

Responses to Follow-up Issues Arising from the Hearing on 5 June 2009

1. *With reference to paragraph 6.11 of the Report of the Hong Kong Monetary Authority on Issues Concerning the Distribution of Structured Products Connected to Lehman Group Companies as submitted to the Financial Secretary on 31 December 2008 (M16), please provide the latest number of cases which have been referred to the Securities and Futures Commission in relation to the sale of Lehman Brothers (LB)-related structured financial products by Registered Institutions (RIs) to vulnerable customers who have some form of visual impairment or mental disability.*

- 1.1 As of 4 June 2009, a total of 474 Lehman Brothers (LB)-related cases have been referred by the Hong Kong Monetary Authority (HKMA) to the Securities and Futures Commission (SFC) for further action. Among the referred cases, the number of cases involving vulnerable customers who have some form of visual impairment or mental disability is 6 and 2 respectively.

2. *With reference to paragraphs 2.2 and 2.3 of DCE/HKMA's responses dated 4 June 2009 to the follow-up issues arising from the hearing on 2 June 2009 (M26), please provide concrete information to substantiate the claim that since the issuance of the circular by HKMA on selling of investment products to retail investors (M6) on 23 October 2008, the RIs distributing such products have deployed sufficient resources to put in place adequate procedures to ensure that their customers are made aware of all relevant information (including risks) issued or made available by issuers of such products in a timely manner.*

2.1 During the hearing on 5 June 2009, there were comments that my response dated 4 June 2009 to item 2 of the Subcommittee's information requests regarding follow-up to the hearing on 2 June 2009 (M26) did not include all the information requested by the Subcommittee including the related resources deployed by registered institutions (RIs) to handle the continued disclosure of product information to their customers, and that the response was made simply based on RIs' verbal confirmation without bothering to find out the details of measures implemented by RIs or to request any supporting evidence from RIs for verification. Since these allegations are serious, I would like to take this opportunity to clarify any misunderstanding arising from the above response to the Subcommittee.

2.2 Firstly, it should be noted that in item 2 of M26, the Subcommittee requested the HKMA to provide information on any follow-up or additional measures requiring RIs and issuers of investment products to enhance disclosure of product information (including risks) to investors purchasing such products since the issuance of the circular on selling of investment products to retail investors (M6) on 23 October 2008. The question did not request for information on resources deployed by RIs to implement the related measures and therefore such information was not provided in the response to the Subcommittee.

- 2.3 Secondly, after the issuance of the two circulars¹ mentioned in item 2 of M26, the HKMA had followed up with the RIs concerned on whether they had implemented the required process to ensure that their customers were kept informed of all relevant information issued or made available by the issuers of the related products in a timely manner. The HKMA specifically requested the relevant RIs to confirm whether they had informed their customers of the information issued by the issuers on all outstanding series of Constellation notes and the LB-related Octave notes between February and April 2009. All relevant RIs confirmed in writing that they had provided the indicative bids on outstanding Constellation notes to investors in the monthly statements and would, upon request, provide the latest indicative bids to investors between statement days. The relevant RIs also indicated that they had passed the relevant information (including frequently asked questions and other special notices from the issuers where applicable) to their customers through letters or other channels (including telephone or SMS messages) in a timely manner (on average, less than 4 business days from the issue dates of the relevant notices). The HKMA had also obtained supporting evidence (such as samples of correspondence to customers) from selected RIs for verification.
- 2.4 Whether sufficient resources have been deployed by RIs to put in place the required process for the continued disclosure of product information to their customers can be assessed based on the effectiveness and outcome of the process implemented. As mentioned in paragraph 2.3, the results of our follow-up with the RIs concerned indicated that the relevant information issued by the issuers was communicated to the customers concerned by the RIs in a timely manner (on average, less than 4 business days from the issue dates of the relevant notices). Based on the results of the implemented process, the HKMA is satisfied that sufficient resources have been deployed by the RIs concerned to put in place the required process.

