



Issues raised by the Lehmans Minibonds crisis
Confidential Report to the Financial Secretary

December 2008





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Exhibits (see separate binder)

1	Memorandum of Understanding between the Securities and Futures Commission and Hong Kong Monetary Authority (12 December 2002)
2	Joint Forum report "Customer Suitability in the Retail Sale of Financial Products and Services" (April 2008)
3	UK FSA report "Retail Distribution Review" (November 2008)
4	Product information sheet published by the Australian Government (July 2008)
5	UK FSA "Mystery Shopping Guide" (November 2006)



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Executive summary

1. Introduction

- 1.1 On 15 September 2008, Lehman Brothers Holdings Inc. filed for bankruptcy protection. Founded in 1850, Lehman Brothers was the world's fourth largest investment bank, and a leader in equity and fixed income sales, trading and research, investment banking, private investment management, asset management and private equity. The firm was headquartered in New York and operated in a network of offices around the world, including Hong Kong.
- 1.2 In Hong Kong it had been a major arranger of a particular type of structured product – a callable credit-linked note that Lehman Brothers had marketed under the name of Minibond since 2002. These products were structured as debentures under the Companies Ordinance and contained complex derivative arrangements. Whilst the notes were structured with underlying collateral so that capital could be repaid at maturity, the severe deterioration of the global credit market meant that the collateral lost significant value, in some cases all of the value.
- 1.3 Following the failure of Lehman Brothers, it quickly became clear that “Lehman products” had been widely sold in Hong Kong via banks and brokers to a broad range of the investing public. The volume of complaints to both the SFC and HKMA escalated rapidly as investors came to realise that they had made significant losses on products that they had considered to be low risk.
- 1.4 This summary and conclusion is provisional at this stage while our investigations continue and is primarily concerned with Minibond products – there are a number of other ‘structured products’ which remain part of our investigation.



2. Initial findings

2.1 Complaints

2.1.1 Whilst findings will ultimately depend on the conclusions of our investigations which are still ongoing, we can at this stage discuss initial trends and themes emerging from our investigations so far. The unprecedented number of complaints received by the SFC, the HKMA and other bodies (in excess of 27,000), along with our preliminary investigation findings, raises the question of whether a substantial number of individuals were mis-sold these products. Whilst the complaints make a broad number of statements the most common generic complaints were:

- (a) Misrepresentation – that the products were wrongly presented as a low risk alternative to deposits and that the risks and complexity were not properly explained;
- (b) Complexity – the products were too complex and risks disclosures were ineffective in alerting investors; and
- (c) Suitability – that as a result of the above, and the failure of brokers and banks to do proper customer due diligence, inexperienced retail investors were left holding products not suitable to their investment profile.

2.2 Regulatory structure

2.2.1 The regulatory structure for the sale of investment products rests on two important pillars – disclosure and suitability. The first of these is the responsibility of the SFC – to ensure that, based on the information provided by the product issuer, sufficient information is disclosed in the product documentation by the issuer to enable a reasonable person to make an informed decision. The second is the responsibility of the Intermediary – that the product is suitable for the particular investor taking into account a full understanding of the client's profile and investment needs. This is covered by the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission ("Code of Conduct"). The Code of Conduct applies to selling Intermediaries whether they are employees of brokers regulated by the SFC, or staff of banks regulated by the HKMA.

2.3 Disclosure

2.3.1 Despite the fact that in many cases the client signed a statement that they "had read and understood [the] programme prospectus and this issue prospectus", many complainants say they did not read or understand either document. The distribution agreements between the Lehman Brothers entities and the distributors required a number of statements to be signed – including the above – before a product could be sold. Despite obtaining apparent confirmation that clients had read and understood the relevant prospectus, Intermediaries were still under an obligation pursuant to the Code of Conduct to explain the nature and risks of the product they were selling and ensure it was suitable. However, this may not have been



understood by many Intermediaries who may have placed undue reliance on these statements and may not have seen the need to give proper explanations of the product.

- 2.3.2 Whilst the prospectuses and marketing materials did contain statements of the risks, in compliance with the regulatory regime, it is apparent from the complaints received that these were not recognised by many investors. Many investors chose not to read the material if any was provided to them. It also appears from complaints received that the manner of communication of risks was ineffective.

2.4 Product description

- 2.4.1 Notwithstanding that the prospectus was largely ignored by many investors, concern has been expressed that the product was so complex that an "average" investor would have found it difficult to understand and it should not have been authorised for sale to the public. Comment has also been raised that given the complex nature of structured products which have features of "notes" but with embedded derivatives, they should not have been authorised as debentures under the Companies Ordinance.

- 2.4.2 In this context, there has been considerable debate in the media over whether Minibonds are 'bonds', 'notes' or 'derivatives'. However, there is no all-purpose definition currently in the law of what constitutes a 'bond' or a 'note'. The Companies Ordinance only provides an inclusive definition of a debenture and Minibonds were designed to fall within this definition. Thus Minibonds could legitimately be described as debentures, bonds, structured bonds, notes, credit linked notes or derivatives. Minibonds is the name under which they were marketed

- 2.4.3 Whether the name Minibond was represented in the selling process as an indication of their being "as safe as" or "equivalent to" high grade corporate or sovereign bonds is a part of our ongoing investigations. However, no-one has made a specific allegation to the effect that they were told Minibonds were like high grade corporate or sovereign bonds.

2.5 Code of Conduct

- 2.5.1 A key issue for the SFC's investigation is whether the sales practices of the Intermediaries complied with the Code of Conduct. There are explicit requirements in the Code of Conduct for Licensed and Registered Persons:
- (a) "In conducting its business activities, a licensed or registered person should act with due skill, care and diligence, in the best interests of its clients and the integrity of the market." (General Principle.2);
 - (b) "When providing advice to a client a licensed or registered person should act diligently and carefully in providing the advice and ensure that its advice and recommendations are based on thorough analysis and take into account available alternatives." (3.4);
 - (c) Know your client – in particular, the "client's financial situation, investment experience, and investment objectives" (5.1a);



- (d) "ensure the suitability of the recommendation or solicitation for that client is reasonable in all the circumstances" (5.2); and
- (e) when providing services to clients in derivative products to "assure itself that the client understands the nature and risks of the products and has sufficient net worth to be able to assume the risks and bear the potential losses of trading in the products" (5.3).

2.5.2 The Code of Conduct also imposes obligations on Intermediaries to ensure their staff are properly trained and supervised.



3. Provisional observations

- 3.1 The regulatory system has not, in this instance, provided adequate protection to all retail investors. Until the conclusion of the detailed investigations into selling institutions by the SFC, it will not be possible to conclude whether this failure is systemic across the industry or limited to specific failings in particular institutions.
- 3.2 The system as structured today, is a combination of disclosure and suitability, administered by two separate regulators, the SFC for disclosure and conduct for the broking industry, the HKMA for conduct of the banking industry.
- 3.3 The dual approach of disclosure combined with a suitability assessment by Intermediaries is common for all major jurisdictions. The system suffered on this occasion from a number of separate but related shortcomings:
- 3.3.1 the Companies Ordinance regime allows structured products to be sold and marketed to the Hong Kong public under a prospectus regime which allows for civil and criminal liabilities but provides little detailed guidance on disclosure specific to structured products;
 - 3.3.2 the liabilities provisions attached to prospectuses resulted in lengthy offering documents which were difficult for investors to digest without investment advice;
 - 3.3.3 whilst marketing materials directed investors' attention to the prospectus, over-reliance appears to have been placed on these marketing materials that were designed to create product awareness rather than to be used as a substitute for the prospectus; and
 - 3.3.4 there is evidence (preliminary at this stage) that some banks or brokers may have serious control failings at the due diligence and training levels and may have failed to ensure there were sufficient supervisory controls or records governing the point of sale process. In lay terms, this means some Intermediaries:
 - (a) did not institute proper management controls over the sales of Minibonds because they did not understand or assess the nature of the product;
 - (b) did not communicate or train front line staff about the product so as to be sure that front line staff would be able to assess the suitability of the product for investors and represent its key features consistently and in accordance with the Intermediary's assessment;
 - (c) provided deficient training or guidance to staff about the key features of the product, including, in some cases, misleading or inaccurate information about Minibonds; and
 - (d) did not monitor, supervise or control the content of point of sale discussions either by instituting adequate quality control mechanisms or ensuring staff were directed to maintain proper, contemporaneous records of each sales discussion.



3.4

It is important to stress that we are still conducting investigations (which remain at a preliminary stage) and whilst the observations above may hold true for some investors, it is not the case that all investors were missold and it appears likely that some complaints will not ultimately be substantiated.



4. Recommendations

4.1 Hong Kong's regulatory structure

4.1.1 **The Government should review whether the current regulatory structure is best suited to facilitate Hong Kong's further development as an international financial centre.**

4.1.2 Whilst the institutional structure of regulation may have been appropriate when there was a clear demarcation of the role of banks, brokers, insurance companies etc., the products are now converging but the conduct of sales in each industry is subject to different regulatory oversight. As part of this review we would recommend that a number of options are considered:

- (a) an integrated regulator such as the UK;
- (b) a Twin Peaks Approach to regulation where systemic risk and prudential oversight of key institutions is enshrined in one body whilst oversight of product disclosure and Intermediaries' conduct is in another; and
- (c) refine the current regulatory structure to cater for market developments and to reflect the lessons learnt from recent market crises.

4.2 Point of sale regulation

4.2.1 **Notwithstanding the overall review of regulatory structure recommended at 4.1, there should be a review of the structure of banking organisation where banks used their general bank deposit channels to help sell investment products.**

4.2.2 A major concern from our review has been that investment products were sold through normal banking channels, often by sales staff who appear to have had inadequate understanding of product features and risks. This review should cover both organisational structure and regulatory oversight of the selling/due diligence process as well as monitoring overall compliance with the Code of Conduct.

4.3 Product documentation

4.3.1 **The SFC has published proposals to amend the Securities and Futures Ordinance to include the prospectus requirements of the Companies Ordinance, as part of these amendments overall disclosure standards should be developed covering offering documents and marketing materials for investment products that are publicly offered.**

4.3.2 Under the existing statutory framework, there are two separate regimes entailing SFC authorisation of product documentation for investment products offered to the Hong Kong public (i.e., the Companies Ordinance prospectus regime and the offers of investments regime in Part IV of the



Securities and Futures Ordinance (Cap.571) ("SFO")). Under the SFO, the SFC has the flexibility to use its codes and guidelines to require issuers to meet certain product features and ongoing disclosure obligations.

- 4.3.3 Given the all-embracing definition of "debenture" in the Companies Ordinance and the potential for arbitrage between the two regimes work is already underway to bring forward amendments to the SFO so that the prospectus regime for shares and debentures is moved into the SFO. Whether this will be done by way of transferring the Companies Ordinance prospectus provisions to the SFO as a discrete part and excluding "structured products" from the definition of "debenture", or by way of a merger of the Companies Ordinance prospectus regime and the SFO offers of investments regime, should be re-considered.
- 4.3.4 Irrespective of whether there would be one or two offering regimes, there is a need for clearer product descriptions with prominent disclosure of risks and a common standard across the current broad range of products. We will also further develop our existing product disclosure and marketing guidelines. However, we would strongly recommend retaining a disclosure based regime coupled with conduct regulation of Intermediaries, which is the general standard for all international markets.
- 4.3.5 A common theme of complaints is that investors were not provided with information they could understand. Whilst the Minibond prospectuses had been drafted in plain language, because of the liability provisions attached to prospectuses, these are lengthy offering documents that may have been difficult for investors to digest without investment advice.
- 4.3.6 Investors should be provided with a summary explaining the nature of the investment product either in addition to the prospectus or offering document, or as part of it. This may present concerns as to prospectus liability for issuers. However, we note that many jurisdictions now require or are introducing rules to require summaries designed to be readily understood by investors.
- 4.4 Definition of professional investors
 - 4.4.1 **The SFC will review whether the "professional investor" definition and assessment criteria under its Code of Conduct remains appropriate.**
 - 4.4.2 Segmentation of investors occurs on both a statutory basis – through the SFO – and on an administrative basis whereby banks and brokers perform customer due diligence as a part of their obligation under the Code of Conduct. This investor segmentation process is a key component in determining the nature and types of any product that may be sold to a particular client. The SFC will review the "definitions" insofar as they are enshrined in statute or the Code of Conduct and work with HKMA to assess the adequacy of processes in banks and brokers.



4.5 Commission

4.5.1 **There should be disclosure at point of sales of the commissions, fees and other benefits that the Intermediary receives from the sale of products.**

4.5.2 Distributors of Minibonds and other similar investments received fees/commissions for the sale of these products. The SFC will review how fees and commissions can be better disclosed to investors and conflicts of interest mitigated.

4.6 Cooling off

4.6.1 **A cooling off period should be introduced following the sale of investment products.**

4.6.2 We consider it may be possible to introduce a cooling off period as currently exists in some insurance contracts. Similar requirements for a cooling off period are included in the SFC's Code on Investment-Linked Assurance Schemes and we would look to extending that concept to other products.

4.7 Dispute resolution

4.7.1 **The Code of Conduct should be amended to require client agreements to specify a right for clients to have their grievances resolved by a dispute resolution procedure and the Government should review the need for a financial ombudsman to provide for a dispute resolution procedure for aggrieved investors.**

4.8 Investor education

4.8.1 **We recommend that the Government appoints an Investor Education Council with a broad remit for educating the public in financial literacy.**

4.8.2 Among the current regulators in Hong Kong, only the SFC has explicit statutory powers to pursue investor education. Under the SFO, our mandate is to promote public understanding of the securities and futures markets, to help investors understand the benefits, risks and liabilities of investing and to promote the importance of making informed investment decisions. From the complaints received and our initial investigations it appears that investors did not fully appreciate or ask sufficient questions on risks and there is evidence of confusion as to the risks and the nature of the products.

4.9 The recommendations set out above are simply a summary of the major recommendations. Full recommendations and analysis are contained in the body of the report.



5. Comments on emerging trends from our investigations

- 5.1 In this report we make a number of references to the provisional conclusions from our investigations. These are caveated to avoid giving the wrong impression that we have either concluded our work or have in any way made judgements before our work is concluded. However, even with the caveats we would caution that if the comments on our investigations should find their way into the public domain this could prejudice the integrity of our investigations and any enforcement action which might flow from our investigations once they are completed.



