was meant by "SFC authorization" in relation to Minibonds.

KYC and suitability assessment
(Please refer to paragraphs 5.46 to 5.47, 5.52 to 5.53, 5.56, 5.58 to 5.64)

(f) Notwithstanding the policies and procedures put in place by individual RIs, there was evidence that not all the requisite procedures on KYC and suitability assessment had been followed in every transaction (e.g. suitability assessment not done before the transaction, special arrangements not carried out in respect of golden age

[2] Passes in English or Chinese, and Mathematics in the Hong Kong Certificate of Education Examination, as stipulated in Paragraph 5.4 of Guidelines on Competence issued by SFC in March 2003. Please see also paragraph 5.24 of Chapter 5.

customers, questions in the risk-profiling questionnaires not understood by the investor).

(g) The fact that some individuals who could hardly be assessed as suitable for LB structured products had been sold such products demonstrated that not all RIs had effectively ensured that KYC and suitability requirements had been properly carried out by sales staff in all cases.

The sales process
(Please refer to paragraphs 5.67, 5.69 to 5.71, 5.73 to 5.75, 5.77 to 5.81)

(h) The lack of understanding of LB structured products as revealed by some investors cast serious doubt on whether the product had been properly explained to them. It was questionable whether individual investors had been provided with relevant prospectuses or given the opportunity to read the prospectuses and ask questions.

(i) Placing a deposit and making an investment require very different considerations on the part of the customer. However, some customers were not aware that they were making an investment, and could not distinguish between banking services and investment services, especially if they had been sold LB structured products when their original intention was only to place or renew a time deposit with the bank. Some customers who were general depositors hardly regarded themselves as investors.

(j) In selling LB structured products to customers, RIs claimed that they only provided investment information, not investment advice. From the perspective of some customers, the line between the two was far from clear, as it was often the case that they had been introduced to such products by the bank staff who also persuaded them to subscribe for these products for higher returns. As the

giving of investment advice which is incidental to the sale of the investment product is permissible under existing regulatory requirement, certain clarification is needed to minimize contention over whether the customers had been given "information" or "advice" in relation to his purchase of an investment product.

(k) RIs tended to rely on the relevant forms, which included certain declarations or acknowledgements, signed by the investors as proof of their understanding of the LB structured products and the suitability of the products for them. There should be other means to collaborate any proof that the product had been properly explained to and understood by the investors.

Monitoring and internal controls
(Please refer to paragraphs 5.94 to 5.96, 5.99 to 5.100)

(l) RIs had relied heavily on reviews of transaction documents to ascertain whether all requisite steps of the sales process had been completed. However, if these documents were not prepared as a true record of what had been done, they could not be relied upon for any review of compliance, or for detecting irregularities.

Handling of complaints
(Please refer to paragraphs 5.104 to 5.105, 5.108, 5.111 to 5.114)

(m) The large number of complaints that remained outstanding before the settlement agreements announced since July 2009 had raised doubts about the adequacy of the complaint-handling processes of individual RIs in resolving LB-related complaints expeditiously. Aggrieved investors had encountered difficulties in the course of pursuing their complaints with the distributing banks and very few complaints had been settled through direct negotiation between the investors and the RIs.

Sales targets and incentives
(Please refer to paragraphs 5.83 to 5.92)

8.6 The evidence available to the Subcommittee did not show that frontline bank staff had relied heavily on the sale of LB structured products in order to meet sales targets and earn incentives, nor were there indications that sales performance was the overriding factor in appraising staff performance. Nevertheless, the Subcommittee considers that the regulators should pay ongoing attention to the remuneration and incentives structures of RIs to ensure that they do not place undue emphasis on sales performance at the expense of compliance.

