



SECURITIES AND FUTURES COMMISSION
證券及期貨事務監察委員會

**WRITTEN RESPONSE TO THE FOLLOW-UP
QUESTIONS RAISED BY THE SUBCOMMITTEE ON
23 JUNE 2009**

26 June 2009



1. **With reference to paragraph 5 of the opening statement made by the Chief Executive Officer of the Securities and Futures Commission (CEO/SFC) (W16) at the hearing on 23 June 2009, please provide a breakdown of the some 8400 complaints filed through SFC since September 2008, including:**
 - 1a. **the number of complaints relating to Minibonds;**
 - 1b. **the number of complaints relating to other Lehman Brothers (LB)-related structured financial products, including credit-linked notes and equity-linked notes; and**
 - 1c. **the number of complaints referred to the Hong Kong Monetary Authority by SFC.**
- 1.1. Following the collapse of Lehman Brothers, we have received a total of 8,421 complaints (as at 29 May 2009) relating to Minibonds and other Lehman Brothers-related structured products.
- 1.2. Insofar as these complaints contained allegations against banks, it is our policy to refer them to the HKMA for their further handling, subject to the SFC having received consent from the specific complainant for such referral. The SFC, on the other hand, notes the complaints for its "top-down" investigation approach but does not follow up on the details of each specific complaint before referring them to the HKMA. As at 29 May 2009, the SFC referred 7,589 complaints to the HKMA out of a total of 7,933 complaints it received which contain allegations against banks. Approximately 300 complainants did not give the SFC the consent simply because they had already filed the same complaint with the HKMA.
- 1.3. In many of these cases the complainants did not even specify the name or type of Lehman Brothers-related structured product that they bought. We are therefore unable to provide a breakdown based on the type of product.
- 1.4. Please find below a breakdown of the complaints received after the collapse of Lehman Brothers based on the allegations made (each complaint may contain more than one allegation):



Major allegations (can be multiple for each complaint)	Against banks	Against licensees
Mis-selling	7,933 (94.2%)	121 (1.4%)
▪ <i>front line staff proactively induced complainants to turn their matured fixed deposits into investments in LB related products for higher returns and other incentives such as free shopping coupons</i>	2,184 (25.94%)	-
▪ <i>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</i>	2,589 (30.74%)	-
▪ <i>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</i>	3,148 (37.38%)	-
▪ <i>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 LB</i>	2,793 (33.17%)	-
▪ <i>banks did not respond to complainants' enquiries and complaints after the collapse of LB</i>	419 (4.98%)	-
▪ <i>distributors of Minibonds had misrepresented that they were low-risk products</i>	-	61 (0.7%)
▪ <i>distributors did not disclose the role of LB</i>	-	63 (0.7%)
Disclosures in and presentation of product documentation ¹	309 (3.7%)	
Conduct of duties of the two regulators	448 (5.3%)	
Total complaints	8,421 (100%)	

¹ Among these 309 complaints, 137 complaints (or 1.6% of the total complaints) are in relation to allegations on product name.



2. **Please confirm whether SFC has, since April 2003, disapproved any product brand names used by issuers in their draft prospectuses and marketing materials submitted to SFC.**
- 2.1. The SFC is empowered under the CO to authorise prospectuses for registration. Before the SFC authorises a prospectus for registration, it has to be satisfied that, based on the information provided by the issuer, all the requirements in the Third Schedule and Part II or Part XII of the CO have been met or are otherwise exempted. In other words, the SFC would review the prospectus against these requirements and where appropriate, authorise the prospectus as a whole. The SFC would look at the product in its entirety and raise requisitions where necessary.
- 2.2. Similarly, the SFC is empowered under the SFO to authorise marketing materials in totality and not just the "product brand name" used by issuers in their draft marketing materials in isolation.



3. **Please provide the checklist(s)/manual(s) that SFC staff are required to follow when vetting the draft prospectuses and marketing materials of Minibonds and other LB-related structured financial products.**
- 3.1. Please note that we need more time to address this request.



4. **Please provide the relevant written records on SFC's authorization of the prospectuses and marketing materials of Minibonds series 27, 34 and 35 (S32) and Constellation Notes series 44, 56 and 58 (S33), including the queries/comments, if any, raised by SFC to the issuers on these documentations.**

- 4.1. Please note that we need more time to address this request.



