~~A-03(03)-SFC(01)-E(O)~~

SFC's answers to certain questions raised by the Subcommittee to study issues arising from Lehman Brothers-related Minibonds and structured financial products in a letter dated 22 December 2008

1. In his 2002-2003 Budget Speech, the Financial Secretary (FS) stated, among other things, that the Government would work with HKMA, SFC, the Hong Kong Exchanges and Clearing Limited and the financial services sector to attract more financial product issuers to Hong Kong, Please give an account of the initiatives taken and the new financial products offered to investors following such initiatives.

The initiatives undertaken by the SFC to attract more financial product issuers to Hong Kong since 2003 include:

(a) The introduction of three sets of guidelines facilitating offers of shares and debentures –

(i) "*Guidelines on use of offer awareness and summary disclosure materials in offerings of shares and debentures under the Companies Ordinance*"[A-01(01)-SFC(14)-E(O) and A-01(01)-SFC(15)-C(O)]: these guidelines relate to the content and manner of publication of certain publicity and disclosure materials that may be issued to the public in Hong Kong;

S1-Appendix 1

(ii) "*Guidelines on using a "dual prospectus" structure to conduct programme offers of shares or debentures requiring a prospectus under the Companies Ordinance (Cap. 32)*" [A-01(01)-SFC(02)-E(O) and A-01(01)-SFC(03)-C(O)]: these guidelines outline the SFC's regulatory approach with respect to offers of shares or debentures on a repeat or programme basis using separately registered programme and issue prospectuses;

S1-Appendix 2

(iii) "*Guidelines on applying for a relaxation from procedural formalities to be fulfilled upon registration of a prospectus under the Companies Ordinance (Cap. 32)*" [A-01(01)-SFC(04)-E(O) and A-01(01)-SFC(05)-C(O)]: these guidelines set out relaxations which will apply if the issuer or its adviser satisfies the SFC that administrative difficulties will otherwise unjustifiably result. In such cases, faxed copies of experts' consent letters and a bulk print proof (being the version approved by the issuer for bulk printing) of the prospectus may be accepted for registration under the CO.

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(b) The gazettal of the Companies Ordinance (Exemption of Companies and Prospectuses from Compliance with Provisions)(Amendment) Notice 2003 [A-01(01)-SFC(34)-E & C(O)] to exempt the issuer of debentures from providing information that is irrelevant to investors and/or that will impose an undue burden on the issuer in the prospectus.

S1-Appendix 4

(c) The introduction of the Companies (Amendment) Bill 2003 which, among other things, entrenched the regulatory approach set out in the Guidelines regarding offer awareness materials and the use of a "dual prospectus" structure for programme offerings. In addition, the Bill also

expressly excluded from the definition of "prospectus" documents containing or relating to offers and invitations that fall within specified descriptions in the 17th Schedule to the Companies Ordinance – "the safe harbours". After a period of public consultation and scrutiny by the Bills Committee, the Companies (Amendment) Bill 2003 was enacted on 22 July 2004 and came into effect on 3 December 2004.

The range of financial products offered to the public after 2002 includes credit-linked notes, equity-linked notes, commodity-linked notes, index-linked notes and fund-linked notes.

2. *When were the Lehman Brothers-related Minibonds and structured financial products first sold in Hong Kong?*

Please refer to the table below for details.

	Type of Product[1]	**Issuer**	**Arranger**	**Affected Series Number**	**Period offered in Hong Kong**
Lehman Arranged	Minibonds: Credit-Linked Notes	Pacific International Finance Limited	Lehman Brothers Asia Holdings Limited for Series 1 and Lehman Brothers Asia Limited for series 2 to 36	1-36 (32 series in total[2])	April 2002 to May 2008
	Pyxis Equity-Linked Notes: Equity-Linked Notes	Pyxis Finance Limited	Lehman Brothers Asia Limited	1-21	May 2003 to May 2007
	ProFund Notes: Fund-Linked Notes	Atlantic International Finance Limited	Lehman Brothers Asia Limited	1-2	July 2006 to March 2007
Lehman Linked	Constellation Structured Retail Notes: Credit-Linked Notes (with LB as reference entity)	Constellation Investment Limited	DBS Bank Ltd	34-37, 43-46, 55-74 and 78-81	February 2006 to July 2007[3]

[1] This table does not cover listed structured products such as derivative warrants issued by Lehman Brothers Holdings Inc..
[2] Series 4 was not issued because of the breakout of severe acute respiratory syndrome (SARS) in Hong Kong in 2003 whilst series 13, 14 and 24 were not offered because these series number were believed by many local investors to be unlucky and inauspicious.
[3] Series 1 was offered in Hong Kong in September 2003.

	Type of Product[1]	Issuer	Arranger	Affected Series Number	Period offered in Hong Kong
	Octave Notes: Credit-Linked Notes (with LB as reference entity)	Victoria Peak International Finance Limited	Morgan Stanley & Co. International Limited	Series 10-12	August 2006 to October 2006[4]
	Retail Aimed Callable Investment Notes: Credit-Linked Notes (with LB as reference entity)	SPARC Limited	UBS Securities Asia Limited	Global Series 1a, 1b, 2a and 2b	April to May 2007

What procedures did the issuer need to go through before such products could be offered for sale to investors? If such procedures differed among product types, please describe them. What were the changes, if any, in the way these products had been offered and sold?

If a financial product falls within the wide definition[5] of "debenture" in section 2 of the Companies Ordinance ("CO"), the offer document (called a prospectus) must be authorised and registered before the product can be offered to the public in Hong Kong for subscription or purchase. The issuer (whether it is incorporated inside or outside Hong Kong) has to prepare a prospectus which complies with the applicable requirements of the CO. Essentially this means that the prospectus must contain details of all of the matters specified in the Third Schedule to the CO, including the requirement (at paragraph 3 of Part I of the Third Schedule) that the prospectus must contain "*Sufficient particulars and information to enable a reasonable person to form as a result thereof a valid and justifiable opinion of the shares or debentures and the financial condition and profitability of the company at the time of the issue of the prospectus, taking into account the nature of the shares or debentures being offered and the nature of the company, and the nature of the persons likely to consider acquiring them*". Further, the prospectus must contain a statement in a prominent position advising the reader to take independent professional advice in case of doubt about any of its contents. The prospectus must then be authorised for registration by the SFC and be registered by the Registrar of Companies prior to publication, circulation or distribution in Hong Kong. These requirements are set out in Part II of the CO [A-01(01)-SFC(33)-E & C(O)] for companies incorporated in Hong Kong and Part XII of the CO [A-01(01)-SFC(33)-E & C(O)] for companies incorporated outside Hong Kong – see in particular sections 38(1)/342(1), 38(1A)/342(2A), 38D/342C of, and the Third Schedule to, the CO.

S1-Appendix 5

[4] Series 1 was offered in Hong Kong in August 2004.

[5] ""debenture" includes debenture stock, bonds and any other securities of a company whether constituting a charge on the assets of the company or not:"

S1-Appendix 6

These requirements are applicable so long as shares in or debentures of companies whether incorporated in or outside Hong Kong are offered to the public in Hong Kong, and do not distinguish between product types. Hence the same requirements apply to Minibonds and other Lehman Brothers-related structured notes as they fall within the definition of "debenture". Safe harbours from the prospectus regime in the CO are set out in the 17th Schedule to the CO [A-01(01)-SFC(35)-E & C(O)] and include offers to professional investors (as defined in the Securities and Futures Ordinance ("SFO")) and offers where the minimum consideration payable by any person is HK$500,000.

The SFC is not aware of any changes in the way the Lehman Brothers-related Minibonds and other structured financial products have been offered and sold.

3. Throughout these years, were there any aspects of such products that have given rise to regulatory concerns? If yes, please explain the concerns and the action (if any) taken to address such concerns, If no, the reasons.