## Agreements pursuant to section 201 of SFO

(Please refer to paragraphs 6.24 to 6.26, 6.31, 6.40 to 6.41)

8.7 The Subcommittee has found that while the settlement agreements entered into by SFC, MA and the distributing banks pursuant to section 201 of SFO had led to the resolution of the bulk of LB-related complaints, these agreements had their limitations. Whilst it is understood that these agreements are the compromise reached after long-drawn negotiation between SFC, HKMA and the distributing banks, the Subcommittee considers it unfair to exclude certain investors from the repurchase offers by arbitrarily designating them as "experienced investors", when no such designation is found in existing legislation.

## Power to order payment of compensation

(Please refer to paragraphs 6.42 to 6.45)

8.8 Currently, neither SFC nor MA has the power to order an RI to compensate an investor, even if there are adverse findings against the RI. In the absence of such power, the regulators might have to agree not to take enforcement action against the RIs in order to reach an agreement with them pursuant to section 201 of SFO to settle the outstanding LB-related complaints. The Subcommittee considers that the regulator(s)

should be empowered to order the payment of compensation without prejudice to disciplinary actions in deserving cases.

## Handling and resolution of LB-related complaints

(Please refer to paragraphs 5.104 to 5.105, 5.112 to 5.114, 6.9 to 6.10, 6.28, 6.37 to 6.39)

8.9 The Subcommittee considers that individual investors' lack of bargaining power and access to information had placed them in a disadvantaged position when negotiating with individual RIs to settle their cases. The recourse to legal action might not be a practicable option due to the time and costs incurred. There is thus a strong need to put in place a simple, speedy and affordable mechanism for resolving disputes between the aggrieved investors and the financial institutions.

## Investor protection

(Please refer to paragraphs 7.2 to 7.4, 7.23 to 7.34)

8.10 The LB incident has exposed the inadequacies of the regulatory system in safeguarding investors' interest. While investors should not look forward to an investment environment which is risk-free, the Administration and the regulators have an undisputable responsibility in investor protection. As demonstrated in the LB incident, the prevailing "disclosure-cum-conduct regulation" regime has failed to provide sufficient protection to investors for the following reasons:

(a) Disclosure of information, often in copious product documentation, was not helpful in facilitating investors to understand the product and make an informed decision.

(b) The large number of complaints about mis-selling and the regulatory concerns raised by SFC (as set out in the relevant press releases on the various settlement agreements announced since July 2009) are strong

indication of the failure of RIs to comply properly with relevant regulatory requirements at the point of sale.

(c) It does not suffice to require only the intermediaries to ensure suitability of the investment product for the customer in question. Many investors who were not suitable for acquiring LB structured products had acquired such products. The Administration and regulators should introduce additional safeguards so that certain products can only be sold to specified categories of investors by intermediaries.

8.11 Despite various investor education initiatives, it does not appear that certain key messages, such as "investor should not invest in products they do not understand" and how investors themselves can best protect themselves, have been delivered to reach the investing public.

## Accountability

8.12 The Subcommittee has also examined the accountability of the following key government officials and CEO/SFC in the LB incident.

Mr Joseph YAM, former MA

8.13 Mr Joseph YAM held office as MA from 1 April 1993 to 30 September 2009 and was the Chief Executive of HKMA. He was accountable for the performance of HKMA, including its role as the frontline regulator of banks supervising their regulated activities in accordance with the standards and requirements set by SFC.

8.14 The phenomenal growth in the securities business of banks since 2003, the increased exposure of retail investors to structured financial products available at banks and investors' insufficient knowledge on such products (as revealed in the surveys conducted by SFC in 2005 and 2006) should have alerted HKMA of the need to step up surveillance on the compliance of RIs so as to ensure that customers

would not be mis-sold investment products. However, as observed in paragraphs 4.45 and 4.46 of Chapter 4, the ongoing regulatory process of HKMA had not detected any serious irregularities in the selling practices of RIs prior to the collapse of LB. This is in contrast to the Subcommittee's findings on the deficiencies in compliance with regulatory requirements by RIs as described in paragraph 8.5 above. The Subcommittee considers that in his capacity as MA and the Chief Executive of HKMA, Mr Joseph YAM should take ultimate responsibility for HKMA's failure to detect and rectify problems related to the sale of investment products before they became widespread among RIs and should be reproved.

