

Responses to follow-up issues arising from the hearing on 14 April 2009

(a) The number of staff planned to be recruited, and the number of staff actually recruited up-to-date, by the Hong Kong Monetary Authority (HKMA) to assist in conducting investigations into complaints about the sale of Lehman Brothers(LB)-related Minibonds and structured financial products.

1.1 On 23 April 2009, 203 staff (comprising 41 Hong Kong Monetary Authority (HKMA) permanent staff, 67 specially recruited contract investigators, 60 temporary personnel seconded from audit firms and 35 temporary staff performing support functions) are working on banking-related complaints, including those related to Lehman Brothers (LB). A further 40 contract staff are expected to report for duty in the coming six weeks or so. The HKMA is currently reviewing the staffing levels with the aim of ensuring that sufficient resources are available to meet the target of concluding our work on at least 70% of the Lehman Brothers-related complaints by March 2010. This review is expected to result in some further increase in staff resources.

(b) The means (e.g. by telephone or questionnaire) by which HKMA's survey was conducted from December 2007 to early 2008 on the sale by Registered Institutions (RIs) of retail credit-linked notes with subprime mortgages as underlying collaterals or with collaterals comprising collateralized debt obligations (CDOs), and where available, sample of the questionnaires used in the survey.

2.1 The survey covered 16 RIs and was conducted by means of a questionnaire provided to the RIs through electronic mails, except for one RI whose response was obtained in writing through an HKMA on-site examination team. A sample of the questionnaire used in the survey is attached at Annex 1.

(c) *HKMA's written advice or notes/records of verbal advice issued in early 2008 to RIs or any of them requesting them or it to adopt a high risk rating classification for retail credit-linked notes with subprime mortgages as underlying collaterals or with collaterals comprising CDOs.*

3.1 The HKMA received the RIs' replies to the survey during the period from December 2007 to January 2008. In the light of the market conditions prevailing at that time and to enhance uniform and prudent treatment among RIs, the HKMA advised those eight RIs which adopted a "medium" or "low" risk rating for retail credit-linked notes (CLNs) to adopt a "high" risk rating classification for retail credit-linked products without full principal protection. Such advice was given through electronic mails or telephone calls and the relevant eight RIs have provided written response on the actions they have taken as a result of the HKMA's advice. According to the HKMA's records, all except one RI (which had already decided not to sell such products by then) had revised the product risk rating to "high" by February 2008 in response to the HKMA's advice.

3.2 In all of the above cases, the following message was conveyed by the HKMA:

"Based on the information provided, we note that your bank has assigned a level [] risk category for CLN products, depending on the credit rating of the underlying Reference Entities and the Charged Asset. We note that the risk categories of credit-linked product appear to be [low] / [medium] risk rating. As discussed with you, our prudential concerns are that classifying credit-linked products without full principal protection as low / medium risk may not be appropriate in view of the complexity of the products, the current market condition and the general practice adopted by other AIs.

With this background, we would like to recommend that banks are expected to classify credit-linked products as high risk products and recommend / introduce such products only to clients with high risk tolerance. Those credit-linked products with protection of the entire principal may nevertheless be assigned with a lower risk tolerance.

We should be grateful if your bank would revisit the classification of credit-linked products and the type of target customers suitable for such products. Please advise us of your review results by [Date], if at all possible."

- (d) *As stated by the Monetary Authority at the hearing on 14 April 2009, HKMA handled a total of 178 cases of suspected mis-selling of investment products by RIs from April 2003 to 14 September 2008. Please advise:*
- (i) *the disciplinary action or sanctions, if any, taken by HKMA against the non-complying RIs involved in each of the nine substantiated cases;*
 - (ii) *whether any of the 19 RIs which sold LB-related Minibonds and structured financial products were involved in any of the 178 cases; if yes, how each of those individual RIs had handled complaints about the mis-selling of investment products*
 - (iii) *whether HKMA's on-site examinations and off-site reviews from April 2003 to 14 September 2008 discovered any mis-selling of investment products by any of the 19 RIs which sold LB-related Minibonds or structured financial products; and if yes, what measures had been recommended by HKMA in each case to individual RI to rectify the irregularities detected, how the measures were implemented by the RI concerned, and what follow-up actions were taken by HKMA to ensure the implementation of these measures.*

General information

- 4.1 Among the suspected mis-selling cases involving 178 customers that were referred to the HKMA's securities enforcement team from April 2003 to 14 September 2008, cases involving 72 customers were identified in the HKMA's day-to-day regulatory process and the remaining cases involving 106 customers were originated from customer complaints received by the HKMA. Among the 72 customers, 42 of them are related to 3 of the 19 RIs which sold LB-related Minibonds and structured financial products and were the subject of customer complaints since the collapse of LB.