We rely on a range of measures which were designed to ensure that investors were not sold products which were not adequately explained – these measures include: (a) the prescribed disclosure requirements in the CO; (b) civil and criminal liability provisions for untrue statements (including material omissions); and (c) conduct regulation on the sales process. However we have also considered changes to the means by which structured products are regulated to address particular concerns (see further below).

First, we must explain our regulatory objectives and functions which are set out in sections 4 and 5 of the SFO. These require the SFC to, amongst other things:

(i) take such steps as it considers appropriate to maintain and promote the fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry (section 5(1)(a));
(ii) encourage the public to appreciate the relative benefits of investing in financial products through persons carrying on activities regulated by the SFC (section 5(1)(j));
(iii) 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 (section 5(1)(k)); and
(iv) 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 (section 5(1)(l)).

In pursuing its regulatory objectives and performing its functions, the SFC is required to have regard to, amongst other things:

(i) the international character of the securities and futures industry and the desirability of maintaining the status of Hong Kong as an international financial centre (section 6(2)(a));
(ii) the desirability of facilitating innovation in connection with financial products and with activities regulated by the SFC (section 6(2)(b)); and
(iii) the need to make efficient use of resources (section 6(2)(e)).

The public in Hong Kong comprises different classes of investors with different permutations of risk profile, financial circumstances, investment objectives, investment experience and personal characteristics such as age and health. It would be extremely difficult (if not impossible) for any regulator (nor is it reasonable to expect any regulator) to decide at the outset whether a particular financial product is suitable for the public in general.

Suitability of a product can only be viewed in the light of the particular circumstances of each investor and, accordingly, in line with the approach adopted in other leading jurisdictions, our regulatory framework is premised on (i) disclosure regulation and (ii) conduct regulation at the point-of-sale where licensed intermediaries who interface with retail investors have to comply with the SFC Code of Conduct and ensure product suitability for individual investors. Conduct regulation involves various elements –

(i) We prohibit the sale of financial products except by corporations which are licensed by the SFC and banks that are registered with the SFC to carry on regulated activities.

(ii) We ensure that the representatives of licensed corporations are suitably qualified while the HKMA is responsible for ensuring that the representatives of banks are suitably qualified.

(iii) We require that licensed corporations and their representatives observe the Code of Conduct whilst HKMA is responsible for ensuring that banks and their representatives do so.

(iv) We recognize that professional investors require less protection than non-professional investors and some provisions of the Code of Conduct need not be observed in the case of professional investors.

(v) We have put in place a comprehensive programme of investor education.

(vi) When products are offered for sale in Hong Kong by regulated persons and there appears to have been a breach of the Code of Conduct, we take enforcement action which may result in prosecution or disciplinary action.

S1-Appendix 7

In the Consultation Paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance issued in August 2005 ("CO Phase 3 Reform Exercise") [A-01(01)-SFC(10)-E(O)] we consulted the public on, inter alia, our proposal to "merge" the CO prospectus regime into the SFO Part IV regime and create a unified offering regime that harmonized the legal and regulatory requirements for investments with similar features. The key paragraphs in the 2005 Consultation Paper are paragraphs 9.7. and 9.8 –

> 9.7 The investment arrangements and instruments for which each regime is designed may give rise to different risk and reward exposure for an investor. Thus, in the case of equity or debt capital raising, the investor's exposure is to the financial performance and prospects of the company issuing the shares or debentures. For financial products, in addition to exposure to the issuer's (or guarantor's) creditworthiness, the investor is also exposed to the performance of the underlying asset, opportunity or risk. The different characteristics of investment arrangements and instruments justify differences between the regulatory framework of the applicable regime. Investment arrangements and instruments providing investors with broadly similar risk and reward exposure should be subject to equivalent regulatory treatment, regardless of their particular legal form. Similarities in risk

and reward exposure justify similar disclosure and comparable levels of investor protection and regulatory oversight or intervention.

9.8 The inconclusive case law on the definition of "debenture" creates the potential for some investments to be regulated under either the CO prospectus regime or the SFO investment advertisement regime. As the two regimes are quite different, room exists for market distortion and regulatory arbitrage. The adverse consequence of regulatory arbitrage in circumstances where the legal or regulatory frameworks are not designed to accommodate a particular instrument is inadequate investor protection.

Although there was widespread support for the proposal that investment arrangements and instruments providing investors with broadly similar risks and rewards should be subject to equivalent regulatory treatment, there was a divergence of views on whether the CO prospectus regime and the SFO Part IV regime should be merged as an offer of, e.g., shares for fund raising purposes was considered and is inherently different from an offer of financial products in the ordinary course of business of the issuer.

Some respondents to the 2005 Consultation agreed with the proposal to "harmonise" and did not appear to question the two public offering regulatory regime structure (i.e. one for shares and plain-vanilla debentures under a "prospectus regime" and another for financial products under "Part IV") whilst the majority advocated a "merger" of the prospectus regime with the SFO Part IV regime (i.e. so that there will only be one public offering regime covering everything including shares, debentures and other financial products).

In September 2006 the SFC issued Consultation Conclusions on such Consultation Paper. This paper explained that in light of diverse market responses to the earlier consultation paper the SFC would, amongst other things:

(i) proceed with proposals to transfer the provisions in the CO relating to the public offering of shares and debentures to the SFO as a discrete part separate from the offers of investments regime in Part IV of the SFO;

(ii) harmonise the legal and regulatory treatment of investment products with similar risk and reward exposure (irrespective of their legal form) without seeking to merge the CO prospectus regime and the SFO offers of investments regime. This was proposed to be done by:

a) amending the definition of "debenture" where it appears in the CO prospectus regime and the SFO offers of investments regime to the effect that all "structured products" will fall outside the definition of a "debenture", with the intention of subjecting public officers of structured products to regulation under the SFO offers of investments regime. For this purpose, structured products are products that, in addition to exposure to the credit or default risk of the issuer (or guarantor where applicable), contain an exposure to an underlying asset, opportunity or risk that is usually unrelated to the issuer or the guarantor; and

b) formulating non-statutory product codes or guidelines tailored for products with similar characteristics to supplement the SFO offers of investments regime.

In view of the CO Rewrite Exercise (which commenced in mid-2006) where the target as announced by the Administration in 2006 was to introduce the new Companies Bill into the Legislative Council by the 3rd quarter of 2010, it was felt appropriate to propose changes to Parts II and XII of the CO [A-01(01)-SFC(33)-E & C(O)] regarding prospectuses in tandem with the CO Rewrite Exercise. However, we may need to revisit these proposals in light of recent events and the review by the Government of the issues raised in our review report submitted to the Financial Secretary on 31 December 2008.

S1-Appendix 5

4. *Please explain:*

(a) the procedures under the current regulatory regime for the issuance in Hong Kong of:-

(i) credit-linked notes; and

(ii) equity linked notes.

Please see the response to Question 2 above.

(b) the documentation required for the issuance of each type of the above structured notes: and

Credit-linked notes and equity-linked notes are structured as "debentures" as defined in section 2 of the CO. Before they can be offered by a company (including a company incorporated outside Hong Kong) to the public in Hong Kong for subscription or purchase, the company has to prepare a prospectus which (i) complies with the applicable requirements of the CO; (ii) has been authorised for registration by the SFC; and (iii) has been registered by the Registrar of Companies prior to publication, circulation or distribution in Hong Kong.