8.15 Noting the deficiencies in compliance by RIs as described in paragraph 8.5 above and the large number of complaints alleging the mis-selling of LB structured products, the Subcommittee does not subscribe to any view that the relatively few enforcement actions taken by HKMA against ReIs in the years preceding the collapse of LB were indicative of a good level of compliance with the regulatory requirements at the point of sale. Had HKMA been more effective in enforcing the regulatory requirements on the conduct of regulated activities, cases of mismatch in which LB structured products had been sold to investors who were hardly suitable for these products could have been reduced.

<u>Mr Martin WHEATLEY, former CEO/SFC</u>

8.16 Mr Martin WHEATLEY was CEO/SFC from 23 June 2006 to 8 June 2011. The proposal to transfer the regulation of public offers of structured products from the CO prospectus regime to the offers of investments regime under SFO was one of the consultation conclusions published by SFC in September 2006. If this initiative was implemented, SFC would be able to issue product codes to prescribe structural requirements, in addition to disclosure requirements, taking into account the nature of the product. Product issuers could no longer make use of the "safe harbours" in the Seventeenth Schedule to CO (commonly relied on for issuing private placement notes) and the "dual prospectus" approach under CO to issue structured products frequently and successively. However, the legislative amendments did not materialize

until May 2011 following the passage of the Securities and Futures and Companies Legislation (Structured Products Amendment) Bill 2010. The original plan of SFC was to pursue this legislative proposal together with the other initiatives under Phase 3 of the CO rewrite exercise. It was only after the LB incident in 2008 that SFC decided to advance this legislative proposal ahead of the original schedule.

8.17 Through its own studies and surveys conducted in 2005 and 2006, it was clear to SFC that an increasing number of structured products had found their way into the retail market. SFC was also fully aware that the disclosure requirements under the CO prospectus regime had its limitations and were not adequate in regulating the public offers of structured financial products. Had the legislative amendments been introduced at an earlier time in, for example, 2006 or 2007, the public offers of structured financial products, such as Minibonds and other LB structured products issued by way of private placement, could have been more effectively regulated under the offers of investments regime of SFO. The Subcommittee is greatly disappointed that Mr Martin WHEATLEY, then CEO/SFC, had not secured the enactment of the relevant amendment legislation in a timely manner, and considers that he should take certain responsibility for the belated transfer of the regulation of public offers of structured notes from the CO prospectus regime to the offers of investments regime under SFO.

8.18 SFC was aware from the outset that Minibonds would likely be distributed to the general public through retail banks. Its studies and surveys conducted in 2005 and 2006 also revealed, amongst others, that investors' knowledge on structured financial products was inadequate. Hence, SFC should have no difficulty in envisaging that retail investors might, by virtue of the product name, understand Minibonds as a type of traditional bonds. However, as described in paragraphs 4.20 to 4.22 of Chapter 4, SFC had taken a strictly legalistic view on the term "Minibonds" (迷你債券) and considered that it was not in itself misleading. As the then CEO/SFC, Mr Martin WHEATLEY should take responsibility for not having sufficient sensitivity to the needs and perception of general investors in connection with SFC's vetting of product documentation.

Mr John TSANG, FS and Prof CHAN Ka-keung, SFST

8.19 Mr John TSANG and Prof CHAN Ka-keung have taken up their current posts since 1 July 2007. As the principal officials with the policy responsibility in financial matters, it is incumbent upon Mr TSANG and Prof CHAN to keep abreast of market developments and to provide the necessary policy steer to ensure the effective regulation of the financial system in Hong Kong.