Background and findings

Regulatory structure for financial supervision

6. Hong Kong's regulatory structure

6.1 Hong Kong's approach to financial supervision may be classified as an Institutional Approach¹ with functional characteristics. That is a firm's legal status, whether a bank, a broker or an insurance company, determines which regulator is tasked with overseeing its activity from both a safety and soundness and a business conduct perspective. The key regulators are:

- (a) the Hong Kong Monetary Authority ("HKMA");
- (b) the Securities and Futures Commission ("SFC");
- (c) the Insurance Authority ("IA"); and
- (d) the Mandatory Provident Fund Schemes Authority ("MPFA").

6.2 The HKMA is the government authority in Hong Kong responsible for maintaining monetary and banking stability. HKMA's policy objectives are:

- 6.2.1 to maintain currency stability within the framework of the Linked Exchange Rate system;
- 6.2.2 to manage the Exchange Fund;
- 6.2.3 to promote the safety and stability of the banking system. The Banking Ordinance (Cap. 155) ("BO") specifies that without limiting the generality of this objective the HKMA shall:
 - (a) be responsible for supervising compliance with the provisions of this Ordinance;
 - (b) take all reasonable steps to ensure that the principal places of business, local branches, local offices, overseas branches and overseas representative offices of all authorized institutions and local representative offices are operated in a responsible, honest and business-like manner;
 - (c) promote and encourage proper standards of conduct and sound and prudent business practices amongst authorized institutions and money brokers;

¹ See Appendix 1 that provides a summary of the four regulatory approaches discussed in the Group of Thirty report "The Structure of Financial Supervision Approaches and Challenges in a Global Marketplace" dated 6 October 2008. The Group of Thirty is a consultative group on international economic and monetary affairs. More information about the group can be found at its website www.group30.org.



- (d) suppress or aid in suppressing illegal, dishonourable or improper practices in relation to the business practices of authorized institutions;
- (e) co-operate with and assist recognized financial services supervisory authorities of Hong Kong or of any place outside Hong Kong, whenever appropriate, to the extent permitted by this or any other Ordinance;
- (f) consider and propose reforms of the law relating to banking business and the business of taking deposits; and
- (g) take all reasonable steps to ensure that any banking business, any business of taking deposits, or any other business, carried on by an authorized institution is carried on:
 - (i) with integrity, prudence and the appropriate degree of professional competence; and
 - (ii) in a manner which is not detrimental, or likely to be detrimental, to the interests of depositors or potential depositors; and

6.2.4 to maintain and develop Hong Kong's financial infrastructure².

6.3 The SFC's six regulatory goals are set out in the SFO:

- (a) keeping the securities and futures industry fair, efficient, competitive, transparent and orderly;
- (b) helping the public understand how the industry operates;
- (c) protecting the investing public;
- (d) minimising crime and misconduct in the markets;
- (e) reducing systemic risks in the industry; and
- (f) helping the Financial Secretary maintain financial stability in Hong Kong.

6.3.1 The SFC regulates:

- (a) **Intermediaries³** Brokers, investment advisers, asset managers and investment bankers subject to a licensing regime. They must first satisfy our criteria before dealing in securities or futures or giving investment advice. Their business must then comply with conduct and financial position obligations. Where banks conduct securities and futures business, the banks must be registered with the SFC as Registered Institutions but the HKMA oversees their compliance with SFO regulations.

²As set out in the HKMA's annual report.

³Intermediaries means Licensed Corporations and Registered Institutions.



- (b) **Public offers of securities** Listed companies and investment funds must meet disclosure and other rules to sell securities to the Hong Kong public. Offering documents and marketing materials for products offered to the public (other than for listed securities) are subject to SFC authorisation unless otherwise exempted.
 - (c) **Market operators** Hong Kong Exchanges and Clearing Limited ("HKEx"), the holding company of the Stock Exchange of Hong Kong Limited ("Stock Exchange"), Hong Kong Futures Exchange Limited and their related clearing houses, are directly overseen by the SFC. The SFC shares some of its regulatory responsibilities with the Stock Exchange, which oversees non-statutory rules relating to listed companies.
- 6.4 The IA is responsible for regulation and supervision of the insurance industry in Hong Kong. The principal functions of the IA are to ensure that the interests of policy holders or potential policy holders are protected and to promote the general stability of the insurance industry.
- 6.5 The MPFA's role is to ensure the provision of retirement protection for Hong Kong's workforce through an effective and efficient system of prudential regulation and supervision of privately managed provident fund schemes.
- 6.6 An overview of the division of labour between HKMA and the SFC in respect of the regulatory regime over banks that conduct securities business is set out below.
 - 6.6.1 The SFC has to authorize the issue of documents offering or marketing investment products⁴ before they can be offered to the Hong Kong public (see the discussion in section 8) and is the primary regulator for Licensed Corporations and their staff. The SFC does not directly regulate banks that are registered with the SFC as Registered Institutions ("Registered Institutions") or their staff even though Registered Institutions are registered with the SFC under the SFO.
 - 6.6.2 HKMA is the front line regulator for Registered Institutions and their staff.
 - 6.6.3 Staff of Registered Institutions (known as Relevant Individuals) are not required to be approved by the SFC or the HKMA. Although the HKMA enters their names in its Register of Relevant Individuals, it does not carry out any prior assessment of their fitness and properness. Instead it relies upon Registered Institutions to ensure that these staff members meet the requirements of the SFC's Guidelines⁵. The HKMA conducts background checks prior to registering staff members of Registered Institutions as Relevant Individuals, including checking with the SFC to ascertain whether it has recorded anything adverse concerning any particular individual. Following registration, the HKMA may also assess the on-going competence of a Registered Institution's staff during on-site examinations. In cases where a staff member of a Registered Institution is found not to be

⁴ Investment products includes securities (e.g., shares and debentures including structured notes), regulated investment agreements and collective investment schemes etc..

⁵ Fit and Proper Guidelines, the Guidelines on Competence and the Guidelines on Continuous Professional Training.



fit and proper, the HKMA may exercise its power to require the removal of such staff member from the Register.

- 6.6.4 The Memorandum of Understanding made between the SFC and the HKMA on 12 December 2002 ("MOU") (**Exhibit 1**) sets out how the SFC and HKMA shares responsibilities in respect of regulated activities conducted by Registered Institutions. The regulatory objective is that all Intermediaries should be subject to consistent regulatory measures.



Regime for regulation of sales of investment products to the Hong Kong public

7. Overview of regime

- 7.1 The regulatory structure for the sale of investment products in Hong Kong rests on 2 important pillars:
 - 7.1.1 the authorisation of product documentation that is principally directed at ensuring the adequacy of disclosure; and
 - 7.1.2 a requirement on the persons recommending or soliciting a product to ensure suitability of the product for the particular investor.
- 7.2 The 2 pillars are supported by enforcement against cases of non-compliance with requirements.
- 7.3 It is within this regulatory structure that the Hong Kong public is expected to make informed investment decisions regarding the suitability of a particular investment product using the information and advice provided.
- 7.4 This approach is consistent with other leading markets where the requirement is to ensure that a product is suitable for an investor and the assessment is made at the time of solicitation/recommendation⁶.

⁶ In April 2008, the Joint Forum (consisting of Basel Committee on Banking Supervision, International Organisation of Securities Commissions and International Association of Insurance Supervisors) published a report entitled "Customer Suitability in the Retail Sale of Financial Products and Services". The report considers how regulators and regulatees across banking, securities and insurance sectors deal with the risks posed by mis-selling of financial products including regulatory requirements to ensure adequate disclosure of information to investors and requirements for firms to ensure that investment products are suitable for investors. See Exhibit 2.



8. Regime for authorising product documentation

- 8.1 Where investment products are offered to the Hong Kong public, the offering documentation must be authorised by the SFC unless an exemption applies.
- 8.2 Under existing legislation the requirements for authorisation of product documentation are set out in the Companies Ordinance (Cap. 32) ("CO") and the SFO, which of these legislative requirements applies depends on the legal form of the investment product. Following public consultation in September 2006 the SFC announced proposals to transfer the prospectus requirements in the CO into the SFO. 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 third quarter of 2010 (and public consultation on the White Bill in mid-2009), it was felt appropriate to propose changes to Parts II and XII of the CO regarding prospectuses in tandem with the CO Rewrite Exercise.
- 8.3 Under both regimes, the regulatory focus for authorising documentation relating to investment products sold to the Hong Kong public is disclosure based rather than based on the commercial merits of the investment or its suitability to investors. Authorisation of product documentation does not contain or imply any recommendation from the SFC that the product is suitable for a particular investor. The duty to ensure that a product is suitable for an investor is the Intermediary's responsibility, which is described in section 10 below.
- 8.4 The authorisation requirements are complex and fragmented. A summary of these two separate regimes entailing SFC authorisation of offering documents in respect of offers of investment products or instruments to the investing public (i.e., the CO prospectus regime and the offers of investments regime in Part IV of the SFO) is set out below. A more detailed description of the authorisation requirements is set out in **Appendix 2**.
- 8.4.1 Shares and debentures (including structured notes) – CO prospectus regime
- (a) Where the security that is offered to the Hong Kong public is a share or a debenture, the document containing the invitation is a prospectus that must be authorised for registration in accordance with the requirements in the CO unless an exemption applies.
 - (b) Prospectuses of structured notes such as Minibonds, which are structured as debentures, are authorised by the SFC under the CO.
- 8.4.2 Securities and Regulated Investment Agreements ("RIAs") – section 105 of the SFO
- (a) Unless an exemption applies, any advertisement, invitation or document which invites the Hong Kong public to acquire or dispose of securities or to enter into a RIA⁷ must be authorised under section 105 of the SFO.

⁷ Regulated investment agreement is defined in Part 1 of Schedule 1 to the SFO as "an agreement the purpose or effect, or pretended purpose or effect, of which is to provide, whether conditionally or unconditionally, to any party to the agreement a profit,



- (b) Offering documents for products such as equity linked investments ("ELIs"), which are treated as securities/RIAs, are authorised under section 105 of the SFO.

8.4.3 Collective Investment Schemes ("CISs") – sections 104 and 105 of the SFO

- (a) Unless an exemption applies, CISs such as unit trusts and mutual funds offered to the Hong Kong public must be authorised under section 104 of the SFO.
- (b) Unless an exemption applies, offering documents and marketing materials for a CIS must be authorised under section 105 of the SFO before they can be issued to the Hong Kong public.

8.5 Exemptions from authorisation requirements

8.5.1 There are a host of, as well as a different set of, exemptions from the authorisation requirements under the SFO and the prospectus regime in the CO.

- (a) Exemptions from the CO prospectus regime are set out in the Seventeenth Schedule of the CO. Where one of these CO exemptions applies and a document is exempt from the prospectus requirements, the SFO requirements for a document to be approved do not apply. Exemptions in the Seventeenth Schedule include an offer:
 - (i) to not more than 50 persons;
 - (ii) with a minimum denomination of HK \$ 500,000;
 - (iii) with a maximum size of HK \$ 5 million; and
 - (iv) to professional investors.
- (b) Exemptions from the SFO authorisation requirements include:
 - (i) the issue of any advertisement, invitation or document by an Intermediary licensed or registered for Type 1, Type 4 or Type 6 regulated activities in respect of securities; and
 - (ii) the issue of any advertisement, invitation or document made in respect of securities, RIAs or CISs intended to be disposed of only to professional investors.
- (c) In the case of Minibonds, these exemptions were not relied upon as Minibonds were offered to the Hong Kong public and the Minibonds prospectuses were authorised by the SFC under the CO prospectus regime.

income or other returns calculated by reference to changes in the value of any property, but does not include an interest in a collective investment scheme".



- 8.6 The regulatory focus in the documentation authorisation process is on disclosure rather than on the commercial merits of the investment. The SFC vets prospectuses (such as the Minibonds prospectuses) against the content requirements in the Third Schedule to the CO based on the information provided by the issuer. Apart from the specific requirements in the Third Schedule, the CO also sets an overall disclosure standard that prospectuses must contain sufficient information to enable a reasonable person to reach a valid and justifiable opinion of the shares or debentures⁸. Under the CO, if the statutory criteria are satisfied, the SFC has discretion to waive compliance with the requirements of the Third Schedule and to impose conditions. The waivers granted by the SFC are posted on the SFC website as required under the CO.
- 8.7 In applying the authorisation requirements for CISs under the SFO provisions, the SFC refers to product codes and guidelines it has issued in respect of the more commonly available types of CISs. Although these codes and guidelines do not have the force of law, they set out the bases for the authorisations including disclosure requirements and, in some cases, structural features which are broadly in line with international practices and standards. For example, the SFC has issued the Code on Unit Trusts and Mutual Funds that established guidelines for the authorisation of CISs in the form of unit trusts and mutual funds.
- 8.8 Where there are no specific codes or guidelines (e.g., for authorisation requirements under section 105 of the SFO), to prevent potential regulatory arbitrage, the SFC will draw reference from requirements that are applied to products that have similar risk and reward exposures. An example is ELIs the offering documents and marketing materials of which are authorised under section 105 of the SFO. In these cases, the SFC refers to the approach applied to prospectuses for structured notes that are authorised under the CO as both products have similar risk and reward exposures.
- 8.9 Apart from product offering documentation, marketing materials also need to be authorised under the relevant provisions in the law unless an exemption applies. The SFC has issued guidelines governing the disclosure standards for marketing materials of the more commonly available types of CISs authorised by the SFC as well as guidelines that the SFC has regard to when vetting marketing materials of shares and debenture offerings under the CO. Although these guidelines may not have the same specific requirements, they share the same overarching principle that the materials should not be false, biased, misleading and must carry proper risk warnings.
- 8.10 There are also differences in respect of requirements for on-going disclosures and issuer eligibility in respect of offers of shares and debentures, securities and RIAs and CISs.
- 8.10.1 In the case of the more commonly available types of CISs authorised under section 104 of the SFO, the SFC has set out specific requirements in product codes for on-going disclosures and structural features such as issuer/manager eligibility. These requirements are imposed in authorising the CIS.
- 8.10.2 Unlike a CIS where the scheme itself must be authorised by the SFC under section 104 of the SFO prior to it being offered to the public, there is no requirement or power for the SFC to "authorise" the shares, debentures or RIAs offered to the Hong Kong public.

⁸ Paragraph 3 of the Third Schedule to the CO.