S1-Appendix 5

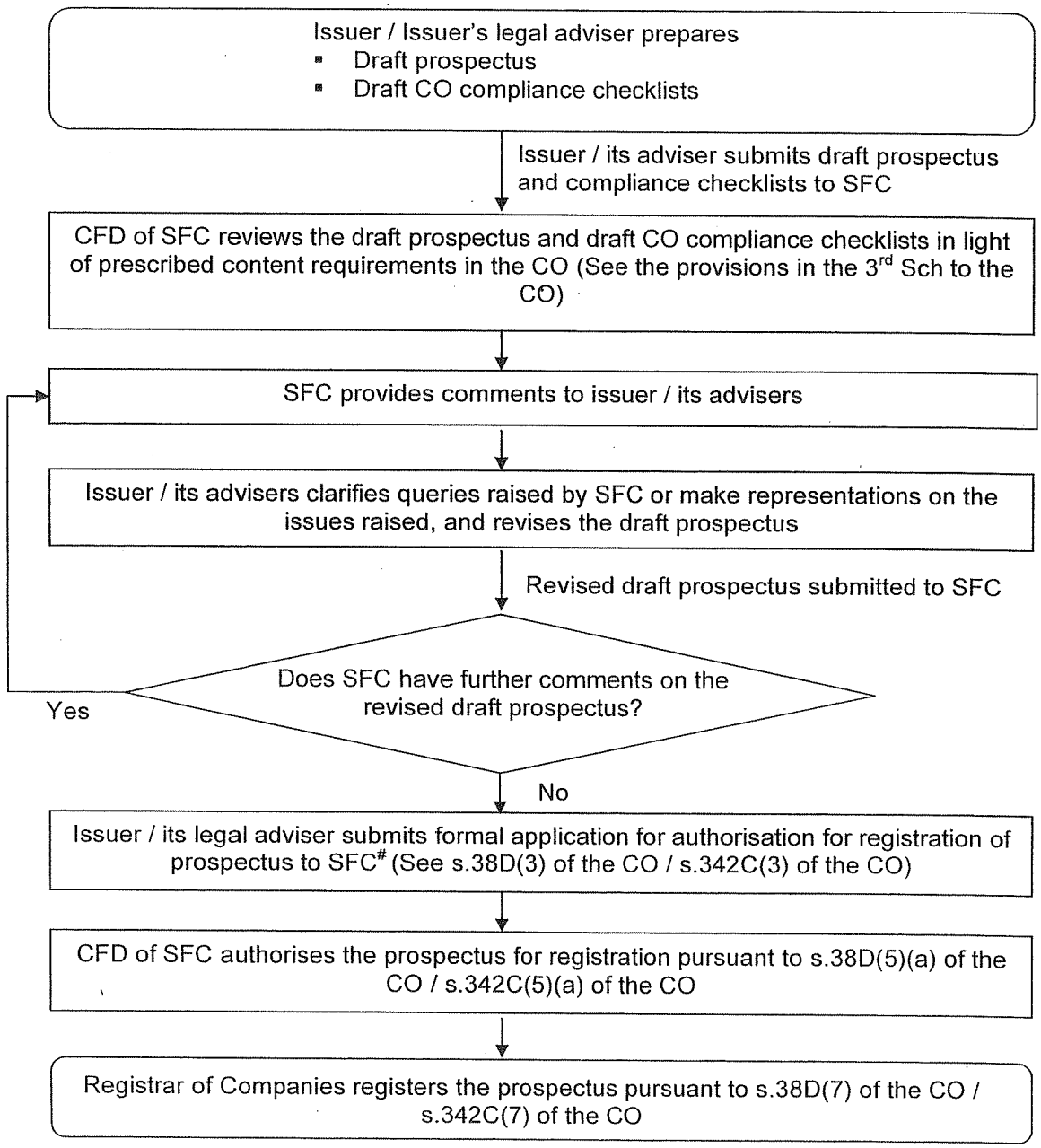
Under sections 38D/342C of the CO [A-01(01)-SFC(33)-E & C(O)], an application for authorisation for registration of a prospectus has to be made in writing to the SFC and there has to be delivered to the SFC together with the application a copy of the prospectus proposed to be registered which has been signed by every director or proposed director of the company (in the case of a company incorporated in Hong Kong) or certified by 2 members of the governing body of the company as having been approved by resolution of the governing body (in the case of a company incorporated outside Hong Kong) or by their respective agents authorised in writing. Where applicable, there has to be endorsed on or attached to the prospectus proposed to be registered any requisite consent to the issue of the prospectus by any person as an expert (e.g. auditor's consent where the prospectus contains an auditor's report).

(c) the policy and process of approving such notes and advertising materials by the regulator(s)

We review the prospectus against the disclosure requirements in the CO and ensure that an adequate description of the product in question and the associated risks of investing in such product are set out in the prospectus in plain language.

Procedure for registration of prospectuses

CLNs and ELNs are structured as "debentures" as defined in section 2 of the CO. Hence, public offers of CLNs and ELNs are regulated under the prospectus regime. Below is an illustration of the steps involved for registration of prospectuses.



#: The formal application encloses the following documents:

(a) two copies of the prospectus signed by every director or proposed director (in case of a company incorporated in Hong Kong) or certified by 2 directors as having been approved by board resolution (in the case of a company incorporated outside Hong Kong) or by their respective agents authorised in writing;
(b) completed compliance checklists;
(c) any requisite consent to the issue of the prospectus - e.g. auditor's consent where the prospectus contains an auditor's report.

The following section describes the process which applies to all applications relating to prospectuses for offers of debentures to the public:

(i) Upon receipt of the draft prospectus and draft CO compliance checklists from the issuer or its legal advisers, the Corporate Finance Division of the SFC ("CFD") reviews the drafts in light of the requirements of the CO. The SFC does not verify the information in the prospectus or to review supporting documents to ascertain the accuracy of statements made in the prospectus. Instead we rely on the provisions of the CO which make it a criminal offence to make untrue statements (including material omissions) in a prospectus and also civil liability for misstatements. Further, the prospectus must contain a statement in a prominent position advising the reader to take independent professional advice in case of doubt about any of its contents.

(ii) CFD provides their comments to the issuer / its advisers and asks them to clarify or make representations on issues raised, and reviews and comments on subsequent iterations of the draft until they considered the draft to be in acceptable form.

(iii) The issuer / its legal adviser then submits its formal application for authorisation for registration of the prospectus together with the following documents: (1) completed CO compliance checklists; (2) two copies of the prospectus signed by every director or proposed director (in the case of a company incorporated in Hong Kong) or certified by 2 directors as having been approved by board resolution (in the case of a company incorporated outside Hong Kong) or by their respective agents authorised in writing; and (3) any requisite consent to the issue of the prospectus – e.g. auditor's consent where the prospectus contains an auditor's report.

(iv) CFD then authorises the prospectus for registration.

(v) The Registrar of Companies then registers the prospectus.

Marketing materials are designed to raise investors' interest in an offer. They do not take the place of the prospectus. Investors are directed in the marketing materials to read and understand the prospectus before investing. By definition marketing materials are not prospectuses and therefore will not contain all relevant information for investors to make an informed investment decision. In reviewing the marketing materials, the SFC refers to the *Guidelines on Use of Offer Awareness and Summary Disclosure Materials in Offerings of Shares and Debentures under the CO* [A-01(01)-SFC(14)-E (O) and A-01(01)-SFC(15)- C(O)] which have been published by the SFC. The Guidelines require, among other things, that the marketing materials must not contain anything that is inconsistent with the information contained in the prospectus, and that the contents must not be false, biased, misleading or deceptive.