8.20 The regulation of the securities business of banks by both HKMA and SFC has been in operation since April 2003 and there is no lack of developments calling for regulatory attention. These included the phenomenal growth in the securities business conducted by banks since 2003, concerns from brokers that banks appeared to have been more favourably treated in carrying out regulated activities (as noted in paragraph 3.35 of Chapter 3) and the relatively lack of enforcement action and sanctions on ReIs. The Administration's role is to ensure not only that the regulators are sufficiently resourced and appropriately empowered to carry out their functions, but that the relevant regulatory objectives are achieved.

8.21 Notwithstanding the above, there is no evidence that before the collapse of LB, Mr John TSANG and Prof CHAN Ka-keung, in their capacity as FS and SFST respectively, had initiated, or required the regulators to undertake, a comprehensive review of the current regulatory arrangement. Not until the collapse of LB affecting tens of thousands of investors did Mr John TSANG, FS, require HKMA and SFC to submit review reports to him. Mr John TSANG and Prof CHAN Ka-keung should take responsibility for failing to initiate a timely review of the current regulatory arrangement to identify and address issues of concern. Being the chairman of CFR and FSC respectively, there is no indication that Mr John TSANG and Prof CHAN Ka-keung had been aware of issues of regulatory concern straddling the work of HKMA and SFC, and consequently did not sense the need to conduct a review of the regulatory arrangement.

8.22 As described in paragraph 3.26 of Chapter 3, in about mid September 2008, the principal concern of the top level of government was the stability of the local banking and financial sectors. It is not apparent that Mr John TSANG and Prof CHAN Ka-keung, in their capacity as FS and SFST respectively, had been aware of the extent of exposure of local retail investors to structured financial products, and the fact that the credit risks inherent in LB structured products had indeed been assumed by the investors of such products. At that time, they did not have a reasonable grasp of the dire consequences for these retail investors should LB fail. The Subcommittee expresses disappointment that Mr John TSANG and Prof CHAN Ka-keung had not performed their respective functions to a level that was expected of them in overseeing the regulation of the securities business of banks by HKMA and SFC.

# RECOMMENDATIONS

8.23 Arising from its concluding observations, the Subcommittee has formulated the following recommendations with a view to improving the regulation of the securities business carried on by banks and the protection available to investors.

## The disclosure regime for the offer of investment products

Disclosure requirements specific to structured financial products

8.24 The Subcommittee notes that as a result of the transfer of the regulation of the offer of structured financial products from CO to SFO[3] in May 2011, SFC has been able to stipulate the disclosure requirements that are specific to structured financial products by issuing the Code on Unlisted Structured Investment Products (SIP Code)[4] under section 399 of SFO. A structured product cannot be offered unless the offer

[3] Please see paragraph 4.5 of Chapter 4 and Appendix 4(b).

[4] The SIP Code is part of the SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products published under section 399 of SFO in June 2010.

documentation of the product has complied with the disclosure requirements and has been authorized by SFC under SFO. The Subcommittee considers the new arrangements an improvement over the CO prospectus regime.

8.25 Given the innovation in financial products, **the Subcommittee recommends that SFC should review regularly, and where necessary, revise the disclosure requirements set out in the SIP Code having regard to market developments and its regulatory experience.**

Quality of disclosure

8.26 In the context of the guidance provided in the SIP Code, **the Subcommittee recommends that SFC should:**

**(a) consider making it mandatory for disclosure of information on structured financial products for sale to retail investors to be written in plain language; and**

**(b) evaluate at regular intervals the effectiveness of the Advertising Guidelines applicable to structured products, such as how best to present the risks and returns of a product in a balanced manner.**

8.27 The Subcommittee notes that as required under the SIP Code, every offering document must contain a Product Key Facts Statement (PKFS) which highlights the key features and risks of a product in a clear and concise manner.