8.10.3

Section 105 of the SFO and the CO do not have statutory requirements on on-going disclosures and structural features as unlisted products normally do not have a secondary trading market. Investors are warned that there might not be liquidity in their investments and, as disclosed in the prospectus or offering document, investors are expected to hold these products to maturity. Instead, in vetting the disclosures, the SFC will draw reference from requirements on products with similar risk and reward profiles. For example:

- (a) as a matter of practice, an issuer would, in response to inquiries raised by the SFC during the document vetting process, represent in the offering documents of ELIs that it will make disclosure of information to avoid the establishment of a false market or which may significantly affect the ability of the issuer to make payment on the products; and
- (b) the issuer of an ELI or an equity-linked note ("ELN") will need to meet the eligibility criteria set out in Chapter 15A of the Main Board Listing Rules of the Stock Exchange for issuers of structured products.



9. Licensing or registration requirements for persons that sell products to the Hong Kong public

9.1 Corporations carrying on regulated activities⁹ must be licensed or registered under the SFO.

9.1.1 There are 2 types of legal entities which may be licensed by or registered with the SFC to carry on business in a regulated activity, namely:

- (a) A corporation licensed by the SFC for the regulated activity (i.e., a Licensed Corporation); and
- (b) A bank (or authorised financial institution) registered with the SFC for the regulated activity (i.e., a Registered Institution).

9.1.2 Each Licensed Corporation or Registered Institution must have at least two individuals who are approved by the SFC or have obtained consent from the HKMA (as the case may be) for each regulated activity for which it is licensed or registered. They are known as "Responsible Officers" for Licensed Corporations and "Executive Officers" for Registered Institutions and are responsible for directly supervising the conduct of the entity's regulated activities.

9.1.3 Individuals who carry on a regulated activity for a Licensed Corporation must be licensed by the SFC (i.e., Licensed Representatives). Staff employed by a Registered Institution to conduct regulated activities are not required to be approved by the SFC or the HKMA. Their names are entered in the HKMA's Register of Relevant Individuals (i.e., Relevant Individuals).

9.1.4 Applications for a licence or registration may only be granted if the SFC or the HKMA is satisfied that the applicant is "fit and proper" (except for Relevant Individuals who are not approved by the SFC or the HKMA). In determining whether a person is fit and proper, the SFC and the HKMA will have regard to a number of specified factors which are set out in the SFO and the guidelines published by the SFC that elaborate on these factors.

9.2 Licensed Corporations

9.2.1 Applications from corporations to be licensed, their proposed Responsible Officers and Licensed Representatives involve the submission of formal application documents, which are assessed and approved by the SFC.

⁹ There are 9 types of regulated activities listed in Schedule 5 to the SFO:

Type 1: dealing in securities
Type 2: dealing in futures contracts
Type 3: leveraged foreign exchange trading
Type 4: advising on securities
Type 5: advising on futures contracts
Type 6: advising on corporate finance
Type 7: providing automated trading services
Type 8: securities margin financing
Type 9: asset management



- 9.2.2 In considering applications for approval as a Responsible Officer and for a representative licence, the SFC assesses the applicants' fitness and properness with reference to relevant statutory provisions and guidelines published by the SFC and then makes a decision as to whether or not to issue a licence.
- 9.3 Registered Institutions
- 9.3.1 The process of registration of a Registered Institution requires collaboration between the SFC and the HKMA. On receiving an application from a bank to be registered to carry on regulated activities, the SFC refers the application to the HKMA. The HKMA, after considering the application, consults the SFC on the merits of the application and advises the SFC as to whether it is satisfied that the applicant is fit and proper. The SFC then makes its determination in relation to the application.
- 9.3.2 After registration, the Registered Institution is supervised and regulated by the HKMA as the front line supervisor. The SFC is responsible for making rules and publishing codes and guidelines which may be applicable to both Registered Institutions and Licensed Corporations. The SFC may also investigate if a complaint is referred to it by the HKMA and this may lead to disciplinary action. However, if the SFC proposes to exercise its powers under the SFO and the person concerned is a bank or an officer of a bank the SFC must first consult HKMA.
- 9.3.3 An intended Executive Officer must seek the consent of the HKMA to have this status conferred upon him. The decision whether to give a person Executive Officer status is made by the HKMA. The HKMA advises the SFC of the names of the Executive Officers whom it has approved. These individuals are identified in the SFC's public register as the Executive Officers of the relevant Registered Institutions.
- 9.3.4 Staff employed by a Registered Institution to conduct regulated activities are not licensed or otherwise approved by the SFC. Registered Institutions are required to ensure that its Relevant Individuals meet the Fit and Proper Guidelines, the Guidelines on Competence and the Guidelines on Continuous Professional Training issued by the SFC. HKMA will conduct background checks on them with the SFC and other relevant agencies if necessary but will not assess the fitness and properness of Relevant Individuals prior to placing their names on the register. HKMA will decide whether to include a person's name in the HKMA's Register of Relevant Individuals. The names of these individuals do not appear in the SFC's public register of licensed persons.
- 9.4 A detailed description of the SFC's licensing requirements is set out in **Appendix 3**.



10. Conduct requirements on Licensed Corporations and Registered Institutions

10.1 Basic conduct principles

- 10.1.1 The conduct of Intermediaries is governed by the Code of Conduct. The basic conduct principles and requirements for selling and advising on investment products in the Code of Conduct are summarised in **Appendix 4**.
- 10.1.2 Nine general principles set out in the Code of Conduct underpin the conduct of securities business in Hong Kong. They impose general requirements of honesty, fairness and due diligence on Intermediaries and their staff who perform regulated activities.
- 10.1.3 The Code of Conduct also stresses that Intermediaries have obligations to act in the best interests of both clients and the market and makes clear that the primary responsibility lies with senior management. This requirement is reinforced under "The Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the SFC" ("Internal Control Guidelines"). The Internal Control Guidelines state that the primary duty to ensure that an Intermediary has proper and sufficient controls in place so that regulatory requirements are complied with lies with senior management of the firm.
- 10.1.4 Under more detailed requirements, the Code of Conduct obliges Intermediaries to ensure that staff are fit and proper, properly trained and supervised and places the responsibility on Intermediaries for the acts and omissions of their staff and agents.

10.2 Specific point of sale requirements

- 10.2.1 With respect to point of sale requirements, the Code of Conduct sets out 2 specific requirements for Intermediaries. These are the requirements for an Intermediary:
 - (a) when making a recommendation or solicitation, to ensure the suitability of the recommendation or solicitation for that client is reasonable in all the circumstances. The suitability requirement under the Code of Conduct is pivotal to guiding the selling practices of investment products by Licensed Corporations and Registered Institutions (5.2 of the Code of Conduct); and
 - (b) when providing services to a client in derivative products (including futures contracts or options, or any leveraged transaction) to assure itself that the client understands the nature and risks of the products and has sufficient net worth to assume the risks and bear the potential losses of trading in the products (5.3 of the Code of Conduct).

- 10.3 The requirement on an Intermediary to ensure suitability of the recommendation or solicitation of a product for a client under 5.2 of the Code of Conduct may be waived for clients who meet specific criteria (i.e., professional investors). This is discussed further in section 12 below. However, irrespective of who the client is the requirement in 5.3 of



the Code of Conduct must be complied with if the Intermediary is providing services to the client in respect of a derivative product such as Minibonds.



11. Regulatory supervision of Licensed Corporations and Registered Institutions

11.1 Supervision of Licensed Corporations

11.1.1 SFC Licensed Corporations are subject to inspection to assess their general compliance with applicable legal and regulatory requirements. Moreover, 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.

11.1.2 In recent years, the SFC has conducted a number of themed inspections on SFC licensed investment advisors focusing on their selling practices and has taken enforcement action where appropriate. In one of the themed inspections, the SFC has also worked with the HKMA with a view to having a more consistent and unified inspection approach and yardstick for assessing compliance of selling practices requirements by the Licensed Corporations and Registered Institutions. The number of SFC licensed investment advisors inspected covered by these themed inspections in the past years are:

2004	15
2006	10
2007	4
2008	9

11.1.3 In February 2005, the SFC issued the first themed inspection report on the selling practices of investment advisors and provided its key inspection findings. In May 2007, the SFC published its second themed inspection report and FAQs on suitability obligations setting out some practical considerations that investment advisers should take into account when seeking to comply with the standards of conduct expected of them ("FAQs").

11.2 Supervision of Registered Institutions

11.2.1 As mentioned above, banks carrying on regulated activities in Hong Kong require registration with the SFC as Registered Institutions. The SFC is responsible for granting or refusing applications by Registered Institutions to be registered to carry on a regulated activity but shall have regard to any advice given to it by the HKMA and may rely wholly or partly on that advice in making the decision.

11.2.2 In general, Registered Institutions are subject to the legal and regulatory requirements under the SFO in the same way as SFC Licensed Corporations in respect of their regulated activities.

11.2.3 The HKMA is the front line supervisor of Registered Institutions, their relevant individuals and persons involved in the management of any regulated activity. The HKMA is responsible for day-to-day supervision of the performance by them of regulated activities, including on-site inspections, review of information submitted by Registered Institutions and handling of complaints against Registered Institutions.



11.3 Policing and Enforcement

- 11.3.1 The policing and enforcement of point of sale advice is governed by provisions under the SFO that:
- (a) create criminal offences;
 - (b) create civil remedies that are enforced by the courts; and
 - (c) empower the SFC to make rules and regulations that are enforced by way of disciplinary proceedings conducted by the SFC.
- 11.3.2 Advice in connection with the sale of an investment product which does not meet the standards set down by the statutory and regulatory regime in force is generally referred to as "misselling".
- 11.3.3 Misselling usually involves misrepresentation or negligent advice about an investment product given by an Intermediary to a client. This:
- (a) may occur in the form of inaccurate marketing materials or oral representations;
 - (b) usually involves an Intermediary making inaccurate claims as to the risk involved in investing in the product or the potential returns that can be made;
 - (c) may involve negligent advice or the omission of advice about an investment; and/or
 - (d) may involve a failure to take reasonable care or reasonable steps to ensure that an investment product is suitable for the client's overall circumstances.
- 11.3.4 The SFC is empowered to commence disciplinary proceedings against:
- (a) Licensed Corporations, their Responsible Officers, their Licensed Representatives and persons involved in the management of their businesses; and
 - (b) Registered Institutions, their Executive Officers, their Relevant Individuals and persons involved in the management of their businesses
- if they are guilty of misconduct or are found to be no longer fit and proper to remain regulated¹⁰. Evidence of the failure to comply with the provisions of the Code of Conduct will be relevant here.
- 11.3.5 Following disciplinary proceedings, the SFC may impose one or more of the following sanctions (as the case may be):
- (a) revocation or suspension of licence;

¹⁰ Section 194 of the SFO for Licensed Corporations and Licensed Representatives. Section 196 of the SFO for Registered Institutions and Relevant Individuals.



- (b) prohibition order, that is, prohibiting the entity or the person from:
 - (i) applying to be licensed or registered;
 - (ii) applying to be approved as a Responsible Officer of Licensed Corporation;
 - (iii) applying to be given consent to act as an Executive Officer of a Registered Institution;
 - (iv) seeking through a Registered Institution to have his name entered into the register maintained by the HKMA under section 20 of the BO;
- (c) fines up to HK \$ 10 million or three times the profit made or loss avoided for the conduct; and
- (d) public or private reprimand.

11.3.6 However 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 HKMA under sections 58A and 71C of the BO.

11.3.7 The Securities and Futures Appeals Tribunal has the jurisdiction to review disciplinary decisions of the SFC.

11.3.8 There are also SFO provisions which create offences in respect of the issuing of advertisements, and/or invitations or documents relating to investments to the Hong Kong public (unless exemptions apply). These matters may be brought before the criminal courts by the SFC. Other provisions in the SFO provide a process and remedies in respect of civil market misconduct where disclosure of false or misleading information about securities is likely to induce transactions. (Where the civil route is adopted, the Financial Secretary may refer the matter to the Market Misconduct Tribunal which has broad powers to inquire and impose sanctions in appropriate cases.) **Appendix 5** sets out the key statutory provisions which, *inter alia*, empower the SFC to police and enforce statutory provisions and regulations by way of criminal proceedings or civil action.



12. Who is a retail investor?

- 12.1 The concept of "retail" or "retail investor" is not recognised in the SFO or the CO. The authorisation requirements apply only when offers are made to the Hong Kong public. The regulatory regime operates with carve-outs and exemptions, including when services or products are offered to "professional investors". Accordingly, there is a public offering when a product is offered to persons other than those falling within an exemption.
- 12.2 There are 2 types of professional investors under the SFO:
- 12.2.1 market professionals - these are the specified entities set out in paragraphs (a) to (i) in Part 1 of Schedule 1 to the SFO including investment banks, brokers and managers of authorised funds; and
 - 12.2.2 high net worth investors – these are persons (entities and individuals) who have been prescribed under the Securities and Futures (Professional Investors) Rules ("the PI Rules") as professional investors. These include high net worth individuals with a portfolio of not less than HK \$ 8 million (or the equivalent in foreign currency).
- 12.3 The authorisation requirements under the CO prospectus regime as well as under the SFO are exempted when an offer is made to professional investors only (including both the market professionals and the high net worth investors).
- 12.4 Certain Code of Conduct requirements (e.g., the suitability requirement in 5.2) may be waived for clients who are market professionals. However, for high net worth investors, additional experience-and-knowledge criteria must be established before these Code of Conduct obligations can be waived.
- 12.5 To fulfil the experience-and-knowledge criterion, the Intermediary must be able to demonstrate that a client, who has met the wealth criterion, is knowledgeable and has sufficient experience in the relevant products and markets and he has chosen to be treated as a professional investor. The process and the matters which the Intermediary must use in assessing a high net worth investor as a professional investor are set out in the Code of Conduct¹¹. The Intermediary must also have procedures in place to enable it to carry out a confirmation exercise annually to ensure that the client continues to meet the wealth criterion.
- 12.6 The Code of Conduct requirements which may be waived for professional investors include the suitability requirements in 5.2. However, even where the client is a professional investor the Intermediary must comply with the requirement in 5.3 of the Code of Conduct, that an Intermediary providing services to clients in derivative products such as Minibonds is required to assure itself that the client understands the nature and risks of the products and has sufficient net worth to be able to assume the risks and bear the potential losses of trading in the products.

¹¹ 15.3 and 15.4 of the Code of Conduct.