S1-Appendix 1

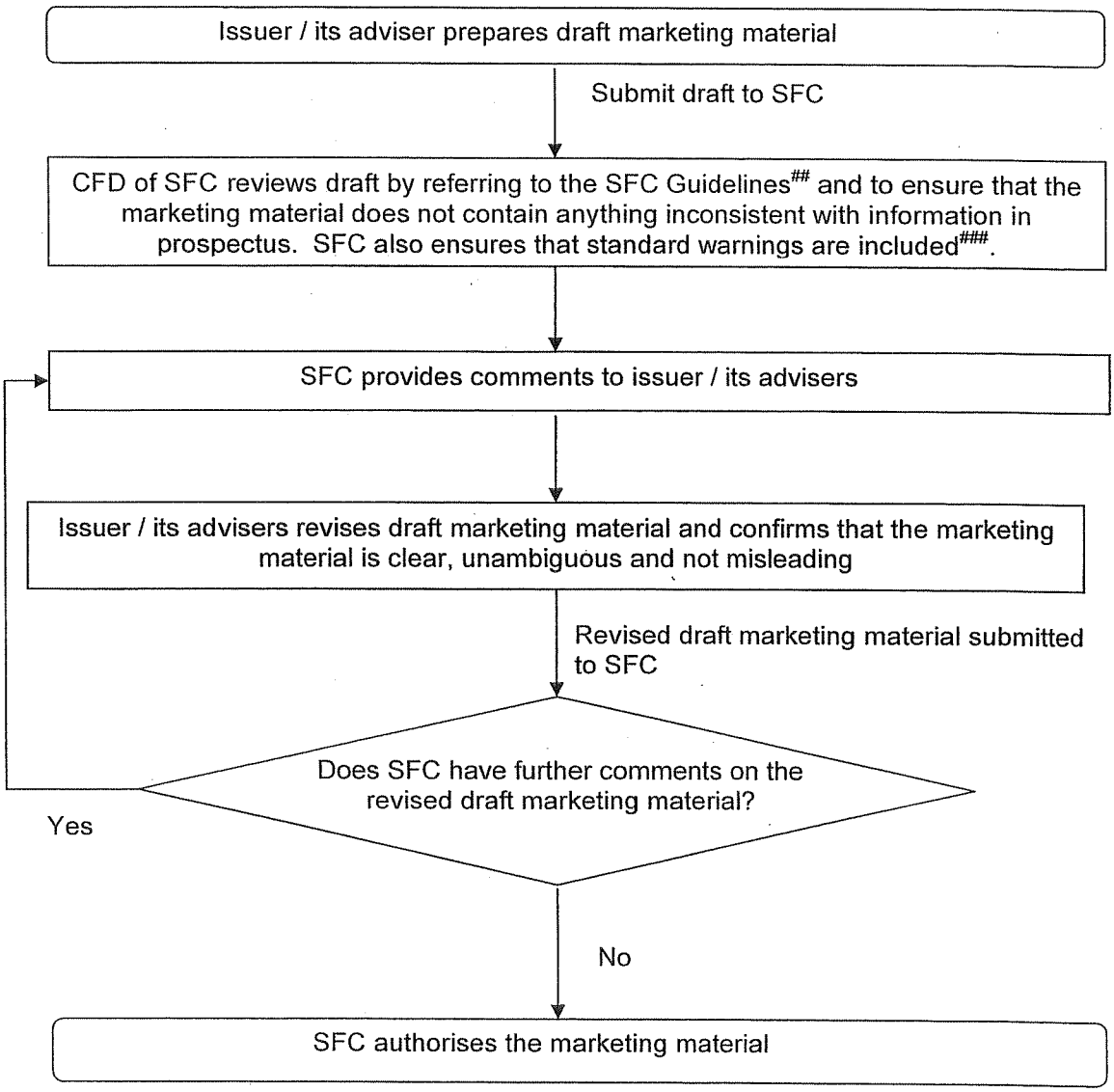
For details of provisions regulating marketing materials relating to debentures, please refer to paragraph 5.5 of Appendix 2 to SFC's Review Report on Lehman Brothers-related issues.

Upon receipt of the draft marketing materials, CFD reviews the drafts to ensure that the marketing materials do not contain anything that is inconsistent with the information contained in the prospectus and that standard warnings are included in each of the marketing materials – for example:

- investment involves risks (and where applicable, non-principal protection);
- prospective investors should read the relevant offering documents for detailed information about the issuer/guarantor and the offer before investing;
- the material does not constitute an offer or an invitation to induce an offer;
- the offer is made solely on the basis of the information contained in the offering documents and applications will only be taken on the basis of the offering documents; and
- SFC's authorisation of the marketing material does not imply the SFC's endorsement or recommendation of the products and the SFC accepts no responsibility for the contents of the marketing material.

The SFC also requires issuers to confirm for each marketing material that it is clear, unambiguous, accurate and not misleading.

Procedure for seeking authorisation of marketing material relating to debentures (including structured notes e.g. CLNs and ELNs)



##: *Guidelines on Use of Offer Awareness and Summary Disclosure Materials in Offerings of Shares and Debentures under the CO*

###: Standard warnings are included in each of the marketing materials – for example:

- investment involves risks (and where applicable, non-principal protection);
- prospective investors should read the relevant offering documents for detailed information about the issuer/guarantor and the offer before investing;
- the material does not constitute an offer or an invitation to induce an offer;
- the offer is made solely on the basis of the information contained in the offering documents and applications will only be taken on the basis of the offering documents; and
- SFC's authorisation of the marketing material does not imply the SFC's endorsement or recommendation of the products and the SFC accepts no responsibility for the contents

S1-Appendix 8

6. With reference to the Annex of LC Paper No. CB(2) 169/08-09(02) (copy attached) provided by SFC/HKMA:

(a) Please provide information on the structure of each "relevant product series" listed in the footnote of the Annex (namely, Minibonds series, ProFund Notes series, Equity Linked Notes series, Structured Retail Notes series, Retail-Aimed Callable Investment Notes Global series and Octave Notes series).

Please see the following table :

	Type of Product	Issuer	Arranger	Structure
Lehman Arranged	Minibonds: Credit-Linked Notes	Pacific International Finance Limited	Lehman Brothers Asia Limited	See section A below
	Pyxis Equity-Linked Notes: Equity-Linked Notes	Pyxis Finance Limited	Lehman Brothers Asia Limited	See section B below
	ProFund Notes: Fund-Linked Notes	Atlantic International Finance Limited	Lehman Brothers Asia Limited	See section C below
Lehman Linked	Constellation Structured Retail Notes: Credit-Linked Notes (with LB as reference entity)	Constellation Investment Limited	DBS Bank Limited	See section D below
	Octave Notes: Credit-Linked Notes (with LB as reference entity)	Victoria Peak International Finance Limited	Morgan Stanley & Co. International plc[6]	See section D below
	Retail Aimed Callable Investment Notes: Credit-Linked Notes (with LB as reference entity)	SPARC Limited	UBS Securities Asia Limited	See section D below

A. Structure of Minibonds

1. Minibonds were issued to the Hong Kong public under a secured continuously offered note programme set up by Pacific International Finance Limited (i.e. the Minibond issuer) in order for it to issue notes to the public in Hong Kong. The programme was authorised and approved by resolutions of the board of directors of the issuer on 30 March 2000. All the programme documentation, including the Minibonds, is governed by English law (except that the master swap guarantee is governed by New York law). Pacific International Finance Limited has no significant assets (other than the collateral backing the Minibonds acquired using the proceeds of issue). Minibonds were arranged by Lehman Brothers Asia Limited.

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[6] Series 19 – 22 only. From series 1 – 18 the arranger was Morgan Stanley & Co. International Limited.

2. Minibonds are credit linked notes which provides a fixed income investment opportunity. In return for investors taking credit risk on the "*reference entities*" (which are designated companies or sovereign entities), the issuer agreed to pay a fixed rate interest on the notes.

3. Minibonds were intended to be redeemed at 100% of their principal amount on the maturity date, unless a credit event (i.e. bankruptcy, failure to pay, and restructuring) happened to any one of the reference entities before then. If a credit event happened, the issuer would redeem the Minibonds in an amount equal to the "*credit event redemption amount*", and the issuer would not pay interest for any part of the interest period during which the credit event happened or any subsequent period. The credit event redemption amount would likely be less, and could be significantly less, than the principal amount of the Minibonds.

4. In addition, the issuer had a "call option", which means the issuer could choose to repay the Minibonds early, at 100% of the principal amount plus interest.