8.28 The Subcommittee considers the PKFS a useful aid, but **recommends that SFC should proactively evaluate the effectiveness of the PKFS with a view to ensuring that the information is presented in a way that can be comprehended by lay investors.**

Need for review of the disclosure regime

8.29 One of the issues that has emerged from the LB incident and examined by the Subcommittee is whether the disclosure regime should be retained or replaced by another regime, such as a product approval regime which operates by way of certain products being prohibited from sale to investors, or subject to vetting before approval can be given for their sale. In the light of financial innovations and the diversity of investment products, such a regime may arguably safeguard investors against risky products. However, according to information available to the Subcommittee, this approach is not found in other jurisdictions commonly looked to by Hong Kong when considering international practices. A number of problems are envisaged under this regulatory approach, including the following:

(a) Financial innovation may be stifled resulting in less choice to investors. This may work to the detriment of fostering Hong Kong's status as an international financial centre.

(b) There are practical difficulties in determining the products that should be approved or disapproved, as a product not suitable for retail investors may suit certain investors who are conversant with financial products and willing to assume higher risks in order to achieve higher returns.

(c) A pre-approval regime will risk substituting the regulator's judgement for that of the investors. Moral hazard will arise as investors may become less wary of potential risks and decide to purchase an "approved" product in the mistaken belief that it must be sound and safe. This pre-approval will also reduce intermediaries' awareness of their obligations to conduct product due diligence and ensure suitability of the product for the particular customer.

8.30 **The Subcommittee recommends that the current disclosure regime should be beefed up with reference to the TCF initiative announced by FSA in UK requiring due consideration be given to treating customers fairly throughout the product cycle[5], and by requiring the product issuer to disclose the following matters:**

**(a) the target customers for whom the product is likely to be suitable; and**

**(b) how the product characteristics are suitable for that particular group of target customers.**

## Regulation of the conduct of RIs and their staff

8.31 Irrespective of whether and how the regulatory structure may be changed, the Subcommittee believes that the regulators should take measures to remedy the deficiencies in RIs' compliance with regulatory requirements.

Strengthening the supervision of RIs

8.32 To strengthen supervision of RIs, **the Subcommittee recommends that both on-site examinations and off-site surveillance of RIs should focus on the capability of the management controls and systems within the RIs to ensure that:**

**(a) sales staff are fit and proper, adequately trained and have sufficient understanding of the investment products being sold by them;**

**(b) the remuneration and incentives structure for sales staff gives sufficient recognition to due compliance, in addition to sales performance;**

[5] Please see paragraphs 7.29 to 7.31 of Chapter 7.

**(c) product due diligence is performed in full compliance with the requirements under the Code of Conduct and Suitability FAQ. Assessments of the products should demonstrate in what aspects such products are considered suitable or unsuitable for different risk categories of investors;**

**(d) prior to the transaction, all necessary steps are taken to fulfil an intermediary's obligations in respect of the KYC requirements and suitability assessment;**

**(e) there is adequate and effective means to monitor the sales process without placing undue reliance on documentation only; and**

**(f) processes are in place for handling customers' complaints expeditiously and fairly.**

8.33 The Subcommittee notes that one of the measures implemented by SFC and HKMA after the LB incident is the mystery shopper programme to test the sales processes of RIs periodically. The Subcommittee sees merits in this regulatory tool to obtain first-hand information on the way RIs sell investment products to their customers.

8.34 **The Subcommittee recommends that the regulators should:**

**(a) make use of tools such as mystery shoppers; and**

**(b) publish the general findings of these initiatives for reference by the industry and the public.**

Benchmarking the practices of RIs

8.35 The Subcommittee recognizes that it is a matter for individual RIs to devise their own practices and procedures to carry out regulated activities in compliance with regulatory requirements; and regulators should not seek to prescribe how RIs should manage their affairs.

However, the LB incident has revealed deficiencies in the practices adopted by certain RIs, as highlighted in paragraph 8.5 above.