Impact of failure of Lehman Brothers Holdings Inc on Hong Kong investors

13. Lehmans in Hong Kong

- 13.1 Founded in 1850, Lehman Brothers was the world's fourth largest investment bank, and a leader in equity and fixed income sales, trading and research, investment banking, private investment management, asset management and private equity. The firm was headquartered in New York and operated in a network of offices around the world including Hong Kong.
- 13.2 On 15 September 2008, Lehman Brothers Holdings Inc. ("Lehman Holdings") filed a petition in the United States Bankruptcy Court for the Southern District of New York seeking relief under Chapter 11 of the United States Bankruptcy Code. Lehman Holdings' assets were frozen by this biggest bankruptcy proceedings in history.
- 13.3 In Hong Kong, Pacific International Finance Limited ("Pacific"), a Cayman Islands-incorporated special purpose vehicle issuer¹², issued approximately HK \$ 13.9 billion of unlisted credit-linked notes called Minibonds to Hong Kong's retail investors, which were arranged by a Hong Kong subsidiary of Lehman Holdings. Minibonds were linked to the credit of companies including HSBC, Hutchison Whampoa, DBS Group Holdings Ltd., Swire Pacific Ltd., Sun Hung Kai Properties Ltd., Goldman Sachs Group Inc. and Morgan Stanley. A total of 32 series of Minibonds have been issued¹³.
- 13.4 When Lehman Holdings filed for bankruptcy three of the 32 series of Minibonds had matured and one series had been the subject of an early call. In respect of these four series investors were repaid the principal amount of their investments amounting to approximately HK \$ 1.3 billion. There remained Minibonds with a nominal value of HK \$ 12.6 billion in the hands of approximately 34,000¹⁴ investors.
- 13.5 Other special purpose vehicles, namely, Atlantic International Finance Limited ("Atlantic") and Pyxis Finance Limited ("Pyxis"), also issued approximately HK \$ 150 million of unlisted fund-linked and equity-linked notes to the Hong Kong public that were also arranged by a Hong Kong subsidiary of Lehman Holdings.
- 13.6 Minibonds issued by Pacific, the fund-linked notes issued by Atlantic and the equity-linked notes issued by Pyxis were all arranged by Lehman Brothers (collectively referred to as "Lehman-arranged notes"). These Lehman-arranged notes were secured by collateral issued by Lehman Brothers or third parties, and swap arrangements guaranteed by Lehman Holdings. Hence these investment products relied on Lehman Holdings to continue.

¹²Pacific is what is commonly referred to as an orphan SPV. The characteristic of an orphan SPV is that it is not owned by, or legally controlled by, the person for whose special purpose it has been established - while, at the same time, that person (sometimes called "the arranger") should be able to rely upon the fact that, in practice, the SPV will carry out the transaction or transactions into which it is expected to enter in a manner which is predictable.

¹³Series 4 was not issued due to 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 numbers are believed by many to be unlucky and inauspicious.

¹⁴Based on the number of accounts at Banks and Licensed Corporation holding Minibonds. There may be duplication if customers hold Minibonds in more than one account



- 13.7 The Lehman-arranged notes were sold to the Hong Kong public through distributors which were Licensed Corporations or Registered Institutions. In total 20 banks and 3 brokers acted as distributors for the series of Minibonds still held by investors when Lehman Holdings filed for bankruptcy protection (A list of these banks and brokers is set out in Appendix 6). Other entities may have sold Minibonds to investors as issuers reserved the right to distribute their bonds through other channels and distributors may have appointed sub-distributors.
- 13.8 In addition to the Lehman-arranged notes, banks sold other Lehman's products that did not require prior approval as they fell within one of the exemptions referred to in 8.5 above. According to the information provided by the HKMA to the Legislative Council pursuant to its House Committee special meeting on 13 October 2008 these products with a nominal value of some HK \$6.2 billion were held in 6,130 different client accounts.
- 13.9 When Lehman Holdings filed for Chapter 11 on 15 September 2008, Lehman Holdings had 134 derivative warrants listed on the Stock Exchange; only 114 of these had warrants held by investors. Trading in these warrants was suspended on 16 September and they remained suspended. The market value of Lehman Holdings warrants held by investors at the close of the market before the suspension was HK \$ 21.7 million. As at 30 November, 2008, 54 warrants had since expired out-of-the-money and of the remaining 60 Lehman Holdings derivative warrants only 4 are in-the-money.



14. Lehman linked instruments

14.1 There were other credit-linked notes issued by third parties which were linked to Lehman's credit (collectively referred to as the "Lehman-linked notes"). These Lehman-linked notes were issued by:

14.1.1 Victoria Peak International Finance Limited arranged by Morgan Stanley - approximately HK \$ 408 million outstanding;

14.1.2 Constellation Investment Limited arranged by DBS Bank - approximately HK \$ 2.45 billion outstanding; and

14.1.3 SPARC Limited arranged by UBS - approximately HK \$ 49 million outstanding.

14.2 As with the Lehman-arranged notes, the Lehman-linked notes were sold to the Hong Kong public through distributors which were Licensed Corporations or Registered Institutions.

14.3 Similar Lehman related products were sold overseas.

14.3.1 In Asia examples include:

- (a) Lehman-arranged CLNs sold under the name Minibonds are only found in Hong Kong and Singapore. Lehman-linked CLNs were also sold in Hong Kong, Singapore and Indonesia.
- (b) Taiwan's Financial Supervisory Commission reported that domestic financial institutions, including banks, securities firms, fund managers and insurance firms, were holding Lehman related products totalling NT \$ 40 billion in value, while their wealth management clients also held some NT \$ 40 billion worth of Lehman related structured notes.

14.3.2 In Europe examples include:

- (a) Lehman issued products were sold in Spain. Protestors claim that almost 3,500 Spanish investors have lost a combined EUR 3 billion after investing in products issued by Lehman Brothers under advice from Spanish private banks.
- (b) In Germany, the product with the name "Zertifikate", or Certificate in English, was sold by banks to around 60,000 small investors, according to the Berlin-based German Institute for Investor Protection. The overall losses are said to be up to EUR 500 million. These Certificates are structured financial products in the form of bearer instruments of Lehman Brothers and the returns are linked to the performance of certain stocks or indices.

14.3.3 In the USA examples include:

- (a) Lehman issued Principal Protected Notes designed to return the principal invested at maturity along with gains from a broad index such as S&P 500. These were unsecured debts of Lehman Brothers.



According to StructuredRetailProducts.com Lehman Brothers sold over US \$ 900 million of retail structured products in 2008.



- 15. Impact of Lehman's failure on Lehman-arranged notes and Lehman-linked notes**
- 15.1 For the Lehman-arranged notes, the bankruptcy filing of Lehman Holdings could result in the early termination of the swap arrangements and thus the early redemption of the Lehman-arranged notes. Under the terms and conditions of 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.
- 15.2 For the Lehman-linked notes, Lehman Holdings' Chapter 11 filing amounted to a credit event, and the Lehman-linked notes have been or would be early terminated. The issuers of these Lehman-linked notes have advised noteholders through the distributors that they would be recovering or could expect to recover none (and for a few series, less than 10%) of their investment.
- 15.3 For the products issued by Lehman Holdings (including those described in 13.8 and 13.9), any amounts owed in respect of such products will be unsecured claims that will be paid, if at all, only after secured claims have been paid in the amount allowed by the US bankruptcy law. It is likely that holders of such products may not be able to recover much of their investments.



16. What is a Minibond?

- 16.1 Minibonds is the name used to describe credit linked notes ("CLNs") issued by Pacific, which were arranged by a Hong Kong subsidiary of Lehman Holdings. These CLNs are structured debt instruments under which payments of interest, principal or both, are affected by, amongst other things, the occurrence of a credit event on a basket of companies (referred to as reference entities) such as HSBC, Hutchison Whampoa, DBS Group Holdings Ltd., Swire Pacific Ltd., Sun Hung Kai Properties Ltd., Goldman Sachs Group Inc. and Morgan Stanley. Credit events normally include situations where an entity in the basket of reference entities becomes insolvent or fails to repay loans etc..
- 16.2 Minibonds are secured on collateral and swap arrangements with another Lehman subsidiary guaranteed by Lehman Holdings. Funds raised were used to purchase collateral that was AAA rated at the time of purchase.
- 16.3 Complexity of the structure of a product does not necessarily mean that the product is an unduly risky investment in normal market conditions. The risks associated with Minibonds were set out in some detail in the prospectuses that provided general warnings to investors in plain language:
- 16.3.1 "Our Notes are not principal protected; you could lose part, and possibly all, of your investment";
- 16.3.2 "Our notes are not suitable for everyoneBefore applying for any of our Notes, you should consider whether our notes are suitable for you in light of your own financial circumstances and investment objectives. If you are in any doubt, get independent professional advice."
- 16.4 In addition, the prospectuses included disclosures advising investors as to specific risks.
- 16.4.1 Credit event of a reference entity - as Minibonds are linked to the credit risk of the reference entities, when there is a first credit event by one of the reference entities of Minibonds there will be early termination. The redemption price is calculated by reference to the price of the borrowing obligations of the reference entity which has suffered the credit event. Usually, the price of borrowing obligations of the affected entity will drop when the circumstances leading to the credit event becomes known. The value of Minibonds and amount holders receive is likely to be less or significantly less than their principal investment.
- 16.4.2 Early termination - when there is early redemption the swap arrangements will be early terminated and the collateral will be sold to make payment. Holders will only receive their share of the proceeds from the sale of the collateral after other payments. If there is a termination amount payable under the swap, the swap counterparty's claims against the collateral will be paid ahead of the Minibond holders' claims. As the only assets which back Minibonds are the collateral and swap arrangements, the amount eventually received by holders may be significantly less than the principal amount of Minibonds held by them.



16.4.3 Early redemption occurs when:

- (i) there is a credit event (see 16.4.1);
- (ii) there is an event of default under Minibonds;
- (iii) the collateral or the underlying securities of the collateral is repaid early;
- (iv) Cayman Islands (where Pacific is incorporated) imposes taxes on Pacific or Minibonds; or
- (v) the swap arrangements are terminated due to, e.g., liquidation of the swap counterparty.

16.4.4 Decline in market value of the collateral – the market value of the collateral depends on its liquidity. Although the collateral was AAA rated at the time it was purchased, its credit rating and value may decline subsequently. In the event of an early redemption, the collateral will be sold to make the redemption to holder. Holders will only receive their share of the proceeds from the sale of the collateral after other payments. If the market value of the collateral falls (e.g., when the credit quality of the collateral falls), the amount a holder will receive may be less or significantly less than the principal amount.

16.4.5 Where the collateral consists of collateralised debt obligations (“CDO”) and there is an early termination of the CDO arising from credit events of its reference entities, there would be an early termination of Minibonds even though no credit event has occurred to any of the Minibond reference entities.

16.4.6 Holders may not be able to sell their Minibonds or they may receive less than the amount invested if they sell their Minibonds before maturity as there is no liquid trading market for Minibonds.



Nature of complaints

17. Complaints to SFC

17.1 Summary of complaints

17.1.1 As of 30 November 2008, the SFC had received 8,055 complaints related to Lehman Brothers. The majority (7,537) were received via the Democratic Party. Of the 8,055 complaints, 5.9% of them related to Licensed Corporations, product regulation or were complaints against the SFC (collectively "the SFC's area of responsibility").

17.1.2 The following is a breakdown of the complaints:

Complaints relating to SFC's area of responsibility	473
Complaints relating to banks and passed/being passed to HKMA	7,712
Total number of complaints related to Lehman Brothers [#]	8,055

Note: [#] Some complainants covered areas relevant to both SFC and HKMA, and therefore the figures above do not add up.

17.2 Nature of complaints against Intermediaries

17.2.1 Among the total of 8,055 complaints, 7,799 complaints were made against specific Intermediaries and/or their staff, out of which 7,712 were against distributor banks (i.e., Registered Institutions).

17.2.2 The most common allegations against banks include:

- (a) front line staff proactively induced complainants to turn their matured fixed deposits into investments in Lehman related products for higher returns and other incentives such as free shopping coupons;
- (b) front line staff failed to consider the complainants' risk profile and personal circumstances when selling products, particularly in the case of the retired, elderly, less-educated and less-sophisticated, and risk adverse clients;
- (c) front line staff did not provide product information (e.g., term sheets and prospectuses), nor did they explain product features and risks at the point of sales. Some even misrepresented that the products, especially Minibonds, were risk-free, just like fixed deposits;
- (d) front line staff only highlighted the well-known reference entities of Minibonds, emphasizing that the risk of Minibonds was only tied to the credit risk of these reference entities without mentioning the role of and the risk associated with Lehman Holdings; and
- (e) banks did not respond to complainants' enquiries and complaints after the collapse of Lehman Brothers.



- 17.2.3 The SFC refers all complaints against banks to the HKMA. So far, we have passed 6,954 complaints to the HKMA.
- 17.2.4 In addition, there were 87 complaints alleging misselling by SFC licensees. The most common allegations include:
 - (a) distributors of Minibonds had misrepresented that they were low-risk products; and
 - (b) distributors did not disclose the role of Lehman Brothers.
- 17.3 Allegations against the SFC include:
 - 17.3.1 SFC should not have approved such sophisticated structured products for marketing to retail investors with low investment knowledge (see discussion in section 24);
 - 17.3.2 SFC should not have allowed the product to be called Minibonds, which misled investors into thinking that they were low-risk (see discussion in section 25.2);
 - 17.3.3 SFC should not have approved misleading advertisements of these products, which did not clearly spell out the role of Lehman Brothers and the design led readers to focus on the reference entities only whereas Lehman Brothers just appeared in very small plain print (see discussion in section 28); and
 - 17.3.4 SFC should have verified the contents of the prospectuses which did not disclose detailed information about the collaterals and swap arrangements (see discussion in section 24).



Investigations

18. SFC's investigatory approach

- 18.1 The SFC has commenced investigations into each Registered Institution (where the HKMA has opened a case into a complaint and referred it to us) and Licensed Corporation involved in selling Minibonds and Lehman related products. Our objectives are:
- 18.1.1 to respond quickly to the maximum number of complaints in the shortest possible time; and
 - 18.1.2 to obtain a full and proper understanding of the position of each organization without taking short cuts that will prejudice our assessment or our legal obligations to act fairly.
- 18.2 These investigations are complex, wide-ranging, likely to discover similar issues and trends, require centralised co-ordination and need to follow a consistent approach. Accordingly in the first instance we will deal with each Licensed Corporation and Registered Institution scrutinizing the selling process within each organization on a top down basis examining key issues such as:
- 18.2.1 the management controls;
 - 18.2.2 the due diligence process;
 - 18.2.3 the training and supervision of sales staff;
 - 18.2.4 the record keeping; and
 - 18.2.5 the procedures used at point of sale especially the way in which suitability was determined.
- 18.3 This approach will also enable us to answer the obvious forensic question that arises from so many complaints, namely is there a systemic problem in the sale of these products to be identified and remedied. This approach is consistent with the SFC's overall enforcement strategy as exemplified in the SFC's published guidelines on fines¹⁵. The guidelines make it clear that the SFC's assessment of the amount of a penalty involves an assessment of *the whole of the conduct* in question. For example, relevant factors identified in the guidelines include:
- 18.3.1 the impact of the conduct on the integrity of the market;
 - 18.3.2 whether significant losses have been incurred by clients or the investing public generally;
 - 18.3.3 whether the conduct is widespread;
 - 18.3.4 whether the conduct was engaged in by the whole firm or only by an individual; and

¹⁵ The SFC's Disciplinary Fining Guidelines.