5. Minibonds are not principal protected: if a credit event happened to any one of the reference entities on or before the second business day prior to the maturity date, investors would lose part, and possibly all, of their investment. As the only assets which back each series of the Minibonds are the collateral, and the swap arrangements with Lehman Brothers (in the case of series 9-36, please see paragraph 8 and 9 below), the value of the collateral, in the event that it had to be enforced upon an early redemption of the notes, could be significantly less than its principal amount if the credit quality of the collateral declined since its purchase date or if there was no liquid market. In addition, under the trust deed which constitutes the Minibonds, the claims of the swap counterparty for any amounts due to it under the swap arrangements, including any termination payment, would be paid first out of the proceeds of sale of the collateral before the claims of noteholders are met.

6. The issuer would also have to redeem the Minibonds early, at less than their principal amount, if there was an event of default under the Minibonds; if there was a default on the collateral; (except series 5, 6 and 7) if the swap arrangements were terminated early; or if the issuer became unexpectedly subject to taxation in the Cayman Islands, where the issuer is incorporated.

7. The issuer would use the money which investors invest in each series of the Minibonds to buy a package of assets which must meet certain criteria as specified in the relevant prospectus at the date of purchase (which would be after the date of the relevant prospectus offering the Minibonds), one of which would be that the assets had an AAA-rating at the time of purchase. Such assets were used by the issuer as security for the performance of the issuer's payment obligations under each such series and were kept separately from the assets which back up other series. The assets are held by a custodian and are subject to security in favour of the trustee. The principal amount of the collateral would be equivalent to the total principal amount of the particular series of Minibonds issued. The issuer would have to rely on receiving money or securities due under the terms of the assets the issuer holds in the full amounts and on the dates due if the issuer was to meet its obligations to investors. If the issuer did not receive what was due to it under the terms of the assets, the issuer would not be able to meet its obligations to investors and would have no choice but to default. As the issuer has no other

assets, investors would have to bear the loss. Claims against the issuer for the loss are not allowed.

8. The earlier series of the Minibonds (series 5, 6, 7 and 9) were secured upon notes issued by Lehman Brothers Treasury Co. B.V. and guaranteed by Lehman Brothers Holdings Inc. For series 9, the security also comprised swap arrangements with Lehman Brothers Special Financing Inc. as swap counterparty and Lehman Brothers Holdings Inc. as swap guarantor. The swap arrangements would enable the issuer to meet its payment and other obligations under the series 9 notes.

9. The later series of the Minibonds (series 10-36) were secured upon AAA-rated collateralised debt obligation securities (CDO), and swap arrangements with Lehman Brothers Special Financing Inc. as swap counterparty (guaranteed by Lehman Brothers Holdings Inc. as swap guarantor) for the payment of principal and interest under the notes. The CDO was linked to a portfolio of international credits. Redemption in full of the principal of the Minibonds at maturity would be dependent upon the redemption in full of the CDO.

10. The arrangements contemplated by the swap agreement are intended to enable the issuer to meet its payment and other obligations under the notes, taking into account the scheduled cashflow receipts on the collateral held and tailored to each series of notes. The Minibonds were not obligations of and would not be guaranteed by the swap counterparty or Lehman Brothers Holdings Inc as swap guarantor. The swap guarantee comprises a guarantee only in respect of the swap counterparty's payments due under the swap agreement. For each series of Minibonds, the obligations of each party under the swap agreement are as follows:-

(a) on each interest payment date in respect of the collateral, the issuer would pay to the swap counterparty a sum equal to the interest receivable by the issuer in respect of the collateral;

(b) on each interest payment date in respect of the Minibonds, the swap counterparty would pay to the issuer an amount equal to the interest due on the Minibonds; and

(c) upon the occurrence of a credit event, the issuer would deliver the collateral to the swap counterparty and the swap counterparty would pay to the issuer a cash amount equal to the market value of debt obligations of the reference entity in respect of which the credit event has occurred. That amount would be adjusted by (i) swap termination payment and (ii) any difference between the principal amount of the collateral and the market value of the collateral.

The issuer would apply the redemption monies received in respect of the collateral in settlement of the redemption monies required to be paid on the notes.

11. The issuer has the right to terminate the swap agreement if:-

(a) the swap counterparty fails to make a payment when due under the swap arrangements or Lehman Brothers Holdings Inc. fails to make a payment under the swap guarantee; or

(b) the swap counterparty or Lehman Brothers Holdings Inc. suffers insolvency-related events.

12. Upon termination of the swap agreement, the issuer or the swap counterparty may be liable to make a termination payment to the other upon the termination of the swap agreement (regardless of which party may have caused the termination). The amount of any termination payment would be based on the cost of entering into a swap transaction with the same terms and conditions that would have the effect of preserving the economic equivalent of the swap agreement. A termination payment could be a substantial amount. Upon early termination of the swap agreement, the notes would be redeemed early. The recourse of the noteholders is limited to the proceeds of sale of the collateral (less costs and expenses) plus or minus the termination payment. The redemption amount would likely be less, and could be substantially less, than the principal amount of the Minibonds.

13. The Minibonds were not listed on any stock exchange. The distributors held the Minibonds for investors in accounts at Euroclear or Clearstream, which are two major international clearing systems for securities. Interest and principal on the Minibonds would be paid through the clearing systems and investors would have to rely on the distributors to ensure that payments are credited to individual accounts.

B. Structure of Pyxis Notes

1. Pyxis Notes were issued by Pyxis Finance Limited and sold under the issuer's retail secured note programme, which was established in order for it to issue notes to the public in Hong Kong. The programme was authorised and approved by resolutions of the board of directors of the issuer on 8 October 2002 and 17 April 2003. All the programme documentation, including the Pyxis Notes, is governed by English law. Pyxis Finance Limited has no significant assets (other than the collateral backing the Pyxis notes acquired by the issuer using the proceeds of issue). Pyxis Notes were arranged by Lehman Brothers Asia Limited.

2. Pyxis Notes pay a periodic coupon which may be fixed or potential only, depending on the series. Investors' total return on the Pyxis Notes and the amount at which the notes would be redeemed at maturity are linked to the price performance of certain specified listed shares in the underlying basket over the tenor of the notes. The notes also have an auto-call feature which, if triggered, would result in the notes being redeemed at 100%.

3. Security for the notes comprised securities issued by Lehman Brothers Treasury Co. B.V. (except for series 10 which, as disclosed, was AAA-rated securities at the time of purchase) and guaranteed by Lehman Brothers Holdings Inc. as collateral, and swap arrangements with Lehman Brothers Finance S.A. as swap counterparty. Payments by the swap counterparty would be guaranteed by Lehman Brothers Holdings Inc. as swap guarantor. The collateral would be purchased with the money investors invest with the issuer when they bought the notes. The collateral is held by a custodian and is subject to security in favour of the trustee. The principal amount of the collateral would be equivalent to the total principal amount of the particular series of notes issued. The issuer would have to rely on receiving money or securities due under the terms of the collateral the issuer holds in the full

amounts and on the dates due if the issuer has to meet its obligations to investors. If the issuer did not receive what was due to it under the terms of the collateral, the issuer would not be able to meet its obligations to investors and would have no choice but to default. As the issuer has no other assets, investors would have to bear the loss. Claims against the issuer for the loss are not allowed.

4. The effect and operation of the swap arrangements are the same as that for the Minibonds. Please refer to section A (paragraphs 10 – 12) above.

5. Pyxis Notes are not principal protected. The only assets which back the notes are the collateral and the swap arrangements; the swap counterparty's claims against the collateral would be paid ahead of noteholders' claims if the issuer had to redeem the notes unexpectedly, i.e. occurrence of event of default under the Pyxis Notes: early repayment of the collateral for any reason, including an event of default under the collateral; tax reasons and termination of swap arrangements. Investors would have no further claim against the issuer for any loss of their investment after the issuer has paid out all the proceeds of the collateral and, if any, of termination of the swap arrangements.