8.36 To better assist RIs to fulfil their obligations which will in turn provide better protection to investors, **the Subcommittee recommends SFC and HKMA to consider the feasibility of setting benchmarks on the following key requirements to achieve consistency in standards and better protection for investors:**

**(a) product due diligence and the risk-rating of investment products (e.g. whether products sharing common features, such as non-principal-protected structured financial products, should receive a uniform risk-rating);**

**(b) training for sales staff (e.g. whether intermediaries should be required to provide training to staff in respect of each series of a product, and the basic requirements that should be adopted for testing the staff's knowledge after training);**

**(c) the risk profiling conducted on customers (e.g. whether it is necessary for certain assessment methodology to be adopted across the board in order to avoid anomalous results that are hard to justify);**

**(d) the basic information on an investment product that must be explained to the customer by the intermediaries before completion of transaction (e.g. the lock-up period for the investment, whether the product is principal-protected, the worst scenario arising from the investment etc.);**

**(e) handling of risk-mismatched transactions (e.g. whether it is necessary to set certain thresholds for permitting such transactions); and**

**(f) complaint-handling procedures (e.g. to make it a mandatory requirement that RIs should interview the complainants (where practicable), and specify their performance pledges in handling customer complaints).**

Review of the minimum qualifications for ReIs

8.37 In the light of the Subcommittee's observation in paragraph 8.5(d) above, **the Subcommittee recommends that the regulators should consider raising the minimum academic qualification of ReIs (e.g. a university degree and/or professional training in specified fields such as finance or accounting).**

Sales process

8.38 As highlighted in paragraph 8.5(i) above, there is potential confusion between banking services and investment services in the mind of a customer if the same staff who handles his bank accounts also sells him investment products. The Subcommittee agrees that RIs should be required to take steps to ensure clearer differentiation between traditional deposit-taking activities and retail securities business. It notes that after the LB incident, RIs have already been required by HKMA to put in place a number of measures such as segregation of premises, complete separation of information on a customer's deposit accounts and his investment accounts, etc.

8.39 **The Subcommittee recommends that HKMA should:**

**(a) review the effectiveness of the above improvement measures; and**

**(b) publish the findings of such reviews for reference by the industry and the public.**

8.40 Arising from its observation in paragraph 8.5(j) above, the Subcommittee considers that the line between the offering of investment information and of investment advice was far from clear. Besides, it was often the RIs' view that the sale of an investment product was a transaction on a one-off basis, and their duty towards the investors ceased upon completion of the transaction. However, the Subcommittee doubts whether such a stance is fair and in the interest of investors.

8.41 The Subcommittee recommends that the regulators should consider, whether by legislation or by amending the Code of Conduct, stipulating that:

**(a) when providing investment information to their customers, RIs would be deemed to be providing also incidental investment advice, unless RIs have proof to the contrary; and**

**(b) where the investor who has acquired an investment product remains a customer of the RI by holding valid account(s), the duty of the RI to the investor should continue throughout the product tenor.**

8.42 As analyzed in Chapter 5[6] , the evidence given by the RIs and the investors differs considerably on whether and how the relevant steps in the sales process of LB structured products had been properly completed. The Subcommittee is of the view that the investor, who is also a party to the transaction, should also be informed of the requisite steps leading to conclusion of the transaction.

8.43 **The Subcommittee recommends that the regulators should consider requiring RIs to take the following measures:**

**(a) to provide their ReIs with a checklist setting out the requisite steps to be taken for the transaction;**

[6] Please see paragraphs 5.59 to 5.60 and 5.80 of Chapter 5.

**(b) the ReI to inform the customer of these requisite steps;**

**(c) the ReI to seek the customer's acknowledgment upon completion of each of the specified steps; and**

**(d) to audio-record the above steps as part of the sales process.**

Through the above measures, the ReIs can assure themselves that the requisite steps had been duly completed while the customers will also be in a position to ascertain the completion or otherwise of the necessary steps applicable to the transaction in question. These measures will contribute to a structured sales process and facilitate RIs to make a reasonable estimate of the minimum time required to conduct a typical sale process properly.