- 18.3.5 whether the conduct reveals serious or systemic weaknesses in respect to management systems or internal controls.
- 18.4 The SFC has now commenced investigations into each Registered Institution (where the HKMA has opened a case into a complaint and referred it to us) and Licensed Corporation. As at 30 November 2008, the HKMA had referred 186 individual complainants (out of a total number of 2,788 complaints which it has opened for investigation) whose complaint appears to warrant further work by the SFC. The SFC expects to receive referrals from HKMA for many months to come as HKMA processes the increasing volume of individual complainants.
- 18.5 As described above the HKMA is the frontline regulator of Registered Institutions and is responsible for the day-to-day supervision of the performance of regulated activities by Registered Institutions.
- 18.5.1 Under the MOU, in the first instance, the HKMA investigates complaints against Registered Institutions. Where the HKMA considers it to be appropriate the HKMA refers to the SFC as soon as reasonably practicable those complaints against Registered Institutions that appear to relate to the SFC's functions under the SFO.
- 18.5.2 The SFC and the HKMA consult one another as appropriate in relation to complaints.
- 18.5.3 The SFC reviews all cases referred to it by the HKMA and takes such action as it considers appropriate.
- 18.6 When the HKMA refer cases to the SFC what is provided is, in essence, a complaint summary/assessment. This is a useful starting point. The cases referred by the HKMA then require formal investigation by the SFC. This will normally include compelling production of relevant documentation (which will often be voluminous and complex), interviewing witnesses/suspects and then analysing the evidence obtained.



19. **SFC's investigations: Emerging trends**
- 19.1 Inevitably some of the investigations are more advanced than others. All investigations are ongoing and so it is inappropriate to draw any conclusions from the investigation work undertaken to date. At best, it is possible to identify some trends or themes that are emerging and which continue to be explored.
- 19.2 For the avoidance of any doubt it is important to emphasise that the SFC has not reached any conclusions in respect of the matters under investigation, still less on whether any formal enforcement action should be commenced and if so the type of any such action. These are all matters which may fall to be considered in the future, once the investigations are concluded.
- 19.3 The SFC is continuing with the investigations with an open mind.
- 19.4 Strictly subject to these qualifications, the following can be identified as trends or themes emerging from the investigations.
- 19.5 A potential conclusion, on a preliminary and tentative basis, is that there is evidence some Registered Institutions or Licensed Corporations may have serious control failings at the due diligence and training levels and may have failed to ensure that there were sufficient supervisory controls or records governing the point of sale process. In lay terms, this means some Registered Institutions or Licensed Corporations:
- 19.5.1 did not institute proper management controls over the sales of Minibonds because they did not understand or assess the nature of the product;
 - 19.5.2 did not communicate or train front line staff about the product so as to be sure that front line staff would be able to assess the suitability of the product for investors and represent its key features consistently;
 - 19.5.3 provided deficient training or guidance to staff about the key features of the product, including, in some cases, misleading or inaccurate information about Minibonds; and
 - 19.5.4 did not monitor, supervise or control the content of point of sale discussions either by instituting adequate quality control mechanisms or ensuring staff were directed to maintain proper, contemporaneous records of each sales discussion.
- 19.6 While all investors in Minibonds were obliged to sign disclaimers and acknowledgements stating they had read and understood the prospectus, these statements may have little or no value if the point of sale staff, given the task of explaining the product, had been given inaccurate or misleading information about the product by the distributor and there is no evidence that the investor actually relied on the prospectus in deciding to buy the Minibond.
- 19.7 One emerging area of concern is how each Registered Institution or Licensed Corporation viewed its function and legal responsibilities. The sale of Minibonds was, for example, organised through a distribution agreement between relevant Registered Institutions or Licensed Corporations and Lehman Brothers. Under the distribution agreement, distributors were under a contractual obligation to use "reasonable



commercial efforts to procure purchasers" of the Minibonds. Arguably, each Registered Institution or Licensed Corporation was agreeing to leverage their branch and customer network to sell the Minibonds widely in return for the revenue generated by the sales commission.

- 19.8 Another relevant feature is, under the distribution agreement, distributors mostly acquired Minibonds from a Lehman Brothers entity before selling them onto their clients. In most cases, the sale to investors was accordingly between each distributor and the investor directly rather than between Pacific and the investors via the distributor.
- 19.9 A key issue that arises here is the extent of conflict between the distributors' duty, on one hand, to Lehman Brothers to use reasonable commercial efforts to procure purchasers for the Minibonds and, on the other hand, the duties owed to clients under the Code of Conduct to only sell products that were suitable to each client (which implies in some cases a duty not to sell if the product was unsuitable).
- 19.10 *Product due diligence*
- 19.10.1 Product due diligence is the key means by which a Licensed Corporation or Registered Institution assesses and understands a product to be sold to clients. Good due diligence is part and parcel of the organization's obligation to "know the product" which is a threshold requirement for the assessment of suitability. Critical issues for investigation include how well the due diligence process was conducted; whether it was updated and refreshed as market conditions changed or as the product evolved; whether the due diligence process was properly supported and aligned with both senior management and the front line staff; whether due diligence lessons were clearly included in training front line staff, communicated throughout the organisation and followed.
- 19.10.2 There are indications of serious inadequacies in the product due diligence undertaken by some Licensed Corporations or Registered Institutions including cases where there was little or no dedicated due diligence at all which means front line staff were provided with little or no guidance as to the Licensed Corporation's or the Registered Institution's own assessment of the product, its relevant risk rating, which clients the product might be suitable for etc..
- (a) Due diligence staff reviewed early Minibond series and then wrongly assumed each subsequent series was the same without refreshing the process in changed markets or without realising important features of the product had changed.
- (b) Due diligence staff made basic mistakes, misunderstanding the regulatory context or failing to reach conclusions on the risk profile of the product.
- 19.10.3 The absence of any evidence of, or poor, due diligence is often a sign that investors who bought the relevant products may have been mis sold the product.



19.11 *Training for sales staff*

- 19.11.1 The SFC is also examining whether and how staff involved in point of sale processes understood the product, were trained and supervised. It is axiomatic that staff who do not understand the product and who do not know how the organisation rates the product will not be able to sell the product properly nor make accurate assessments of suitability.
- 19.11.2 There are indications of poor or non-existent systems for front line staff training, including:
- (a) provision of initial training at the inception of the Minibond series without follow up or refreshment as the product changed and evolved;
 - (b) initial training being given by short power point slides without additional support follow up or testing;
 - (c) no mandatory training sessions at all in some Registered Institutions or Licensed Corporations;
 - (d) training materials littered with mistakes and errors including representations that:
 - (i) the product was suitable for all types of investors when the prospectus for the Minibonds states the opposite; and
 - (ii) there was a liquid market for the Minibonds when there was no liquid market but a limited and qualified buy back facility with Lehman Brothers; and
 - (e) failure to provide front line staff with guidance on risk rating of the product or failure to give any risk rating at all.
- 19.11.3 There are also indications that a number of Registered Institutions or Licensed Corporations may have relied upon the same set of training materials containing the same critical mistakes. This raises important issues such as whether individual Registered Institutions or Licensed Corporations failed to undertake their own assessment of these materials before passing them onto front line staff and whether the mistakes in the training materials created a contagion of misunderstanding across several Registered Institutions or Licensed Corporations.
- 19.11.4 Either separately or in combination with absent or poor due diligence, training failures can create a very strong inference of misselling.

19.12 *Record keeping on suitability analysis and disclosure of risks to clients*

- 19.12.1 Under the Code of Conduct, Licensed Corporations and Registered Institutions are required to ensure that products are suitable for the client in all the circumstances including whether the product is suitable given the person's financial position, needs and expectations as well as tolerance for risk. It appears very few Registered Institutions or Licensed Corporations maintained any contemporaneous or other record of what occurred at point



of sale other than relying on investors to sign disclaimers and other acknowledgements to the effect they had read and understood the prospectus etc.. This raises a number of issues including:

- (a) whether the Registered Institution or Licensed Corporation had any system for supervising the conduct of their front line staff including the manner in which the disclaimers and acknowledgements were being procured;
- (b) what opportunity was given to investors to read the prospectus (there were in fact two prospectuses, a programme prospectus and a product prospectus for each series of Minibond); and
- (c) how the front line staff could assess whether the prospective investor understood the prospectus especially if the Registered Institution's or Licensed Corporation's training materials were deficient or wrong or both.

19.12.2 Some Registered Institutions or Licensed Corporations used questionnaires and profiling documents to understand their client's financial position and risk tolerance. We are continuing to examine these systems. However, in some cases we have concerns about how they were calibrated. For example, one system automatically assumed that younger age, larger size of investment and longer term of investment translated into a higher tolerance for risk. It is not clear why these assumptions might be accurate.

19.12.3 Moreover, it is not clear how these systems were used and how they were aligned with the sales process because it seems Minibonds were sold to all classes of investor including those with relatively low or zero risk tolerance (including clients who were investing all of their available money in Minibonds). Objectively, the SFC would expect that clients with low risk tolerance would be provided with additional information or caution before proceeding to buy Minibonds compared to those with higher risk classifications. However, we have not found evidence yet to show that Registered Institutions or Licensed Corporations were distinguishing between clients on the basis of financial position and risk tolerance or that the risk assessment of each customer changed or was aligned at all with the sales process.



Issues and recommendations

20. Focus of recommendations

- 20.1 A number of trends and themes are emerging from our investigations relevant to the Code of Conduct. These are set out in section 19 above.
- 20.2 It is important that steps are taken to restore public confidence in Intermediaries and the regulatory system. Whilst the full story of Minibonds has yet to emerge, the public perception is that information made available to investors by Intermediaries was misleading and Intermediaries did not meet their obligations to properly advise investors and ensure that investors understood the products they were buying. It will take some time before our investigations are able to provide a reasonable evaluation of the extent of culpability of Intermediaries.
- 20.3 To restore confidence of investors we believe that changes are needed in the following areas:
- 20.3.1 Hong Kong's regulatory structure;
 - 20.3.2 Point of sale regulation;
 - 20.3.3 Regulatory supervision of documentation relating to investment products to be offered to the Hong Kong public;
 - 20.3.4 Definition of professional investors;
 - 20.3.5 What Intermediaries should do;
 - 20.3.6 Dispute resolution;
 - 20.3.7 Investor education; and
 - 20.3.8 Enforcement powers.
- 20.4 We also note that for some years the UK FSA has been refining an approach, called Treating Customers Fairly or TCF, that looks at customer protection from the perspective of desired outcomes rather than prescribing what should be done by market players. **Appendix 7** sets out a brief summary of this approach. The UK FSA issued on 25 November 2008 a report titled "Retail Distribution Review" that looks at investment advice provided to consumers both as to quality of advice and how Intermediaries offering independent advice are remunerated. This report is included in **Exhibit 3**. How TCF and the new proposals regarding investment advice develop and their success may influence how Hong Kong develops regulatory requirements in the longer term.



Hong Kong's regulatory structure

21. Hong Kong's regulatory structure

- 21.1 The Group of Thirty Report (see **Appendix 1**) comments that the Institutional Approach adopted by Hong Kong is generally considered suboptimal given the evolution of the markets. The report notes that the Functional Approach, where the supervisor is determined by the business transacted rather than the legal status of the entity, remains common and appears to work well. The Integrated Approach, with one single universal regulator, adopted by the UK FSA, brings with it the need to strike a balance between what may be conflicting objectives. The recent failure of Northern Rock in the UK demonstrates the risks posed when one regulator has two functions.
- 21.2 The regulatory approach that has attracted more attention recently is called Twin Peaks with a separation of regulatory functions between two regulators: one that performs the safety and soundness supervision and one that focuses on conduct-of-business. Most recently the USA in the report by the Department of the Treasury "Blueprint for a Modernized Financial Regulatory Structure" proposed as a long-term optimal regulatory structure an objective-based regulatory approach with three entities - a market stability regulator, a prudential financial regulator and a business conduct regulator.
- 21.3 ***We recommend that the government consider whether the current regulatory structure is best suited to facilitate Hong Kong's further development as an international financial centre.***



22. **Securities activities of banks**

- 22.1 As discussed above a number of complaints included the allegation that bank staff suggested Minibonds to customers whose fixed deposits had expired. It is said that these customers had not sought to invest or trade in securities and that they were steered by banking staff towards Minibonds.
- 22.2 There is a concern that banks and their staff may have used information about bank customers to target customers with funds, many of whom were not sophisticated investors. We consider that having banking staff responsible for securities business presents conflicts of interest and blurs the distinction between banking services, where bank customers are familiar with the risks, and investments in securities that present a different set of risks that may be new to traditional banking customers.
- 22.3 Having a clear line of demarcation between banking services and securities services would ensure that customers are aware of the nature of the advice they receive. This could be achieved by requiring all securities activities in respect of consumers be conducted by separate entities. In the USA for example, sales in the retail sector of most investment products deemed securities sold by banking groups are required to be sold by subsidiaries or affiliates of the bank holding companies. These companies are registered broker dealers subject to the same enforcement and regulatory requirements as other securities firms. This is not the only way however that such separation of functions can be achieved.
- 22.4 There should also be a clear demarcation of premises and staff to avoid confusing customers as to the nature of the services being offered. As we discuss later all Intermediaries should ensure that staff responsible for selling investment products, such as Minibonds, should have the necessary skills and knowledge to understand and explain the products. Restricting sales of investment products to designated staff will help ensure that these staff obtain the skills required to advise on these products.
- 22.5 ***We recommend that the structure of banks' securities operations should be reviewed to see how best to provide clear differentiation of banking services from security services.***



Point of sale regulation

23. Point of sale regulation

23.1 It remains to be established whether individual Intermediaries failed to sufficiently assess suitability of investment products for individual investors and to ensure that investors understood their investments and the related risks. Many of the complaints suggest that this was the case. For the purpose of this section we assume that there is merit in these complaints though we wish to remind readers of this report that these matters are under investigation and at present are merely allegations.