5. The attached written questions raised by Mr. LEUNG Kwok-hung and handed to CEO/SFC at the hearing on 23 June 2009.

Document 1

Observations from the data given by SFC and HKMA and questions relating to these observations

I have made a comparison of supervisory activities of and disciplinary action taken by HKMA and SFC in the periods between April 2003 and Sept 2008 and complaints received by them on the misconducts of RIs (banks) supervised by HKMA and LCs (license corporations) supervised by SFC respectively on the carrying out of the regulated activities:

1	2	3	4	5	6	7
	Number of RI supervised by:	In April 2003 to Sept 2008, the number of disciplinary inquiries for suspected breaches of Code of Conducts completed by	The number of above cases on which disciplinary actions are taken by	In the 2 nd thematic review in 2006, the enforcement actions taken by	In the 1 st surveys in 2006, it shows that the sales of structured products are 77% by RIs and 23% by LCs	After Lehman collapsed, the number of complaints received by
HKMA is	102 RIs	178	9	3 cases out of 12 RIs	---	21,045
SFC is	1,560 LCs	527	430	5 LCs out of 10 LCs	---	115

The data in the tables reveals some major differences in the performance of HKMA and SFC in delivering their policy objectives and policy outcomes. I have listed out several observations for the above data and proposed 1 questions for you to answer. Please read and provide written answer.

Observations:

1. HKMA has only detected a low number and low percentage of suspected breaches by RIs in the period between April 2003 and Sept 2008 and the percentage of suspected cases leading to disciplinary actions (9 out of 178) is also low. But in the same period, SFC has detected a high number of suspected cases and has brought out a much higher rate of disciplinary actions (430 out of 527); (see column 3 & 4);
2. 50% of the LCs under inspection in the thematic review is disciplined and only 25% of RIs are disciplined. Is the big contrast due to the fact that



- a. SFC took a more stringent stand toward the LCs than HKMA toward RIs? OR
 - b. A relatively higher propensity of the LCs than RIs to commit misconduct in sales? (see column 5);
3. The sale of structured product by LCs is 23% of the total and the complaints received after the collapse of Lehman is less than 0.5% of the total whereas the complaints on RIs is 99.5% (see column 7). The above result appears to support an affirmative answer to 2a more than to 2b above?
 4. The above data give good support to convince a reasonable person that the low percentage of complaints to LCs after the collapse of Lehman is a consequence of the stronger enforcement and tighter supervisory action against the sales structured products. Agree or not?
 5. Hence, the harm to the investors by the misconduct of RIs in the sales of structured products is something that can be considerably reduced if the regulators responsible for supervising, monitoring, and regulating the RIs have done what a reasonable regulator would have done a discharge his duty with the care, diligence, and skill that a reasonable person would expect them to display in the protection of investors. Agree or not?
 6. Or in another word, the harm to the investors by the misconduct of RIs in the sales of financial products is something that can be considerably reduced if the regulators responsible for supervising, monitoring, and regulating the RIs have discharged his duty with the same degree of care, diligence, and skill that SFC has done to the LCs in the protection of investors. Agree or not?

Questions:

Do you agree with each of the above observations? Please comment one by one.

Item 1 on Document 1

- 5.1. Before addressing the question, it should be noted that we understand from the HKMA that the figures provided by the HKMA earlier was meant to only cover possible mis-selling cases rather than all possible breaches of the Code of Conduct. As regards the number of disciplinary inquiries for suspected breaches of Code of Conduct completed by, and the number of resulting disciplinary actions taken by, the SFC in the period April 2003 to September 2008, please refer to paragraph 82 of my written statement submitted to the Subcommittee on 10 June 2009.

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Items 2, 3 and 4 on Document 1

- 5.2. We do not have information on RIs and their supervision of RIs to confirm this.

Items 5 and 6 on Document 1

- 5.3. We are not in a position to comment. HKMA is the frontline regulator of banks.



Document 2

Warning on Structured Products

1. Please submit us a list of major communications between SFC and HKMA with summaries of the topics covered, dates of communication, warnings made and response to the warnings from January 2003 to Sept 2008.
2. Please give us the hyperlinks to the articles you mentioned in para 74 of your written statement on June 10.
3. Please list the names of those committees that you said you have not participated (In para 1.13 of your written submission).
4. Referring to para 5.12 of your written submission, why HKMA has not started thematic review on structured product earlier under your warning in 2005?
5. Did they give any explanation to you?
6. Why you do not press for it?
7. Do you have the impression that HKMA has understand your warning, the risk and the complexity of the structured products, particularly those containing CDS or any kind of high leverage derivatives?
8. Do you think that CDS by itself is highly leveraged?
9. Do you think that a CDS is a high risk commitment of its seller?