## Complaint-handling and disputes resolution

Regulatory powers

8.44 The division of regulatory powers between HKMA and SFC has given rise to operational complexities which are not conducive to effective handling of complaints and enforcement.

8.45 **The Subcommittee therefore recommends that:**

**(a) investigatory and disciplinary powers against RIs and their staff should rest with a single regulator;**

**(b) as far as permissible under the relevant legislation, the regulator should introduce greater transparency through -**

**(i) publication of general information or statistics on the investigation and enforcement outcomes of complaint cases;**

**(ii) keeping the complainants informed of the progress of investigation of their complaints, including the actions taken/to be taken; and**

**(c) in case the regulator decides not to take further action on a complaint, it should provide a proper explanation of the reasons to the complainant.**

Exercise of the power under section 201 of SFO

8.46 The Subcommittee has noted that the majority of LB-related complaints had been resolved through various settlement agreements reached between SFC, MA and the distributing banks pursuant to section 201 of SFO. The purpose of this section is to give SFC an explicit power to enter into negotiated settlements with persons intended to be disciplined where the particular circumstances of a case render it appropriate to do so. Although it may be questioned whether SFC's entering into the various settlement agreements in relation to LB structured products is a use of its power envisaged when section 201 was first enacted, there can be no doubt that the power to enter into negotiated settlements is a necessary and legitimate part of the disciplinary powers of SFC. The Subcommittee sees no need to modify SFC's power under section 201 of SFO to enter into settlements with persons intended to be disciplined.

8.47 The Subcommittee is deeply concerned about some investors being designated as "experienced investors" and excluded from certain repurchase offers. **The Subcommittee therefore recommends that when exercising its power under section 201 of SFO, SFC should not agree to adopt any arbitrary and non-statutory threshold to exclude certain persons from the settlement offers.**

Power to compel payment of compensation

8.48 The Subcommittee sees merits in empowering the regulator(s) to order RIs to pay compensation. **The Subcommittee therefore recommends that the regulator responsible for enforcement should**

**also be vested with appropriate statutory powers to order the payment of compensation where the findings so justify.**

Need for a dispute resolution mechanism

8.49 The LB incident has demonstrated the need to put in place an independent and affordable avenue for resolving financial disputes between individual investors and the financial institutions. The Subcommittee notes the establishment of the FDRC for resolving monetary disputes between financial institutions and individual customers by way of mediation or arbitration.

8.50 In this connection, **the Subcommittee recommends that HKMA should review the effectiveness of the LB-related Products Disputes Mediation and Arbitration Scheme in resolving disputes so that the lessons learned can shed light on the future operation of FDRC.**

## Investor protection

8.51 As described in paragraphs 7.3 and 7.4 of Chapter 7, investor protection is one of the regulatory objectives and functions of SFC specified in SFO. However, investor protection is not explicitly stated in BO as one of the functions of MA, although Mr Joseph YAM, then MA, has stated that investor protection is also a function of MA that can be construed from the relevant provisions of BO. To ensure better protection for investors, many of whom may obtain investment services from banks, the Subcommittee considers it necessary to impose on MA a statutory duty of investor protection. **The Subcommittee therefore recommends that investor protection should be added as one of MA's functions under BO**.

8.52 As discussed in paragraphs 8.29 and 8.30 above, the Subcommittee does not consider that Hong Kong should put in place an investor protection regime based on pre-approval of certain products for sale. Instead, it recommends beefing up of the disclosure-based regime

(complemented by regulation of intermediaries' conduct at the point of sale).

8.53 Notwithstanding the above, it is clear to the Subcommittee that there are individuals who may not be capable of protecting themselves against malpractices such as mis-selling of investment products[7]. The regulators should not overlook the need of these vulnerable individuals for higher protection. Financial innovations have also brought to the market new products whose structures and risks are increasingly difficult to comprehend. The Subcommittee therefore sees a need for measures to be introduced to require that certain products can only be sold to specified categories of investors.