Specific replies

Item (i)

- 4.2 The cases involving 9 customers have been investigated by the HKMA's securities enforcement team and referred to the Securities and Futures Commission (SFC) for appropriate actions. So far, disciplinary actions have been taken by the SFC against a former relevant individual of a RI found guilty of mis-selling investment products to 6 of these customers. The former relevant individual involved was banned from re-entering the industry for 32 months from 26 November 2008 to 25 July 2011 and fined \$260,000. In respect of the remaining 3 customers, the HKMA has completed the relevant investigation concerning 3 relevant individuals (ReIs), a former ReI and an executive officer of a RI and referred the 3 customers' cases to the SFC for its decision on possible disciplinary action.

Item (ii)

- 4.3 Out of the 19 RIs which sold LB-related Minibonds and structured financial products and were the subject of customer complaints since the collapse of LB, 15 of them were involved (together with some other RIs) in the 178 cases of suspected mis-selling of investment products identified during the period from April 2003 to 14 September 2008.
- 4.4 As mentioned under the "General information" section above, these suspected mis-selling cases were either identified in the HKMA's day-to-day regulatory process or originated from customer complaints received by the HKMA. All these cases were handled directly by the HKMA's securities enforcement team and were not referred to the banks concerned.
- 4.5 The HKMA's procedures for handling of suspected mis-selling complaints

(other than LB-related complaints after 14 September 2008) and referral of possible mis-selling cases identified in the HKMA's day-to-day regulatory process are summarised below:

- (1) when a securities-related customer complaint is made to, or an incident is identified by, the HKMA that involves possible misconduct, the matter will be referred to the HKMA's securities enforcement team. The team will assess the information available and submit the matter to the internal Event Review Committee to decide whether a case should be opened and the scope of any investigation; and
- (2) if sufficient evidence is collected during the investigation, the HKMA's securities enforcement team will exchange views with the SFC and then submit the case to the internal Disciplinary Committee to consider whether, and if so what, disciplinary sanctions should be imposed. If the Monetary Authority (MA), on the advice of the Disciplinary Committee, considers that disciplinary sanctions should be imposed, he will consult or make a recommendation to the SFC as appropriate.

Item (iii)

- 4.6 During the period from April 2003 to 14 September 2008, the HKMA identified through on-site examinations 42 suspected mis-selling cases involving 3 of the 15 RIs mentioned in item (ii) above and a breakdown of such cases is given in Table 1 below.

Table 1

Year	2003 (Since 1 Apr)	2004	2005	2006	2007	1 Jan 2008 to 14 Sep 2008	Sub-total	15 Sep 2008 up to the date of preparing this paper	Total
Number of customers affected	0	0	0	2	3	37	42	47*	89

* These 47 customers are in addition to the 42 customers mentioned in the “General Information” section and were referred to the HKMA’s securities enforcement team after 14 September 2008 based on the thematic examinations performed by the HKMA before that date.

4.7 Section 120 of the Banking Ordinance (Cap.155) (BO) imposes restrictions on the MA’s ability to disclose supervisory information of the type requested that was obtained in the course of the exercise of the MA’s functions under the BO. Nevertheless, section 120(5)(a) of the BO provides one of the gateways through which the MA may disclose such information provided that it is disclosed in the form of a summary so as to prevent particulars relating to the business of any particular authorized institution being ascertained from it. To assist the Subcommittee in its inquiry, we have therefore summarized in the following paragraphs information on the measures that were recommended by the HKMA to RIs to rectify material internal control issues identified, the implementation of these measures by the RIs and the HKMA’s follow-up actions to ensure the implementation of these measures.

4.8 It should be noted that the HKMA’s recommendations made to different RIs varied according to the nature and severity of the internal control issues and of the possible mis-selling cases identified. Out of the 89 customers referred to in Table 1 above, the cases involving 67 customers were related to RIs in respect of which the HKMA’s on-site examinations identified internal control issues. With regard to the remaining cases

which involved 22 customers, based on the information collected from the on-site examinations, these cases reflected possible improper practices of individual staff, rather than control issues of the relevant RIs.

4.9 With respect to the internal control issues identified, the HKMA's major recommended measures included:

- (1) suspension of the sale of the related investment products by the relevant business units (in respect of cases involving 67 customers);
- (2) conduct of an independent review of the relevant business activities by the RIs' internal audit department or an external audit firm (in respect of cases involving 67 customers). The scope of the independent review covers the effectiveness of relevant internal controls in the sale of investment products and, where there was prima facie evidence of mis-selling by individual staff, the examinations of previous transactions handled by the staff and/or the branch involved;
- (3) where the RI considered any relevant individual to be not fit and proper as a result of independent review, notification to the HKMA in writing to remove the particulars of the relevant individual from the HKMA register (in respect of cases involving 21 customers); and
- (4) setting up an action plan to rectify the internal control issues identified from the on-site examinations (in respect of cases involving 67 customers).