¹ Circulars on “Selling of investment products to retail customers” (SC. Ref. No. M6) and “Despatch of information to investors of retail investment product” (Annex 19 to SC Ref. W6(C)) issued on 23 October 2008 and 10 December 2008 respectively

3. *The relevant written records (including emails, memos and other internal correspondence) of the Monetary Authority's instructions, if any, received by DCE/HKMA since August 2008 on matters relating to the regulation of RIs' sale of derivatives (including structured financial products) to investors.*

3.1 The response to item 3 will be provided to the Subcommittee later as additional time is required to retrieve and compile the information requested.

4. Please provide, where applicable:

- (a) the commission rate(s) offered by the issuer(s) of LB-related structured financial products (including credit-linked notes and equity-linked notes) to RIs for the sale of each series of such products;
- (b) a comparison of the commission rate(s) mentioned in (a) and the commission rate(s) in respect of RIs' sale of other similar structured financial products before the collapse of LB; and
- (c) the practices adopted by RIs in providing commission/incentives to their staff involved in the sale of LB-related structured financial products;
- (d) the rate(s) of commission or monetary reward offered by RIs to their staff for the sale of each series of LB-related structured financial products.

Items (a) and (b)

4.1 According to the records gathered by the HKMA from individual RIs during day-to-day regulation of their regulated activities², the commission rates offered by issuers to the RIs concerned in relation to sale of LB-related and non-LB related structured financial products (including credit-linked notes and equity-linked notes) before the collapse of LB are set out in Table 1 below.

Table 1

Commission rates offered by issuers to the RIs concerned														
	LB-related credit-linked notes						Non-LB credit-linked notes	LB-related equity-linked products		Non-LB equity-linked products				
	Minibonds*		Constellation Notes		Octave Notes			SPARC Notes		Pyxis Notes				
	Min	Max	Min	Max	Min	Max	Min	Max	Min	Max	Min	Max		
Overall range	2.00%	3.25%	1.60%	3.00%	2.25%	3.25%	2.65%	3.25%	1.60%	3.25%	1.80%	3.75%	1.25%	4.50%

* For LB-related Minibonds, the commission rates offered by issuers to the RIs

² The records obtained from RIs by the HKMA during day-to-day regulation covered most (although not all) of the series of LB-related structured financial products.

concerned range from 2% to 2.50% and 2% to 3.25% for products with tenor between 3 to 5 years, and over 5 years respectively.

4.2 As indicated in Table 1, the commission rates of selling LB-related credit-linked notes range from 1.60% to 3.25%, which are of about the same range of commission rates for selling non-LB related credit-linked notes. In addition, the range of the commission rates for selling LB-related equity-linked products (i.e. 1.80% to 3.75%) is contained within the range of the commission rates for selling non-LB related equity-linked products (i.e. 1.25% to 4.50%). There was no abnormality noticed in the commission rates offered by issuers to the RIs concerned in relation to sale of LB-related structured financial products before the collapse of LB.

Items (c) and (d)

4.3 The response to items (c) and (d) will be provided to the Subcommittee later as additional time is required to organise and compile the information requested.

5. *Whether HKMA has had any liaison with the Hong Kong Police before and after the collapse of LB in relation to the investigation into cases of suspected mis-selling of investment products by individual RIs. If yes, please provide the details.*

5.1 The HKMA has maintained regular and ongoing liaison with the Hong Kong Police Force (“Hong Kong Police”), through regular meetings, telephone conversations and email communication, in relation to preventive measures of bank-related frauds and investigation into cases of suspected criminal activities committed by banks, their staff and/or third parties that have implications to banks and their customers before and after the collapse of LB. Section 120(5)(d) of the Banking Ordinance (BO) contains a specific gateway that enables the disclosure of information to the Hong Kong Police at the request of the Secretary for Justice relevant to the proper investigation of any criminal complaint. Such referrals to the Hong Kong Police have in the past led to successful prosecution for breaches of the provisions of the BO.

5.2 For cases of suspected mis-selling of investment products by individual RIs and/or their relevant individuals, the HKMA will only consider the need to refer the cases to the Hong Kong Police for action if any criminal element has been identified during the investigation into these cases by the HKMA’s Securities Enforcement Team. Before the collapse of LB, the HKMA did not identify any cases of suspected mis-selling of investment products involving possible criminal or illegal activities committed by RIs and/or their staff and no cases had therefore been referred to the Hong Kong Police for their investigation.