C. Structure of ProFund Notes

1. Profund Notes were issued by Atlantic International Finance Limited under its secured note programme, which was established in order for it to issue notes to the public in Hong Kong. The programme was authorised and approved by resolutions of the board of directors of the issuer on 23 June 2006. All the programme documentation, including the ProFund Notes, is governed by English law (except that the master swap guarantee is governed by New York law). Atlantic International Finance Limited has no significant assets (other than the collateral which backs each series of the Profund Notes). Profund Notes were arranged by Lehman Brothers Asia Limited.

2. Profund Notes may pay zero coupon or a fixed coupon, depending on the series/tranche. The redemption amount upon maturity would depend on the participation in the performance of the underlying fund(s) authorised by the SFC, subject to a minimum of 100% of the principal amount.

3. Profund Notes are structured as principal protected if held until the maturity date or until automatic early redemption (i.e. the occurrence of prescribed events relating to the performance of the underlying fund on designated dates). However, as disclosed in the relevant prospectuses, principal protection of the notes depended upon the creditworthiness of the collateral guarantor – i.e. Lehman Brothers Holdings Inc.

4. Security for the notes comprised securities issued by Lehman Brothers Treasury Co. B.V. and guaranteed by Lehman Brothers Holdings Inc. as collateral, and swap arrangements with Lehman Brothers Finance S.A. as swap counterparty. Payments by the swap counterparty would be guaranteed by Lehman Brothers Holdings Inc. as swap guarantor. The collateral would be purchased with the money investors invest with the issuer when they bought the notes. The collateral is held by a custodian and is subject to security in favour of the trustee. The principal amount of the

collateral would be equivalent to the total amount of the particular series of ProFund notes issued.

5. The effect and operation of the swap arrangements are the same as that for the Minibonds. Please refer to section A (paragraphs 10-12) above.

6. The only assets which back the notes are the collateral and the swap arrangements; the swap counterparty's claims against the collateral would be paid ahead of noteholders' claims if the issuer had to redeem the notes unexpectedly. Investors have no further claim against the issuer for any loss of their investment after the issuer has paid out all the proceeds of the collateral and, if any, of termination of the swap arrangements.

D. Structure of Constellation Structured Retail Notes, Octave Notes and Retail-Aimed Callable Investment Notes

1. The structures of Constellation Structured Retail Notes, Octave Notes and Retail-Aimed Callable Investment Notes are substantially similar, whilst they are arranged by different financial institutions: DBS Bank, Morgan Stanley and UBS respectively. Similar to the Minibonds which were arranged by Lehman, these notes are also unlisted credit linked notes issued by thinly capitalised special purpose companies pursuant to their respective programmes, on a limited recourse basis backed by cashflows from assets held by them, namely, the collateral and the swap arrangements in connection with each series. Such security was purchased with the funds raised in each issue. For each series of these notes, the collateral may consist of or include (but shall not be limited to) synthetic CDO securities and/or CDO squared securities and/or medium term notes and/or liquidity funds and/or cash deposits. Invariably (except where the collateral is cash), one of the criteria that the collateral must meet would be a top three investment grade credit rating at the time of purchase. The swap arrangements were entered into with the objective to enable the issuer to meet its payment obligations under a series of notes.

2. The notes of each series are credit linked, i.e. payments upon redemption (whether at maturity or earlier) depend on, among other things, the credit performance of the designated companies or the sovereign entities). These notes are not principal protected. When a credit event happens to any one of the reference entities, the notes would be early redeemed. The credit event redemption amount is calculated by reference to the prevailing market price of the borrowing or reference obligation (being the reference obligation specified in the relevant prospectus) of the reference entity which has suffered the credit event. The credit event redemption amount investors receive is likely to be less or significantly less than their principal investment.

3. For a description of the features of these notes, and the calculation of the respective redemption amounts on scheduled maturity, occurrence of credit events, exercise of call option, or early redemption due to termination of swap arrangements, please refer to the description for Minibonds in section A. The key differences between these credit linked notes and Minibonds are that these notes are Lehman-linked, whereas Minibonds are Lehman-arranged, and that the swap counterparties and swap guarantors for these notes are NOT Lehman entities but are, respectively, entities of DBS Bank, Morgan Stanley and UBS.

4. Although the style and extent of disclosure in the prospectuses and marketing materials for Constellation Structured Retail Notes, Octave Notes and Retail-Aimed Callable Investment Notes may differ, all the information in this section D has been disclosed in the prospectuses applicable to each series.

(b) Please explain the implications of the collapse of Lehman Brothers on each of the aforesaid "relevant product series".

A. Implications of the collapse of Lehman Brothers on Minibonds

In the case of Minibonds, the chapter 11 bankruptcy filing by Lehman Brothers Holdings Inc. constituted a termination event under the swap arrangements entitling the issuer to terminate the swaps and hence, would trigger an early redemption of the Minibonds. Under the terms and conditions of the Minibonds, in the event of early termination, investors would only get back their share of the proceeds of sale of the collateral less any amount which the issuer may owe to Lehman Brothers under the swap arrangements. The possibility of early redemption (and investors suffering a significant loss) arising from the failure of Lehman Brothers Holdings Inc. to make a payment under the swap arrangements is disclosed in the relevant prospectuses.

B. Implications of the collapse of Lehman Brothers on Pyxis notes

As described above, security for the Pyxis notes comprised securities issued by Lehman Brothers Treasury Co. B.V. (except for series 10 which, as disclosed, was AAA-rated securities at the time of purchase) and guaranteed by Lehman Brothers Holdings Inc. as collateral, and swap arrangements with Lehman Brothers Finance S.A. as swap counterparty. Payments by the swap counterparty were guaranteed by Lehman Brothers Holdings Inc. as swap guarantor. The collapse of Lehman Brothers triggered an early termination of the swap arrangements (and hence, an early redemption of the Pyxis notes) and a drop in the value of the collateral thus resulting in a significant loss to investors.

C. Implications of the collapse of Lehman Brothers on ProFund notes

As described above, security for the ProFund notes comprised securities issued by Lehman Brothers Treasury Co. B.V. and guaranteed by Lehman Brothers Holdings Inc. as collateral, and swap arrangements with Lehman Brothers Finance S.A. as swap counterparty. Payments by the swap counterparty were guaranteed by Lehman Brothers Holdings Inc. as swap guarantor. The principal protection of the ProFund notes depends upon the creditworthiness of the collateral guarantor – i.e. Lehman Brothers Holdings Inc. The collapse of Lehman Brothers triggered an early termination of the swap arrangements (and hence, an early redemption of the ProFund notes) and a drop in the value of the collateral thus resulting in a significant loss to investors.

D. Implications of the collapse of Lehman Brothers on Constellation Structured Retail Notes, Octave Notes and Retail-Aimed Callable Investment Notes

Lehman Brothers Holdings Inc. was a reference entity in certain series of Constellation Structured Retail Notes, Octave Notes and Retail-Aimed Callable Investment Notes. The Chapter 11 bankruptcy filing by Lehman Brothers

Holdings Inc. was a credit event triggering an early redemption of the notes. The notes will be redeemed at the "credit event redemption amount" which will be less, and could be significantly less, than the principal amount of the notes. The credit event redemption amount is the amount equal to the nominal value of the notes less the notional amount of loss on the reference obligation of Lehman Brothers Holdings Inc., less any depreciation in the market value of the collateral and less costs and expenses associated with the termination of the swap arrangements in respect of the notes.

7. It is provided in section 119 of the Securities and Futures Ordinance (Cap. 571) (SFO), that SFC may, upon application by an authorized institution (AI). register the applicant for carrying on one or more "regulated activities". Please explain the detailed process of' how and by whom an application for such registration by an AI is processed, including the criteria/factors for consideration. Please also specify the Officer(s)/Division(s) responsible for processing such applications.