4.10 Regarding the implementation of these measures by the RIs concerned, as required by the HKMA in respect of all cases, the RIs provided written implementation plans, which have to be agreed by the HKMA, with details on the implementation timeframe and the specific actions to be taken to

rectify the identified issues.

- 4.11 As regards follow-up actions, the relevant case officers of the HKMA's Banking Supervision Department are responsible for monitoring the implementation of the recommended measures by the RIs in accordance with the agreed implementation plans. Upon completion of the implementation of these measures, the HKMA will review the effectiveness of the implemented measures during the next round of on-site examination on the institution concerned.

(e) *The findings of each HKMA's on-site examinations and off-site reviews from April 2003 to 14 September 2008 about RIs' sale practices in relation to investment products.*

5.1 *The response to item (e) will be provided to the Subcommittee later as this item requires extensive research of information relating to a large number of on-site examinations and off-site reviews conducted by the HKMA between 2003 and 2008.*

(f) Apart from the circulars referred to by members about RIs' sale practices in relation to investment products (i.e. SC(1)-M3 and SC(1)-MI2), other reports or documents, if any, issued by HKMA on the subject from April 2003 to 14 September 2008.

6.1 The list of circulars issued by the HKMA in relation to sale practices of RIs on investment products from April 2003 to 14 September 2008 is attached (see Annex 2(A)). The list of related circulars issued by the HKMA before April 2003 is also attached for the Subcommittee's reference (see Annex 2(B)). All the documents have been submitted to the Subcommittee before the hearing of 14 April 2009.

Information about selling of retail CLNs with exposures to CDOs in 2006 and 2007

Please provide replies to the following questions regarding the selling of these products in 2006 and 2007. If there have been changes to risk category and / or practices re selling to vulnerable customers during this period, please specify the answers before and after such changes.

	(Q1) Total value of subscription for these products handled in 2006 and 2007 (in USD)	(Q2) Risk Category assigned by the AI to these products	(Q3) These products sold to vulnerable customers? (Y / N)	(Q4) If Y to Q3, what additional safeguards for selling these products to vulnerable customers?	(Q5) No. of complaints about selling of these products received in 2006 and 2007	
					(Q5a) Re selling to vulnerable customers	(Q5b) Re selling to other customers
Name of AI						

Annex 2(A): Circulars issued by the HKMA in relation to sale practices of RIs on investment products from April 2003 to 14 September 2008

Circulars	Reference / Remarks
"New publications of the Securities and Futures Commission (SFC) and the HKMA" dated 21 August 2003	Annex 11 to W6(C) (Written Statement of Mr Joseph Yam, Monetary Authority)
"SFC Guidelines for Addressing Analyst Conflicts of Interest" dated 8 November 2004	Annex 12 to W6(C)
"Register of relevant individuals under section 20(1)(ea) of the Banking Ordinance (BO)" dated 21 February 2005	Annex 13 to W6(C)
"The Securities and Futures Commission's Report (the Report) on Selling Practices of Licensed Investment Advisers" dated 1 March 2005	M2
"SFC press release - Extracts and Advertisements Concerning Prospectuses under the Companies Ordinance" dated 31 March 2005	Annex 14 to W6(C)
"Retail Wealth Management (RWM) Business" dated 3 March 2006	M3
"Controls to ensure the fitness and propriety of staff of authorized institutions" dated 28 September 2006	Annex 15 to W6(C)
"Thematic Examinations on Investment Advisory Activities" dated 1 March 2007	M12
"Questions and Answers on Suitability Obligations Published by the Securities and Futures Commission (SFC)" dated 7 May 2007	M4
"The Securities and Futures Commission's Report on Findings of Second Round of Thematic Inspection of Licensed Investment Advisers (the Report)" dated 1 June 2007	M13
"Controls to ensure compliance with section 114(3) of the Securities and Futures Ordinance (SFO) and section 20(4) of the Banking Ordinance (BO)" dated 13 June 2007	Annex 16 to W6(C)

Circulars	Reference / Remarks
2007	
"Thematic examinations on controls to ensure fitness and propriety of relevant individuals" dated 12 March 2008	Annex 17 to W6(C)

Annex 2(B): Circulars issued by the HKMA in relation to sale practices of RIs on investment products from January to March 2003

Circulars	Reference / Remarks
"Calls in Relation to Securities or Futures Products and Services" dated 13 January 2003	<i>M11</i>
"New securities supervisory regime – register to be maintained by the HKMA and specific guidance in relation to relevant individuals" dated 27 February 2003	Annex 10 to <i>W6(C)</i>
Supervisory Policy Manual module SB-1 issued on 28 March 2003	<i>M1</i>