8.54 **The Subcommittee recommends the Administration and the two regulators to:**

**(a) make reference to overseas practices such as the guidance issued by NASD on the type of investors who could acquire structured financial products[8]; and**

**(b) consider setting some tangible and objective criteria for determining the category of persons that are suitable for acquiring specified products (such as structured financial products), with the result that the products can only be sold to the designated category of investors.**

8.55 The FSA in UK has implemented the TCF initiative to stipulate the respective roles of the product providers and distributors in the fair treatment of their customers throughout the product cycle.

8.56 **The Subcommittee recommends that the Administration and regulators should consider whether and how the UK experience could be applied locally to enhance investor protection.**

[7] Please see paragraph 7.28 of Chapter 7.
[8] Please see paragraph 7.34 of Chapter 7.

## Investor education

8.57 The Subcommittee has noted that there is no lack of investor education initiatives undertaken by the regulators. However, the LB incident has raised questions of whether the messages had effectively reached the investing public. In anticipation of the establishment of the IEC[9], the Subcommittee considers it important for IEC to reach out proactively to different sectors of the community, in particular vulnerable individuals.

8.58 **The Subcommittee recommends that:**

**(a) while the Internet and printed media can continue to be used, greater use should be made of radio and TV as they are the main channels through which less educated and elderly persons obtain information, and that sufficient financial provision for such purposes should be earmarked;**

**(b) SFC should include updates on its regulation of unlisted structured financial products in its Quarterly Reports;**

**(c) banks should be required to make available to their customers the flyers or leaflets published by SFC to apprise prospective investors of "dos" and "don'ts", and that sufficient copies of these materials should be placed in the zones designated for investment services;**

**(d) investor protection and personal financial education should form part of the school curriculum; and**

**(e) in addition to the dissemination of information, any investor education initiatives must unequivocally convey the message that investors should exercise**

[9] Please see paragraph 7.9 of Chapter 7.

**vigilance and due diligence in order to protect themselves, and that they should not invest in products that they do not know or understand.**

## The way forward

8.59 As observed in Chapters 3 and 4 and paragraphs 8.2 and 8.4 above, the Subcommittee has found the present regulatory structure under which the securities business of banks being regulated by both HKMA and SFC largely ineffective.

8.60 **The Subcommittee recommends the Administration and the regulators to examine the feasibility of placing the securities business conducted by banks under the regulation of SFC, which is the regulator for the securities and futures industry; and if this proposed arrangement is adopted, to introduce the necessary legislative amendments.** This will better ensure that the regulated activities conducted by banks and by securities brokers will be subject to consistent regulation.

8.61 The Subcommittee recognizes the importance of safeguarding the independence of SFC and HKMA in performing their respective functions. However, it considers it incumbent upon the Administration to play a proactive role to ensure that its policy objectives are met, and to provide the necessary policy steer.

8.62 **The Subcommittee therefore recommends that the Administration should:**

**(a) keep the regulatory regime (including issues such as the need to align the secrecy provision in BO with that in SFO) under regular reviews, identify and address issues of concern and shortcomings;**

**(b) strengthen the existing forums (such as CFR and FSC) and explore new platforms to facilitate the effective exchange of views among the regulators and between them and the Administration; and**

**(c) enhance the transparency of CFR and FSC by publishing or reporting to the Panel on Financial Affairs the main deliberations and decisions reached at their meetings.**

8.63 As there are still unresolved LB-related complaints, **the Subcommittee recommends that HKMA should:**

**(a) continue to investigate and take appropriate action on these unresolved complaints;**

**(b) re-open unsubstantiated cases if more information is available; and**

**(c) provide full explanation to the complainant if it decides not to proceed further with the complaint in question.**

8.64 **The Subcommittee recommends that the Panel on Financial Affairs should follow up the above recommendations in due course.**