23.2 The obligations set out in the Code of Conduct especially in 5.2 Know your client: reasonable advice and 5.3 Know your client: derivative products as amplified by the FAQs provide a clear obligation for Intermediaries to assess the suitability of a recommendation or solicitation. Regulators should therefore monitor Intermediaries' compliance with the selling practices requirements. If these obligations have not been followed, there is a need for more proactive supervision of Intermediaries to reinforce their obligations in respect of suitability assessment.

23.3 Regulators should conduct inspections of Intermediaries focusing on management controls and the systems within Intermediaries designed to ensure amongst other matters:

23.3.1 staff have suitable training;

23.3.2 reward structures reinforce behaviour designed to ensure compliance with obligations;

23.3.3 products are properly assessed;

23.3.4 investors are adequately assessed to provide sufficient basis to provide recommendation or solicitation;

23.3.5 appropriate records are maintained of recommendation or solicitation provided to individual investors; and

23.3.6 investors classified as professional investors continue to meet the required criteria.

23.4 Intermediaries identified for inspections should be selected on risk-based basis. Consideration would be given to those Intermediaries that:

23.4.1 provide advice to many of the Hong Kong public especially less sophisticated investors; and

23.4.2 sell products that are likely to be less well understood.

23.5 Serious failures in systems and controls identified by these inspections may lead to temporary or even permanent revocation of licenses.

23.6 As well as relying on inspections it is useful for regulators to use "mystery shoppers" to obtain a insight into the way financial products are sold to consumers. Mystery



shopping helps to provide regulators with a first-hand picture of the advice provided by intermediaries and identify problems and areas that require regulator's attention at an earlier stage. The UK FSA has published a guideline¹⁶ on using this technique explaining why and how it uses the technique, and how it uses the findings.

- 23.7 ***We recommend that each regulatory authority responsible for Intermediaries' business conduct determine what changes, including mystery shopping techniques, are appropriate to existing inspection regimes in light of findings from the investigations currently underway.***

¹⁶The FSA's "Mystery Shopping Guide", November 2006. See Exhibit 5.



Regulatory supervision of documentation relating to investment products to be offered to the Hong Kong public

24. Should SFC assess suitability of products sold to the Hong Kong public?

- 24.1 A number of complainants as well as commentators have asserted that as Minibonds were approved by the SFC they must have been low risk and thus suitable for all investors.
- 24.2 We have explained in section 8 above that the nature of the SFC's authorisation is focused on whether there is adequate disclosure and, in the case of CISs, the required structures are in place. For example, the structures for unit trusts are designed to ensure that there are appropriate structural features in place, such as adequate segregation of assets through the use of an independent trustee. However, these features are not designed to ensure that all CISs are suitable for all retail investors.
- 24.3 In authorising the offering documents and marketing materials, the SFC relies upon the information provided by the issuer. The SFC does not verify the accuracy of the information so provided. It should be noted that no regulator in other major financial centres verifies the contents of offering documents or marketing materials. The common view is that it is sufficient to rely on professional advisors to ensure compliance and maintenance of standards with the regulatory body acting as an enforcement agency.
- 24.4 We do not believe that it is appropriate for regulators to assess suitability of products for consumers at the point of vetting of offering documents or marketing materials, and use suitability as a criteria for authorising or refusing to authorise products. For almost every product it is possible to identify some investors for whom the product may not be suitable or for whom the product would only be suitable as part of a portfolio of investments. Limiting approvals to products that are suitable for all investors would not be in the interests of the broader market as this will inevitably result in a limited selection of products being approved. It would also militate against the objective of making Hong Kong an International Finance Centre. We believe that a vibrant and healthy financial market needs to have a broad spectrum of products available for investors, products that offer a variety of risk profiles.
- 24.5 We do not believe it is appropriate for regulators to assess products with a view to assigning a risk rating. Product risk consists of two elements: the inherent risk that derives from the nature and structure of the product and the likelihood of risks materialising that is driven by market conditions. Accordingly product risk assessment needs to reflect current market conditions, it would not be appropriate to rely on an assessment made by a regulator earlier in potentially very different market circumstances.
- 24.6 We are concerned that establishing a process of product approval or risk rating by the regulator will erode Intermediaries' awareness of their obligations to ensure suitability. We believe that any form of product approval or risk rating by regulators will be taken by the market as meeting much if not all of the requirements for Intermediaries to assess products and to match products to the requirements of individual investors.



- 24.6.1 Investors have also been reported as taking SFC authorisation of products as providing comfort as to the risks involved such that investors did not need to make their own enquiries as to the nature of the products.
- 24.7 11 jurisdictions¹⁷ were surveyed for the Joint Forum April 2008 report¹⁸ on how firms meet their obligations to assess suitability of products. Each of these jurisdictions requires regulated firms when recommending products with a significant investment component to retail customers to assess whether the investment product is suitable for such investors. None of these jurisdictions rely on a regulator to assess suitability or assign risk ratings.
- 24.8 In addressing the scope of the SFC's authorisation of documents relating to investment products it is also appropriate to consider whether pre-vetting of documents is appropriate.
- 24.8.1 There may be confusion in the minds of both Intermediaries and investors as to the meaning of the SFC's authorisation of documents relating to products. Not only is there scope for confusion in the minds of users of these documents as to what SFC authorisation means, but there is also scope for confusion in the minds of persons preparing documents as to where responsibility for a document lies.
- 24.8.2 In law responsibility clearly lies with those responsible for preparation of the document. However, in practice the more intrusive the oversight by regulators the more market Intermediaries come to rely on the regulator to do their jobs for them. There is a danger that disclosure becomes a matter of what the regulator will accept rather than what disclosure is required (see 25.4 below for a discussion of the overall disclosure standard).
- 24.8.3 We note that in some jurisdictions, most notably Australia, the regulator plays no role in authorising documents describing products. Issuers are required to issue product disclosure statements which do not have to be pre-vetted by the regulator. However, the regulator has powers to issue a stop order in respect of the offering of the product if the product disclosure statement is defective.
- 24.8.4 A stop order is a powerful regulatory tool as not only does it cause embarrassment to the entities involved but it can cause financial costs as transactions are unwound.
- 24.8.5 Whilst this approach has many merits, we note that the issue of moving to post-vetting of documents has been considered in a number of contexts¹⁹ in respect of documents issued by listed companies. There was no support for dropping the requirement for pre-vetting. We believe that there would be no support for adopting the Australian approach for investment products offered to the Hong Kong public.

¹⁷ Australia, Canada, France, Germany, Italy, Japan, Netherlands, Spain, Switzerland, UK and USA

¹⁸ "Customer suitability in the retail sale of financial products and services" dated April 2008 issued by The Joint Forum consisting of the Basel Committee on Banking Supervision, the International Organisation of Securities Commissions and the International Association of Insurance Supervisors, see Exhibit 2.

¹⁹ Most recently the Stock Exchange consultation paper in January 2008 proposed a reduction in pre-vetting of documents but did not suggest any change to the existing practice of pre-vetting circulars sent to shareholders.



24.9 **We recommend that:**

- 24.9.1 ***Hong Kong maintains the regulatory philosophy of disclosure coupled with conduct regulation of Intermediaries rather than merit regulation; and***
- 24.9.2 ***through investor education, see section 36 below, the SFC advises investors what is meant by SFC authorisation of a product.***



25. SFC authorisation of documentation relating to investment products

25.1 As discussed in section 8 above the present system for authorisation of documentation relating to investment products is fragmented. The prospectus regime in the CO has been in place for many decades but has primarily catered for equity or traditional debt capital raising issues. However, as a result of policy initiatives to increase liquidity through attracting more investment product issuers as well as capital and investors from the Mainland to Hong Kong and to foster the development of retail bonds and other investment products, amendments to the CO were implemented in 2004. Changes included exemptions in the Seventeenth Schedule and the recognition of the dual prospectus regime to facilitate the public offer of shares and debentures under a programme.

25.2 Against this background and given the all-embracing definition of "debenture" in the CO, the potential exists for issuers to bring within the CO prospectus regime an investment arrangement or instrument that they structure as a debenture. While such arrangements or instruments cannot reasonably have been in contemplation when the law was enacted, if they constitute debentures within the meaning of the CO, then as a matter of law they fall within the CO prospectus regime. This was recognised and discussed in the SFC's Consultation Paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance issued in August 2005, and a concept proposal suggesting a merger of the CO prospectus regime and the offers of investments regime in Part IV of the SFO was floated. 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:

25.2.1 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;

25.2.2 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 offers 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.

25.3 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 (and public consultation on the White Bill in mid 2009), it was felt appropriate to propose changes to Parts II and XII of the CO 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 this report. One fundamental issue is whether Hong Kong should still retain two public offering regimes (i.e., (a) the prospectus regime for public offers of shares and debentures; and (b) offers of investments regime under Part IV of the SFO). Alternatively, we could follow the UK approach by having one public offering regime in the SFO. The advantage of having one public offering regime is that it would avoid regulatory arbitrage between different regulatory regimes by structuring investment products in a particular manner. Some may argue that the advantage of retaining two public offering regimes is that public offers of shares and debentures for fund raising purposes should be regulated differently from public offerings of investment products issued as part of the ordinary course of business of issuers.

- 25.4 In the meantime the present fragmented regulatory regime remains. Some products are not subject to a positive overall disclosure requirement but come under the general prohibition in section 107 of the SFO for a person to induce another by any fraudulent or reckless misrepresentation, to invest in securities. Other products are held to overall disclosure standards, which are expressed in different forms, but have very similar effect.

- 25.4.1 The overall disclosure standard currently required of a prospectus under the CO is:

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 them²⁰

- 25.4.2 The overall disclosure standard currently required of a Unit Trust or Mutual Fund is:

Authorized schemes must issue an up-to-date offering document, which should contain the information necessary for investors to be able to make an informed judgement of the investment proposed to them²¹

- 25.4.3 For consistency one overall disclosure standard should be specified for all offering documents that seek to describe an investment sold to the Hong Kong public and that persons responsible for offering documents should be held accountable for failure to meet such standard.

- 25.5 **We recommend that requirements are introduced in the SFO, that:**

- 25.5.1 ***set one overall disclosure standard for all offering documents that seek to describe an investment sold to the Hong Kong public; and***

²⁰ Paragraph 3 of the 3rd Schedule to the CO

²¹ Paragraph 6.1 of the Code on Unit Trusts and Mutual Funds.



25.5.2 *are enforceable against persons responsible for offering documents.*

25.6 **We recommend that:**

25.6.1 *we revisit the issue of whether Hong Kong should retain two public offering regimes for investment products; and*

25.6.2 *consideration is given to whether the existing exemptions from the requirement for SFC authorisation of offering documents for investments are too broad.*



26. Provide investors with information they can understand

- 26.1 A common theme of complaints is that investors were not provided with information they could understand. This may mean that the products were not suitable for these investors, or that the way information was presented did not assist investors to understand the product. Whilst the Minibond prospectuses had been drafted in plain language they are still lengthy documents. The prospectus for series 33 dated 23 July 2007 runs to 56 pages and makes reference to the programme prospectus dated 12 March 2007 that runs to 51 pages. The liabilities provisions attached to prospectuses result in lengthy offering documents which are difficult for investors to digest without investment advice.
- 26.2 Investors should be provided with a summary explaining the nature of the investment product either in addition to the prospectus or offering document, or as part of it. This may present concerns as to prospectus liabilities for issuers. However, we note that many jurisdictions now require or are introducing rules to require summaries designed to be readily understood by investors.
- 26.3 In Australia in July 2008 the government issued a short, readable four-page Product Disclosure Statement ("PDS") for a new product about to be launched: First Home Saver Accounts.
- 26.3.1 In launching this new PDS an Australian Minister commented that "Currently, many complex and lengthy disclosure documents are often between 50 and 100 pages long and are as readable as Latin to the majority of Australians. This is unacceptable."
- 26.3.2 The new disclosure documents are intended to make it much easier for people who are interested in using First Home Saver Accounts to understand and compare the products on offer. Key product information is provided over the equivalent of four A4 pages in concise, plain English and can be read and understood in just a few minutes²².
- 26.3.3 The Australian authorities believe that shorter, clearer disclosure statements will benefit consumers and industry by improving investor protection.
- 26.4 In November 2007 the US Security and Exchange Commission ("SEC") issued proposed rules that would require mutual funds (i.e., CISs) to provide a summary section at the front of each prospectus. The SEC intends that this information would be presented in three or four pages. This proposal was in response to a general recognition that prospectuses were long and complicated and often proved difficult for investors to use efficiently in comparing choices. The SEC commented that too often the language of prospectuses is complex and legalistic and the presentation formats make little use of graphic design techniques that would contribute to readability.
- 26.5 The UK FSA rules²³ set out requirements for the contents of a simplified prospectus for a UCITS (collective investment schemes that can be marketed through out the EU).

²² See Exhibit 4 for the product information sheet.

²³ FSA Handbook COLL 4.6



26.6 ***We recommend that the SFC develops requirements for summaries to be prepared for all products offered to the Hong Kong public including CISs, ELNs, ELLs, equity linked deposits, insurance-linked assurance schemes, CLNs in no more than four pages of plain, concise easily understood language, augmented by charts and diagrams. These product summaries should:***

26.6.1 ***include all key information; and***

26.6.2 ***facilitate comparisons with other products.***



27. On going disclosure obligations for issuers of products

- 27.1 There are no statutory requirements for ongoing disclosure of information to investors for product offering documents authorised under the CO and under section 105 of the SFO²⁴. Whilst issuers of products often commit to providing quotes of prices at which they are prepared to repurchase their products, there is no requirement for them to do this. Also there is no obligation on issuers to ensure that investors are provided with information as to important events that may affect the value of their investments.
- 27.2 We note that HKEx's website contains information about listed companies and other products listed on the Stock Exchange. Listed companies and issuers of listed products are required to file information that is required by investors concerning their companies and products. Having a central source of information is a significant service for investors.
- 27.3 *We recommend that requirements are introduced in the SFO for:*
- 27.3.1 *issuers of investment products to provide relevant information for investors including:*
- (a) *price information; and*
 - (b) *changes in circumstances that may have a significant effect on the value of the investment; and*
- 27.3.2 *Intermediaries to take appropriate steps to ensure that this information is brought to attention of investors.*
- 27.4 *We recommend that the SFC's website becomes the repository of information about unlisted investment products that have been authorised by the SFC.*

²⁴ Generally, most CISs are required to comply with various degrees of on-going disclosure requirements in relevant Product Codes, see Appendix 2.