The SFC (in particular, its Licensing Department) is responsible for granting or refusing applications by AIs to be registered to carry on a regulated activity. The procedure for processing applications by AIs for registration to carry on regulated activities is mainly set out in s.119(2) to (5) and 129 of the SFO [A-01(01)-SFC(25)-E & C(O)] and in the MOU between the SFC and HKMA dated 12 December 2002 [A-01(01)-SFC(26)-E(O)].

S1-Appendix 9
S1-Appendix 10

All such applications received by the SFC will first be referred to the HKMA for consideration. The HKMA consults the SFC on the merits of any such application and advises the SFC whether it is satisfied that the applicant is fit and proper to be so registered. In considering whether an applicant is fit and proper to be registered, the HKMA takes into account:-

(a) the factors set out in section 129 of the SFO (such as the ability to carry on the regulated activity competently, honestly and fairly and the reputation, character, reliability and financial integrity of the AI and its senior management); and

(b) any relevant rules, codes, guidelines or guidance made or published by the SFC under the SFO (such as "Code of Conduct For Persons Licensed by or Registered with the Securities and Futures Commission" [A-01(01)-SFC(20)-E & C(O)], "Management, Supervision and Internal Control Guidelines For Persons Licensed by or Registered with the Securities and Futures Commission" [A-01(01)-SFC(31)-E(O)] and "Guidelines on Competence".)

1-Appendix 11

S1-Appendix 12
M7-Appendix 7

Both SFC and HKMA endeavour to ensure that the referral and consultation process is as expeditious as possible and that the approach adopted in processing applications for registration is consistent with that adopted in processing licence applications.

The SFC has regard to the HKMA's advice on the fitness and propriety of the applicant, and may rely wholly or partly on it in deciding whether or not to register an applicant.

Both the SFC and the HKMA maintain a close dialogue throughout the application process and ensure that a sufficient record of their communications in this regard is maintained.

The power to refer an application to the HKMA may be exercised by the Senior Director (Intermediaries Licensing and Conduct), Director (Licensing), Assistant Director (Licensing), Senior Manager (Licensing) and Manager (Licensing). All other powers of the SFC under s.119 may be exercised by the Senior Director (Intermediaries Licensing and Conduct), Director (Licensing) and Assistant Director (Licensing).

8. *Under section 104(1) of SFO, SFC may authorize any "collective investment scheme" as defined in Part 1 of Schedule 1 to SFO. Are any of the Lehman Brothers-related Minibonds and structured financial products regarded as a "collective investment scheme"? If yes, please describe the authorization process in detail, including the authorizing officers/entities involved. If no, please explain the features or configurations of the Lehman Brothers-related Minibonds and structured financial products; and why, in the opinion of SFC, they do not require authorization as a "collective investment scheme".*

The prospectus for the first Series of Minbonds was first authorized under the CO in 2002, before the SFO, which introduced the concept of CIS, came into effect on 1 April 2003. The prospectuses for subsequent series of Minibonds were also approved under the CO as they fall within the definition of "debentures" in s.2(1) of the CO. When the SFO came into effect, prospectuses for later series of Minbonds, and most of the marketing materials, were exempted from the application of s.103(1) of SFO by s.103(3)(a) of SFO.

The definition of CIS in Part 1 of Schedule 1 to SFO is drawn widely. It covers familiar concepts such as unit trusts, mutual funds, investment-linked assurance schemes and real estate investment trusts and also covers a wider group of investment arrangements. However, several qualifying factors were inserted into the definition to better reflect the special nature of these arrangements, notably that investors' contributions are collectively managed by professional managers for the benefit of the investors.

With the Lehman Brothers-related Minibonds the money paid by Minibond holders was not managed for the benefit of the noteholders any more than money raised by the issue of a corporate bond is invested for the benefit of the bond holders. It was invested by the special purpose vehicle (SPV) issuing the Minbonds in a manner that would generate revenue for the SPV and be available to meet any liabilities should a credit event occur. That revenue was intended to enable the SPV to pay the interest which it had agreed to pay the Minibond holders, and to repay the principal at the end of the term. A Minibond holder is not entitled to participate in or receive part of the revenue earned by the SPV and there is no suggestion to this effect. A Minibond holder is merely entitled to fixed rate quarterly interest. Accordingly, Minibonds were not regarded as CISs.

As regards Equity Linked Notes (ELNs) the prospectuses for which have been authorised by the SFC, thus far none have been regarded as a CIS. The prospectus and marketing materials have all been approved under the CO or under s.105 of SFO. The rationale for this is that with ELNs the money paid by investors is not normally managed for the benefit of the investor. The investor is not entitled to participate in or receive part of the revenue earned

by the SPV – he is merely entitled to fixed rate interest on the principal value of the note.

As regards fund-linked notes (e.g. ProFund notes) the prospectuses for which have been authorised by the SFC, the redemption amount on the maturity date is based on the performance of a named underlying fund. However, the investor merely has a contractual right to an amount which is calculated by reference to the performance of the named funds. The investor is not entitled to participate in or receive part of the profit generated by the named funds. Accordingly, we have taken the view that fund-linked notes are not CISs.

S1-Appendix 13

9. In SFC's written response on 11 October 2008 (LC Paper No. CB(2)25/08-09(02)), it is stated that "the SFC has authorized for registration prospectuses for credit-linked, equity-linked and fund-linked retail structured notes that are Lehman Brothers related". In their follow-up paper provided to the House Committee (LC Paper No. CB(2)169/08-09(0l) Annex 2), HKMA/SFC set out all the Lehman Brothers-related credit-linked, equity-linked and fund-linked retail structured notes that are registered under the Companies Ordinance (Cap. 32). Please explain details of the authorization process, including but not limited to:

(a) the procedure(s), if any, for seeking approval in connection with the offer and distribution of minibonds and structured financial products;

Please see the responses to Questions 2 and 4 above.

(b) the committee, if any, and the person(s) responsible for the authorization; the statutory basis, if any, for granting authorization; as well as any mechanism to safeguard against conflict of interests in granting authorization;

Pursuant to section 10(1) of the SFO, the functions of the SFC relating to prospectus authorisation under the relevant provisions of the CO have been delegated to all Executive Directors of the SFC. In addition, pursuant to section 10(3) of the SFO, the SFC authorised each Executive Director to sub-delegate such functions to any appropriate SFC Committee or any employee as he or she considers necessary for the efficient discharge of functions if they are carried out by his or her Division. Any sub-delegations to an employee is to an employee within that Division who occupies a post at the level of Senior Manager or above. Accordingly, the functions relating to prospectus authorisation (which are carried out by the Corporate Finance Division) have been sub-delegated to Senior Director and Director of the Corporate Finance Division of the SFC (and, as from September 2005, to Associate Director). The process for authorisation for registration of prospectus is set out in the SFC's Process Review Panel Manual.

As for the statutory basis for granting authorisation, please refer to the response to Question 4.

As for mechanism safeguarding against conflict of interests, the provisions of s.379 of the SFO require staff of the SFC to avoid conflict of interests, and section 379(3) of the SFO specifically provides that every staff member must notify the Commission immediately if he is required to consider any matter, in the course of their duties, relating to securities, futures contracts,

regulated investment agreements or interests in any securities, futures contracts, etc -

(i) in which he has an interest;
(ii) in which a company, in which he has an interest, has an interest.