5.3 Shortly after the collapse of LB, the HKMA met with the Hong Kong Police on 24 September 2008 to establish contacts for sharing the number of complaints received by each side and referral of complaints received by the Hong Kong Police to the HKMA where appropriate. Up to 5 June 2009, about 1,100 LB-related complaints received by the Hong Kong Police (in which no criminal

element was identified by the Hong Kong Police) were referred to the HKMA for appropriate action. Upon the Hong Kong Police's request, the HKMA also provided a set of regulatory requirements on the sale of investment products issued by the HKMA and the SFC on 16 April 2009 to the Hong Kong Police to assist its investigation into their cases.

6. *The attached written questions raised by Mr LEUNG Kwok-hung at the meeting on 5 June 2009.*

梁國雄議員在2009年6月5日研訊中向金融管理局副總裁提交的書面問題

下列問題請用書面回答

18. *Selection Criteria* 中的「易受損客戶的比重」是用什麼公式計算出來?
19. 在執行對 RIs 的現場審查中，金管局對選擇產品的 *selection criteria* 除了受歡迎程度(銷售額),投訴數字、售與容易受損客戶的比重、及佣金外，還有什麼? 請全部列出，勿遺漏。
20. 香港的零售銀行有沒有出售自己發行的 CDS 合約? 總數量大不大?
21. 你指「信貸掛勾票據」(CLN)佔零售銀行的「零售結構產品」很小比重，約1%，請給我這 CLN 及「零售結構產品」兩者的客戶數字每年分別的總數，以 04, 05, 06, 07, 08 按年計算?
22. 另請給我這 5 年，從零售銀行購買，含有 CDS 的零售金融產品的客戶的每年總人數。另請給相關「零售結構產品」的客戶每年總人數。

Item 18

6.1 The HKMA adopts a risk-based approach in selecting a sample of transactions to be reviewed during a securities-related on-site examination rather than applying any rigid formula for sample selection. One of the key factors to

determine the sample size is whether a particular product is popular among vulnerable customers. The popularity of a product is decided by the number of transactions entered into with vulnerable customers by RIs (instead of the transaction amounts involved) when comparing with other products. Based on such criteria, the HKMA's on-site examination teams will select a larger sample of transactions of a particular product for compliance testing if such a product is more popular among vulnerable customers compared with other products.

Item 19

6.2 As mentioned in paragraph 6.1, when selecting a sample of securities-related transactions conducted by the examined RIs for review during on-site examinations, the HKMA adopts a risk-based approach in determining what investment products are to be selected. The sampling criteria include the popularity of the investment product (i.e. in terms of the large number of transactions entered into rather than total sales amounts), the number of customer complaints about possible mis-selling of the product, the sales commission attached to the product and the number of transactions with vulnerable customers. When determining what transactions to be chosen for review within the selected investment products, transactions of risk mismatch between the product risk rating and the client risk acceptance level, among others, are included. It should be noted that the examination team may also exercise discretion and its professional judgment to take into account other criterion/criteria in the sample selection process if the team considers that this is necessary to address any potential supervisory concern. For instance, if control or supervisory deficiencies are found in a particular sales team of a RI, a larger sample of transactions conducted by such a team will be selected for review despite the above selection criteria.

Item 20

- 6.3 Please refer to my response dated 29 May 2009 to item 5 of question 6 of the Subcommittee's information requests regarding follow-up to the hearing on 26 May 2009 (SC Ref. No. M23).

Item 21

- 6.4 Please refer to my response dated 29 May 2009 to item 6 of question 6 of the Subcommittee's information requests regarding follow-up to the hearing on 26 May 2009 (SC Ref. No. M23).

Item 22

- 6.5 Please refer to my response dated 29 May 2009 to item 7 of question 6 of the Subcommittee's information requests regarding follow-up to the hearing on 26 May 2009 (SC Ref. No. M23).