28. SFC authorisation of marketing materials

28.1 Complaints against Minibonds' marketing materials can be summarised as:

28.1.1 the SFC should not have allowed these products to be called Minibonds as the name suggested that these were risk free investments; and

28.1.2 the marketing materials did not deal with all the risks related to Minibonds and in particular undue prominence was given to the reference entities without balancing it with upfront risk disclosures about risks relating to Lehman Brothers.

28.2 There is no all-purpose definition currently in the law of what constitutes a 'bond' or a 'note'. The CO only provides an inclusive definition of a debenture and Minibonds were designed to fall within this definition. Thus Minibonds could legitimately be described as debentures, bonds, structured bonds, notes, credit linked notes or derivatives. Minibonds is the name under which they were marketed.

28.3 The marketing materials and the name Minibonds were a minor part of the information that was expected to be passed to investors in order for investors to reach a valid and justifiable opinion on Minibonds. Each distributor had signed agreements with the issuer that investors would only be sold Minibonds on the basis that the investors had read and understood the prospectus and investors were required to sign statements to this effect. The marketing materials were vetted by the SFC to ensure that the marketing materials were not inconsistent with the offering documents and included the specified warnings²⁵. The marketing materials were not intended to be used as standalone documents. They were purely designed to inform investors as to the existence of a Minibonds series.

28.4 The requirements for Intermediaries to assess suitability of a product for an investor and to ensure in the case of Minibonds, which embed derivatives, that investors understood the risks of investing in derivatives, should have ensured that retail investors did not place reliance only on marketing materials in making investment decisions. However, complaints suggest that investors placed significant reliance on marketing materials that had been authorised by the SFC on the basis that investors would read a prospectus before making an investment decision.

28.5 We set out in section 33 below our recommendations that are intended to bolster the existing requirements for Intermediaries to provide proper advice to investors. However, we recognise that investors find it hard to understand disclosure documents that run to many pages, even if written in plain language (see section 26 for recommendations for a summary document). There will always be a tendency for undue prominence to be given to marketing materials with punchy catch phrases and eye catching graphics. We do not support the most drastic solution to this problem of banning all but the most anodyne marketing materials that provide an announcement of a product but give no details as to the nature of the product. We think marketing materials serve an important function by encouraging competition and thus facilitating new entrants or new products to enter the market. However, it is essential that marketing materials are not false and misleading.

²⁵ See Appendix 2 section 5.5



- 28.6 On 3 October 2008 we issued a reminder to issuers of retail investment products:
- 28.6.1 "In light of the widespread public concern over the offering and selling of retail structured products in the aftermath of the collapse of Lehman Holdings, retail investment products issuers are reminded of their duty to ensure their offering documents continue to be up-to-date and to contain sufficient information necessary for investors to make an informed investment decision given the new circumstances. In addition, marketing materials issued must be clear, fair and present a balanced picture with adequate and prominent risk disclosure in compliance with all applicable regulations.
- 28.6.2 Retail investment product issuers should ensure that in their marketing materials, there are upfront, prominent and adequate warnings of all the risks associated with their products, including any new risks that may have emerged in the prevailing market circumstances, before these marketing materials are issued or remain in issue.
- 28.6.3 Going forward, issuers seeking SFC authorisations are urged to conduct a careful review of their applications to ensure that their applications and related offering documents and marketing materials contain clear upfront explanations of the product and risks with sufficient prominence and clarity. Those whose applications have been submitted may wish to revise their documents in light of the recent market events."
- 28.7 ***We recommend that the SFC revises its published guidance on marketing materials to establish general principles, supplemented where necessary by specific requirements, that assist the market to develop materials that are correct, properly balanced and are not misleading.***



Definition of professional investors

29. Definition of professional investors

- 29.1 The term "professional investor" is discussed in section 12 above. In the context of discussing investor complaints about the misselling of accumulators to professional investors, the SFC has undertaken a review of the current professional investors regime, focusing on the assessment criteria (for an Intermediary to treat a high net worth investor as a professional investor) under the Code of Conduct and the minimum asset portfolio requirement under the PI Rules.
- 29.2 In this regard, we have researched the regulatory requirements applicable to professional investors in other comparable jurisdictions e.g., UK, Singapore and Australia and have also met with various market participants, industry associations and the HKMA so as to gather their views on the current professional investors regime at an operational level.
- 29.3 Our current professional investors regime, including the quantum of the minimum asset portfolio specified under the PI Rules, is generally in line with the requirements in other overseas jurisdictions. Comments received from market participants, industry associations and the HKMA support the view that investment knowledge and experience are more crucial than wealth in determining whether an investor should be treated as a professional investor.
- 29.4 Some market participants commented that, as the CO currently provides an exemption to the prospectus requirements if the offer is made to professional investors and underwriters can allocate IPO shares to professional investors, any amendment to the professional investor definition may have implications for the current prospectus regime and placement activities.
- 29.5 The general feedback from market participants was that the current regulatory regime was effective and therefore major changes are not necessary. We consider that it would enhance the current regulatory regime if further clarification or guidance for the industry were given as to how the assessment criteria under the Code of Conduct should be applied.
- 29.6 In this regard, suggestions for change to the Code of Conduct were as follows:
- 29.6.1 an Intermediary should document its assessment of a client's investment knowledge and expertise, together with any supporting information gathered from the client; and
 - 29.6.2 if an Intermediary wishes to provide a client with a product type that the client has no experience in or has not been traded by the client before, the client should be able to demonstrate that he has:
 - (a) traded in products with similar risk-return profiles; or
 - (b) acquired the necessary product knowledge by currently working, or having worked, in the relevant financial sector for at least one year, or having studied relevant subjects or courses.



- 29.7 ***We recommend that the SFC consults the market on whether it is appropriate:***
- 29.7.1 ***to raise the minimum asset portfolio requirement under the PI Rules;
and***
 - 29.7.2 ***to clarify and tighten the assessment criteria under the Code of
Conduct.***



What Intermediaries should do

30. Initial assessment of existing regulatory requirements

30.1 Until our investigations are complete we will not be able to determine conclusively whether, and if so, to what extent the existing requirements are deficient or need to be redrafted or recast. Until that work is finished we have to judge the appropriateness of the requirements in light of our review of the guidance and the complaints received from the investing public. Having reviewed the existing Code of Conduct requirements as amplified by the FAQs (summarised in section 10 above; see also **Appendix 4**) we believe it provides an appropriate framework that if properly implemented should adequately protect the investing public.

30.2 This assessment leads us to the tentative conclusion that, if there have been failures to adequately protect the investing public, and we re-iterate that at this stage this remains to be established, these are failures of proper compliance with the Code of Conduct. Having reached this tentative view, we believe that changes are needed to help bolster understanding of the requirements and help bring home to those responsible for the conduct of businesses of Intermediaries the importance of ensuring that interests of the Hong Kong public are adequately safeguarded.



31. Disclose commissions, fees and other benefits

- 31.1 Under General Principle 6 of the Code of Conduct, Intermediaries, Licensed Representatives (including Responsible Officers) and Relevant Individuals (including Executive Officers) (collectively "Regulated Persons") should try to avoid conflicts of interest, and when such conflicts cannot be avoided, should ensure that their clients are fairly treated. In Hong Kong, the way Regulated Persons who sell/advise on investment products are remunerated gives rise to the perception of conflicts of interest issues, potential or otherwise. This is because Regulated Persons are usually remunerated by way of commission from product providers for each investment product sold/invested in by clients. If clients hold on to their investments for a period of time, the Regulated Persons may receive further payments (known as trail commission) from product issuers. In addition, other benefits such as free air travel etc. (known as soft commission) are also provided by the product issuers.
- 31.2 In recent years the SFC has conducted themed inspections on investment advisors to monitor possible conflicts of interest and other issues. During the inspections, it was noted that a number of firms tended to sell more of those investment products that reward the firms with higher commission rebates. While this finding is not in itself conclusive that these firms or their staff have put their interests ahead of their clients, it does however raise a perception of conflicts of interest. The SFC has published a report on the findings of the inspections. The report stated that if Regulated Persons had strictly adhered to existing regulatory standards, most of the problematic issues identified could have been avoided.
- 31.3 The SFC has also consulted with market participants on ways to mitigate the perception of conflicts of interest. On the issue of disclosure of commission rebate market participants explained the difficulty or impracticality of quantifying commission especially if they are distributing products issued by their affiliated companies, restriction of disclosure due to global confidentiality agreements etc..
- 31.4 Separately, the SFC has reviewed international practices and note that mandatory disclosure of commission rebates is required in countries such as Australia and the UK. In Singapore, market participants are required to disclose any commission rebates, soft commissions and other benefits received by an adviser from a product provider. The International Organisation of Securities Commissions ("IOSCO") is also looking into the issue of point-of-sale disclosure to investors. To date, the IOSCO task force involved has identified the major point-of-sale disclosure issues and are considering a public consultation on the issues.
- 31.5 We believe that it is appropriate to introduce measures to address and mitigate the issue of conflicts of interest by Regulated Persons who sell/advise on financial products. The SFC therefore intends to consult the public on a proposal to require Intermediaries to disclose in plain language the following to prospective clients at the pre-sale stage:
- 31.5.1 Monetary benefits
- (a) The existence and nature of any commission arrangement.
- 31.5.2 Trail commission
- (a) The existence and nature of any trail commission arrangements.



- 31.5.3 Volume discount/Volume benefit
- (a) The existence and nature of any arrangements whereby the Intermediaries receives volume discounts/volume benefits in a range of products.
- 31.5.4 Affiliation with product issuers
- (a) the relationship between the Intermediary and the product issuer;
 - (b) where applicable, the fact that the Intermediary only distributes the investment products issued by its affiliated group; and
 - (c) where there is no clear commission rebate arrangement, the fact that there is some form of reward or benefit, received either directly or indirectly, from the affiliated product issuer.
- 31.5.5 Non-monetary benefits
- (a) The existence and nature of any arrangements whereby the Intermediary receives non-monetary benefits including soft dollars.
- 31.6 ***We recommend that the SFC reviews requirements for comprehensive disclosure to clients at the pre-sale stage of commissions, fees and other benefits the Intermediary receives from the sale of the products that it recommends or is offering to clients.***



32. Cooling off

- 32.1 In line with guidance issued by The Hong Kong Federation of Insurers life insurance contracts include a cooling off clause that allow customers 21²⁶ days after signing the application for a contract (or 14 days after the issue of a contract) to cancel an insurance contract. Similar requirements for a cooling off period are included in the SFC's Code on Investment-Linked Assurance Schemes.
- 32.2 In both cases investors may not receive all the funds they have contributed where there has been a change in the value of the investments linked to the insurance contract.
- 32.3 Legislation in Australia grants investors cancellation rights in a number of investments including:
- 32.3.1 risk insurance products;
 - 32.3.2 investment life insurance products;
 - 32.3.3 unlisted managed investment products;
 - 32.3.4 first home saving accounts;
 - 32.3.5 superannuation products; and
 - 32.3.6 retirement saving accounts.
- 32.4 Legislation in the UK provides cancellation rights for investors. Cooling-off periods apply to contracts concerning financial services (i.e., service of a banking, credit, insurance, personal pension, investment or payment nature) sold by means of distance communication. There are, however, some exceptions to this cancellation right, for example in the context of foreign exchange contracts and securities (such as units in collective investment undertakings, transferable securities and money market instruments) where the price is subject to market fluctuations.
- 32.5 In Singapore there is a cooling-off period for unlisted unit trusts. These cancellation rights are contained in a notice issued by the Monetary Authority of Singapore ("MAS") pursuant to the Securities and Futures Act. The notice is not subsidiary legislation but non-compliance of it is an offence under the Securities and Futures Act.
- 32.6 ***We recommend that the Code of Conduct is amended to require Intermediaries to ensure that products recommended or offered for sale to the Hong Kong public include appropriate cooling off periods. Provision should be made for equitable adjustments to reflect changes in the market value of the assets associated with the investments but not reflect selling or other costs associated with the cancellation.***

²⁶ The standard deadline set by the Hong Kong Federation of Insurers is expressed as the later of a number of dates not just the date the policy is signed.



33. **Assess suitability of investment products for individual investors**
- 33.1 The distribution agreement between Lehman Brothers entities and the distributors required a number of statements to be signed by investors before they could purchase Minibonds. One statement was the investor "had read and understood [the] programme prospectus and this issue prospectus". Many complainants say they did not read or understand either document. Despite obtaining apparent confirmation that clients had read and understood the relevant prospectus, Intermediaries were still under an obligation to explain the nature and risks of the product they were selling and ensure it was suitable. However, this may not have been understood by many Intermediaries who placed undue reliance on these statements and may not have seen the need to give proper explanations of the product.
- 33.2 As described in section 10 above an Intermediary is required (Code of Conduct 5.2 Know your client: reasonable advice) when making a recommendation or solicitation in respect of an investment to ensure the suitability of that investment product for the client. The term "recommendation or solicitation" is very broad and will apply to most situations where a financial product is marketed directly or indirectly to a customer.
- 33.3 The guidance for Intermediaries in the FAQs (# 6) is to document and provide a copy to each client of the rationale underlying investment recommendations made to the client. They should document and record contemporaneously the information given to each client and the rationale for recommendations given to the client, including any material queries raised by the client and the responses given. We will remind Intermediaries of their obligations.
- 33.4 The FAQs (# 3) recommend that Intermediaries make their own enquiries and obtain full explanations about the risks inherent in the investment products rather than to rely on offering documents or marketing materials as being self-sufficient. They should document verification work and enquiries which they have made about the investment products, the criteria for selecting the products and why they are considered suitable for different risk categories of investors etc.. Intermediaries should ensure that this product due diligence be conducted on a continuous basis at appropriate intervals having regard to the nature, features and risks of investment products. We will also remind Intermediaries of these obligations.
- 33.5 In order to provide appropriate advice to investors, Intermediaries need to ensure they have sufficiently qualified staff. Under 4.1 of the Code of Conduct Intermediaries are required to ensure that their staff are qualified to act in the capacity employed and have suitable training or experience to provide advice to investors. Just as investors need to be assessed and matched to suitable investment products, staff also need to be assessed as to capabilities to provide advice on specific products and to individual customers.
- 33.6 ***We recommend that Intermediaries conduct a self examination of their controls and procedures to ensure that these provide senior management with sufficient assurance they meet their general obligations under the Code of Conduct, including:***
- 33.6.1 ***staff to receive adequate training;***
- 33.6.2 ***products only to be sold by staff that have demonstrated a sufficient understanding of the particular product;***



- 33.6.3 ***document and provide a copy to each client of the rationale underlying the recommendations/solicitations made to the client; and***
- 33.6.4 ***product due diligence to be conducted on a continuous basis at appropriate intervals having regard to the nature, features and risks of investment products.***



34. **Assess investors**

- 34.1 The Code of Conduct requires Intermediaries to obtain information from clients about their financial situation, investment experience and investment objectives. Intermediaries should establish each client's investment knowledge, investment horizon, risk tolerance (including risk of loss of capital) and capacity to make regular contributions and meet extra collateral requirements. Each client's information should be fully documented and, where appropriate, updated on a continuous basis.
- 34.2 Each Intermediary needs to establish an appropriate system for categorising investors to assist in matching investors with investment products. The Intermediaries should restrict the sale of products they categorize as high risk to investors with appropriate degree of investment knowledge and risk tolerance. We note that in the USA much guidance is provided by the Financial Industry Regulatory Authority (FINRA) a self-regulatory organization for securities. Under FINRA rules²⁷ individual investors are required to have an account approved for options trading in order to acquire structured products. In Hong Kong, a major advisory industry association²⁸ has provided guidance to its members on categorising of their clients. We are supportive of such initiative that provides a sound basis in developing best practice.
- 34.3 ***We recommend that the SFC brings forward requirements for Intermediaries to adopt suitable criteria for characterising investors with a view to assisting in ensuring that investment advice and products offered are suitable for the investors.***

²⁷ NASD Notice to Members 05-59 dated September 2005.