In addition, the SFC internal code of conduct for staff contains extensive provisions to safeguard against conflict of interests, reminding staff members of the need to comply with s.379 and establishing further mechanisms to ensure compliance. Upon commencement of employment each staff member is required to declare all of his direct or indirect holdings in securities and futures contracts through the Staff Investment Recording System (***SIR System***) under "Initial Disclosure" . The disclosure should include his holdings in any collective investment schemes which he knows or should reasonably know will contain Hong Kong securities. Under "ongoing disclosure" all changes to his portfolio are required to be reported and entered in the SIR system. Investments in securities are limited to HSI stocks and a minimum holding period of 30 days is also laid down. Staff members may not engage in IPOs or in derivative transactions.

(c) the criteria and factors taken into consideration ; and

Please see the response to Question 4(c) above.

(d) the post-offer monitoring mechanism, if any, for such products.

A prospectus for an unlisted issue, which is authorised for registration by the SFC, merely gives prospective investors a one-off snapshot intended to form the basis of a contract between offeror and individual subscriber (see para 11.48 of the Report of the Securities Review Committee May 1988). However, for completeness, we should add that the SFC does collect the issue size of each series issued from each of the structured note issuers. The collated data has been used for research purposes and for publication in the SFC's annual reports. Please also refer to paragraph 8.10.3 of SFC's Review Report on Lehman Brothers-related issues for details.

10. It has been noted that banks and their staff selling Lehman Brothers-related Minibonds and structured financial products arc required to follow, among other things, the relevant statutory provisions, the SFC's Code of Conduct for Persons Licensed by or Registered with the SFC (the Code of Conduct) and the Supervisory Policy Manual and circulars issued by EIKMA. Please explain:

(d) details of various actions taken by the regulators to monitor compliance by banks end securities firms (such as the number of visits, inspection of relevant documents, issuance of circular-letters etc.); and

S1-Appendix 11

The SFC has published the Code of Conduct [A-01(01)-SFC(20)-E & C(O)] to govern business dealings of Licensed Corporations including their selling practices and provides further guidance by way of FAQs and circulars. In particular, the SFC issued two themed inspection reports on the selling practices of investment advisors and provided their key inspection findings first in February 2005 and then in May 2007. The SFC also issued FAQs to

provide further guidance on how investment advisors should ensure suitability when making a recommendation or solicitation in May 2007.

The SFC requires that Licensed Corporations and their representatives observe the Code of Conduct whilst HKMA is responsible for ensuring that banks and their representatives do so.

Licensed Corporations are subject to inspection by the SFC to assess their general compliance with applicable legal and regulatory requirements including those that are in the SFO and the Code of Conduct. Generally, inspections involve interviewing senior management to understand the firm's business operations and systems and controls, testing the systems to ensure proper functioning, performing sample checking of documents and records and obtaining explanation and clarification from relevant personnel of any issues identified.

If there are any topical issues or concerns over certain market practices, the SFC also conducts specific themed inspections of selected Licensed Corporations focusing on a particular practice or issue.

In recent years, the SFC has conducted a number of themed inspections focusing on selling practices adopted by Licensed Corporations:

2004	15
2006	10
2007	4
2008	9

These inspections generally cover, inter alia, product due diligence, know your clients, how to ensure suitability for each recommendation made, supervisory controls by management and documentary standards.

(e) details of sanctions against non-compliance.

Banks and their staff selling Lehman Brothers-related Minibonds and structured financial products are required to follow, among other things, the relevant statutory provisions and the Code of Conduct. Non-compliance with these requirements may result in disciplinary proceedings, criminal proceedings and/or proceedings before the Market Misconduct Tribunal ("MMT"), which may impose different types of sanctions.

Disciplinary proceedings

A breach of the Code of Conduct can result in disciplinary proceedings and, in appropriate cases, the imposition of sanctions (see below).

A breach of the Code of Conduct is not, however, a criminal offence. Nor does a breach of the Code of Conduct enable the SFC to apply to the High Court for injunctive and/or other relief under section 213 of the SFO.

A failure to comply with the Code of Conduct does not, by itself, render a person liable to judicial or other proceedings (sections 169(4) and s399(6) SFO) so a breach of the Code of Conduct does not therefore give rise to other statutory rights or remedies. For example, a breach of the Code of

Conduct does not provide a basis for seeking compensation. This can be contrasted with the provisions relating to market misconduct. Where a person suffers pecuniary loss as a result of market misconduct a right of civil action to seek compensation is contained in section 281 of the SFO. No such right exists in respect of breaches of the Code of Conduct.

Although the HKMA is the frontline regulator of banks and is responsible for the day-to-day supervision of their performance of regulated activities, the SFC is empowered to commence disciplinary proceedings against registered institutions, their executive officers, their relevant individuals and persons involved in the management of their businesses under section 196 of the SFO, if they are guilty of misconduct or are found to be no longer fit and proper to remain regulated.

S1-Appendix 9

Under section 193(1) of the SFO [A-01(01)-SFC(25)-E & C(O)], a person is guilty of "misconduct" if he performs an act or omission relating to the carrying on of any regulated activity for which he is licensed or registered which is likely to be prejudicial to the interest of the investing public. Under section 193(3) of the SFO, the SFC is required to take into account any applicable code of conduct published under section 169 or any code or guideline published under section 399 in considering whether a person is guilty of misconduct. Accordingly, a material breach of a code or guideline published by the SFC may therefore justify disciplinary action under either "misconduct" or by calling into question a person's "fitness and properness".

The SFC is obliged to provide procedural fairness to a person before it can make a decision to impose disciplinary sanctions. This includes giving the person in respect of whom the power is to be exercised a reasonable opportunity of being heard (section 198(1) SFO). Even then, the SFC's disciplinary decisions do not become operative until the time for appealing those decisions has expired (section 198(3) SFO) and, where any appeal has been lodged, the appeal has been heard and determined (section 232(2)(c) SFO).

Following disciplinary proceedings, the SFC may impose one or more of the following sanctions:

(i) revocation or suspension of licence,

(ii) prohibition order, i.e. , prohibiting the entity or the person from:

- applying to be licensed or registered,
- applying to be approved as a responsible officer of licensed corporation,
- applying to be given consent to act as an executive officer of a registered institution,
- seeking through a registered institution to have his name entered into the register maintained by the HKMA under section 20 of the Banking Ordinance ("BO"),

(iii) fines up to HK$ 10 million or three times the profit made or loss avoided for the conduct, and

(iv) public or private reprimand.

In the case of a relevant individual and an executive officer of a registered institution, the power to remove or suspend that individual's particulars from the HKMA's register (and withdraw or suspend the consent given) rests with the Monetary Authority under sections 58A and 71C of the BO.

Criminal proceedings

S1-Appendix 5

Criminal proceedings relate to breaches of the SFO, and Parts II and XII of the Companies Ordinance [A-01(01)-SFC(33)-E & C(O)] by any person/company. Under the SFO, the SFC can prosecute certain breaches itself before a Magistrate (summary prosecutions), and can refer more serious breaches of the SFO to the Department of Justice ("DoJ") (indictable prosecutions). The maximum fine available is $10 million and the maximum term of imprisonment is 10 years (depending on the offence and whether the matter is prosecuted summarily or on indictment).

MMT proceedings

MMT proceedings apply to any person/company who has committed market misconduct (e.g. disclosure of false or misleading information inducing transactions). Following SFC investigations, the SFC may refer suspected civil market misconduct breaches to the Financial Secretary who, on advice of the DoJ, decides whether to refer the matter to the MMT.

The MMT can impose the following sanctions following proceedings before it:

(i) a "disgorgement order" – requiring the payment of profits made or loss avoided from misconduct,

(ii) a "disqualification order" – disqualifying a person from being involved in corporate management for up to 5 years,

(iii) a "cold shoulder order" - prohibiting a person from trading SFC regulated products for up to 5 years,

(iv) a "cease and desist order" – ordering a person not to breach any of the market misconduct provisions again,

(v) a "disciplinary referral order" - referring a person found to have engaged in market misconduct to that person's disciplinary body, and

(vi) a "costs order" – requiring payment of costs of the MMT inquiry and/or SFC investigation.