²⁸ The Institute of Financial Planners of Hong Kong.



Dispute Resolution

35. Dispute resolution

- 35.1 A common theme raised in the weeks since the collapse of Lehman Holdings is the absence of any simple and quick dispute resolution procedures for aggrieved investors. There have been calls for the establishment of a financial ombudsman with powers to order compensation as well as for a general requirement for dispute resolution services. A financial ombudsman would require legislation. By contrast a requirement for all Intermediaries to include in client agreements provisions establishing a right for clients to have their grievances resolved by a dispute resolution procedure can be implemented by changes to the Code of Conduct.
- 35.2 There are various dispute resolution schemes which can be explored although it is not necessary, at this stage, to be overly prescriptive. What is important is that there is in place a procedure which can achieve the outcome of dispute resolution.
- 35.3 That said, a dispute resolution scheme should be simple, consumer friendly, free of charge to the consumer (or at least substantially so) and without any costs risk to the consumer. It should avoid unduly legalistic procedures and discourage the involvement of legal representatives.
- 35.4 A dispute resolution scheme which could be explored is the scheme operated in Australia by Financial Industry Complaints Service Limited ("FICS"). The FICS scheme contains elements of conciliation (aimed at achieving a mutually acceptable resolution) and ultimately determination by a panel if the parties remain unable to arrive at an agreed outcome. The service is independent and free to consumers
- 35.5 ***We recommend that:***
- 35.5.1 ***the Code of Conduct is amended to require that client agreements specify a right for clients to have their grievances resolved by a dispute resolution procedure; and***
 - 35.5.2 ***the Government consults on whether there is a need for a financial ombudsman with statutory powers to order compensation.***



Investor education

36. SFC's statutory investor education role

36.1 Among all the four financial regulators in Hong Kong, only the SFC has explicit statutory functions to pursue investor education ("IE"). Under the SFO, our IE mandate covers the following:

- 36.1.1 to promote public understanding of the securities and futures markets;
- 36.1.2 to help investors better understand the benefits, risks and liabilities associated with investing; and
- 36.1.3 to promulgate the importance of making informed investment decisions.

36.2 Existing focus and approach

- 36.2.1 In order to enhance retail investors' understanding of investment products sold to them, the focus and scope of our IE work are to:
- (a) provide generic information on key features and downside risks of the products, particularly when new products are launched²⁹;
 - (b) promulgate a list of questions that investors should ask before they make their investment decision;
 - (c) explain the duties of Intermediaries at the time of sale and post-sale;
 - (d) promote the importance of checking information in a product's offering document instead of relying on marketing materials and advice of financial celebrities;
 - (e) remind investors to take responsibility for their own investment decisions and not to sign documents unless they understand the terms and conditions of the document and the risks of the product; and
 - (f) increase awareness of the steps investors should take to file a complaint when they encounter wrongdoing.
- 36.2.2 We have made use of all available media to disseminate our IE messages. For instance:
- (a) we have set up the InvestEd website (www.InvestEd.hk), which is a repository of all the SFC's IE materials;
 - (b) we have partnered with the mass media in the period from January 2007 to December 2008:

²⁹ For instance, in December 2003, generic education materials on equity-linked notes and credit-linked notes were launched to help investors understand their nature. In March 2008, education materials about equity-linked notes were updated to include explanations and numerical illustrations of some common special features, e.g., airbag, knock out.



- (i) we have published 127 newspaper articles; broadcast 108 radio segments, 38 TV programmes and 87 videos on buses; and
- (ii) in the area of outreach, we have delivered 115 talks to different demographic groups and run a number of credit courses at the local universities; and
- (c) to make IE activities more appealing to the public, we have also organised financial knowledge quiz and investor story competitions.

36.3 Expansion of SFC's IE service

36.3.1 As the delivery of increased levels of IE was desirable, the SFC expanded its IE service by enlarging the IE budget and recruiting dedicated staff to handle IE work. A budget of HK \$ 20 million, which includes staff and overhead costs, has been provided for fiscal 2008/09, to expand our IE activities.

36.3.2 In light of the financial tsunami giving rise to market volatility globally, we have stepped up our IE work on risks, including risks that might have been neglected by investors in the past e.g., credit risk of product issuers, counterparty risk in structured products and funds that involve swaps and collateralised debt obligations, and non-segregation of assets underlying ELNs.

36.3.3 Additionally, in view of the large volume of alleged misselling complaints, we have launched a new IE campaign - "the Five Elements" - focussing on simple questions that investors should ask before they commit their investment.

36.4 The SFC has been active in IE since 1996, before IE was included as a statutory function under the SFO. We have experienced a number of problems, including:

36.4.1 increasing product innovation;

36.4.2 diversity of investor profiles and knowledge levels;

36.4.3 difficulty in dealing with cross-regulatory issues faced by investors;

36.4.4 conflicting interests of the various regulators' stakeholders (e.g., there were previous complaints from stakeholders that education about unauthorised trading or misselling may tarnish Intermediaries' image); and

36.4.5 ability to communicate effectively with investors due to limitations in budget³⁰ and manpower³¹.

³⁰ As an example, TV has rarely been used as a medium of communication with retail investors even though the SFC's investor surveys found that the majority of investors preferred receiving IE information through this channel.

³¹ Before June 2008, IE staff also had to handle public complaints about market misconduct.



37. Overseas practices

37.1 IE in other major financial markets has undergone a longer period of development, largely because they have a larger population base and earlier and more extensive development of consumer financial products. In recent years, many developed countries have enhanced their IE efforts to promote financial literacy via education strategies for all sectors of society. In these countries the government, regulators and related agencies have worked together to develop a more co-ordinated approach with the aim of raising the overall financial knowledge and capability of their citizens to manage their financial affairs and deal with their day to day financial decisions.

37.2 Governments in the United Kingdom, the United States, Australia and Singapore have all launched a national financial education strategy. As illustrated in the table below, in almost all cases, the governments and the financial regulators are responsible for the strategy, with funding provided by the treasury, supplemented by a levy on the industry/market where the legislation permits.

Country	Responsible party/parties	Funding
UK	FSA (co-ordinator), Government, industry, consumer, voluntary and charitable organisations	Combination of Government money, industry contributions, charitable trusts and FSA
USA	Office of Financial Education under the Department of Treasury ³²	Government grant
Australia	Australian Securities and Investments Commission ³³	Government grant
Singapore	MAS and various government departments	Combination of government grant and MAS's Financial Sector Development Fund

³² Apart from the US government and financial regulators, non-profits organisations and businesses, such as Citi Foundation, the American Institute of Certified Public Accountants, New York Stock Exchange, are also actively involved. These organisations have altogether committed hundreds of millions of US dollars to support youth and adult financial education programmes.

³³ The Australian Government founded the Financial Literacy Foundation in June 2005 to provide a national focus for financial literacy issues. The functions of the Financial Literacy Foundation were transferred to the Australian Securities and Investments Commission from 1 July 2008.



38. Investor Education Council

38.1 Having regard to developments in other developed economies and given the difficulties noted under 36.4 above, in 2007, the SFC proposed establishing an Investor Education Council ("IEC"), a separate body corporate chaired and funded by the SFC, which would co-ordinate and deliver an expanded IE programme across the whole financial services sector. The advantages provided by the creation of IEC, as set out in our proposal, would include:

- 38.1.1 a more holistic approach to investors' education needs, to eliminate overlap and fill gaps among regulators;
- 38.1.2 facilitate broader and deeper IE goals;
- 38.1.3 improved delivery mechanisms to increase effectiveness of IE efforts;
- 38.1.4 increase in the absolute amount of IE delivered to a level closer to the specific needs of the community; and
- 38.1.5 provide a high degree of transparency and independence in IE work in Hong Kong, which will be important in gaining the public and industry's trust and support, as well as positioning the IEC to assume broader financial literacy goals at an appropriate time in the future.

38.2 However, the SFO does not currently empower the SFC to conduct activities beyond the securities and futures industry. This raises a number of legal difficulties with respect to both the involvement of the SFC under this proposal and also the provision of funding for this new body. The SFO does not empower the SFC to establish and own a company, which is our preferred structure for the IEC. A draft consultation paper on the formation of the IEC together with the necessary legal amendments was therefore prepared for consideration.

38.3 While the IEC proposal received "in-principle" support of industry representatives and the other three financial regulators in October 2007, there were concerns that it was not an appropriate time to propose the required legislative changes. As a result, the IEC plan did not proceed as drafted but instead there was some expansion of the IE efforts of the SFC.

38.4 ***We recommend that legislative changes needed for the creation of an IEC are brought forward as soon as possible.***



Enforcement powers

39. **Amendments to SFO to allow certain powers to be delegated by the SFC Board and to extend the grounds for application for certain orders**
- 39.1 Section 213 of the SFO enables the SFC to seek injunctions and other orders, including orders to restore parties to the pre-transaction position, orders stopping acquisition, disposal or trading in certain property, orders appointing an administrator over a person's property, orders declaring certain contracts void or voidable, and other ancillary orders.
- 39.1.1 The SFC must apply to Court when exercising its power under section 213. Currently, the SFC Board must give prior approval to an application under section 213. This approval is non-delegable under section 10 of the SFO.
- 39.1.2 An approval by the SFC Board can either be given at a meeting or by a written resolution. How quickly the meeting can be convened depends upon whether the quorum for a meeting can be met. Although a resolution can be circulated in writing, it has to be signed by all the members who are present in Hong Kong. Thus, a resolution may not be passed instantaneously.
- 39.1.3 In addition, the grounds for seeking orders under the current section 213 are unnecessarily restrictive. For example, currently the SFC cannot seek an injunction order where there is a breach of the mis-selling provisions of the Code of Conduct.
- 39.2 Sections 204, 205 and 206 of the SFO empower the SFC to issue restriction notices, which require Licensed Corporations to take or refrain from taking certain actions in respect of their businesses, to deal or refrain from dealing with property in a specified manner, and to maintain property in any place and manner specified. Currently, these powers are non-delegable under section 10 of the SFO and the issue of restriction notices must be approved by the SFC Board.
- 39.3 In many cases where injunctions are sought from the Court or a restriction notice is served, time is of the essence as part of the justification for an injunction or restriction notice is to ensure that action is not taken by third parties where that action is prejudicial to the interests of the market or individual market participants. Delays can frustrate the purpose of the injunction or restriction notice.
- 39.4 ***We recommend that the SFO is amended:***
- 39.4.1 ***to allow the Board of the SFC to delegate the powers under sections 204, 205, 206 and 213. It will be for the SFC Board to determine what safeguards are needed to ensure that these powers are exercised appropriately. In this regard it should be borne in mind that safeguards already exist by the fact that a judge needs to be satisfied that an injunction (or any other order sought) should be granted; and***
- 39.4.2 ***to allow the SFC to seek orders under section 213 in the event of a breach of the Code of Conduct.***



40. SFC power to order compensation

- 40.1 Where a Regulated Person is guilty of misconduct or the SFC is of the opinion that a Regulated Person is not a fit and proper person, the SFC may commence disciplinary proceedings against the Regulated Person.
- 40.2 The SFC (or the SFAT on appeal) can impose certain sanctions as described in section 11.
- 40.3 Currently, section 201 of the SFO permits the SFC to consider and, if appropriate, to agree other means of resolution. We have entered into remediation agreements involving financial redress and compensation. Resolutions that lead the SFC to enter into remediation agreement should contain one or more of these objectives:
- 40.3.1 to ensure problems do not arise again;
 - 40.3.2 to mitigate the financial consequences of misconduct to the investing public; and
 - 40.3.3 to increase confidence in the capacity of Hong Kong's regulatory systems to solve problems beneficially.
- 40.4 Other jurisdictions have power to order some form of restitution. For example, the FSA in the UK may make restitution orders under section 384 of the Financial Services and Markets Act ("FSMA") 2000 (which can only be made against an authorised firm) if satisfied that:
- 40.4.1 an authorised person has contravened, or been knowingly concerned in the contravention of:
 - (a) a requirement imposed by or under the FSMA 2000; or
 - (b) a criminal offence under any other Act which the FSA has the power to prosecute;
 - 40.4.2 profits have accrued to the person as a result of the contravention; and
 - 40.4.3 one or more persons have suffered loss or been otherwise adversely affected as a result of the contravention.
- 40.5 Where the FSA is so satisfied, it may require the person concerned, in accordance with such arrangements as the FSA considers appropriate, to pay to the appropriate person or distribute among the appropriate persons such amount as appears to the FSA to be just having regard to:
- 40.5.1 the profits appearing to the FSA to have accrued, and/or
 - 40.5.2 the extent of the loss or other adverse effect.
- 40.6 In the absence of a voluntary compromise under section 201 of the SFO, the SFC cannot compel a Regulated Person to compensate an investor, where an adverse disciplinary decision has been made.



- 40.7 ***We recommend that the SFC is provided with powers to impose a compensation order as a disciplinary sanction.***