Item 1 on Document 2

- 5.4. A list of major communications between SFC and HKMA in relation to warning on structured products from January 2003 to September 2008

	Date of communications	Form of Communications	Summary of topics covered	Warnings made	Response to warnings
1	4 August 2006	Letter	SFC sent a letter to HKMA seeking its views on the draft Guidelines for marketing materials for listed structured products before publication in September 2006. HKMA responded on 11 August 2006 that they had no comments on the draft.	N/A	N/A
2	20 October 2006 and 23 November 2006	Phone and Email	The Structured Products Investor Survey published by SFC in November 2006 showed that most investors (87.9%) bought their structured products through banks.	Most investors (87.9%) bought their structured products through banks. Only about half (48.9%) of the respondents recalled having	N/A



	Date of communications	Form of Communications	Summary of topics covered	Warnings made	Response to warnings
				received offering documents from the selling intermediaries, and almost half of them (45.5%) indicated that the sales representatives did not explain the product at the point of sale.	
3	5 October 2006	MOU meeting	HKMA shared their progress and observations of the inspection of selling practices of RIs during the meeting. HKMA advised that in addition to private banks, they would also inspect the selling practices of retail banks. Detail observations were discussed in the meeting held on 15 December 2006.	N/A	N/A
4	15 December 2006	Informal meeting between operational staff	HKMA shared the observations of their inspection of selling practices during the meeting. HKMA advised that regulatory issues were noted in the sale of certain structured products to investors by both retail and private banks inspected.	N/A	N/A
5	13 March 2008	MOU meeting	SFC and HKMA discussed the trends in securities enforcement. It was noted that there was an increase in the number of accumulator-related complaints received by the HKMA. The HKMA apprised the SFC on the size and	There was an increase in the number of accumulator-related complaints received by the HKMA.	The HKMA had conducted a preliminary study to estimate the amount of accumulators sold.



	Date of communications	Form of Communications	Summary of topics covered	Warnings made	Response to warnings
			implications of accumulators.		
6	22 July 2008	MOU meeting	The SFC and HKMA discussed the recent trend in relation to the number of accumulator-related complaints received by the HKMA.	The number of accumulator-related complaints received by the HKMA increased but in a more steady manner.	The HKMA was in the process of reviewing the complaints.
7	31 July 2008	MOU meeting	HKMA shared with SFC the results of examinations on selling of stock accumulators by registered institutions. HKMA advised that a retail bank was found to have internal controls problems and management issues in relation to the sale of accumulators.	N/A	N/A

Item 2 on Document 2

- 5.5. The eight articles and a press release which were published between December 2003 and January 2004 to explain and highlight the risks and features of CLNs, ELNs and structured products are key initiatives launched under an investor education campaign by the SFC on structured products. In order to increase exposure of these educational materials to the investing public, different delivery channels were utilised, with some articles published online on the SFC's Electronic Investor Resources Centre (now the InvestEd website) and some published as newspaper articles.
- 5.6. Please find the details and a brief summary for each IE activity. Hyperlinks are provided where available. Where the article is not available online or not online anymore, a copy has been provided.

	Details of IE activity	Key messages (and hyperlinks)
1.	Structured Products - About Structured Products – Explaining Structured Notes 結構性產品 - 關於結構性產品 - 闡釋結構性票據	<ul style="list-style-type: none"> What are ELNs and CLNs and how they work, including a brief explanation of the swap arrangements behind ELNs or CLNs. http://www.invested.hk/invested/en/html/section/produ



	Details of IE activity	Key messages (and hyperlinks)
	Dec 2003, bilingual	ts/structured/explain_note.html (English) http://www.invested.hk/invested/tc/html/section/products/structured/explain_note.html (Chinese)
2.	Structured Products - About Structured Products – Evaluating Structured Notes 結構性產品 - 關於結構性產品 - 評估結構性票據 Dec 2003, bilingual	<ul style="list-style-type: none"> ▪ Creditworthiness of issuer and “limited recourse” nature of CLNs and ELNs are discussed. http://www.invested.hk/invested/en/html/section/products/structured/evaluating_note.html (English) http://www.invested.hk/invested/tc/html/section/products/structured/evaluating_note.html (Chinese)
3.	Advice to Investors on Structured Notes 就結構性票據給投資者的建議 29 Dec 2003, bilingual	<ul style="list-style-type: none"> ▪ Investors should note that not all ELNs and CLNs are capital protected. ▪ Investors should read the offer documents or the term sheet to understand the pay-off mechanism and other terms and conditions of a structured note. ▪ Where in doubt, investors should consult their financial advisors. http://www.sfc.hk/sfcPressRelease/EN/sfcOpenDocServlet?docno=03PR286 (English) http://www.sfc.hk/sfcPressRelease/TC/sfcOpenDocServlet?docno=03PR286 (Chinese)
4.	Monthly Focus - Structured Notes are Different from Plain Vanilla Bonds 每月焦點 - 結構性票據與傳統的 普通債券不同 Jan 2004, bilingual	<ul style="list-style-type: none"> ▪ This article summarises some key features of ELNs and CLNs and warns investors that these structured notes are different from plain vanilla bonds. ▪ Investors are also warned that the major risk factor they need to consider when purchasing structured notes is that they may not be capital protected. ▪ Investors are also reminded to find out who the issuer of the structured notes is and whether such issuer is creditworthy and if the issuer is a SPV. The ability of the issuer to meet its obligations to noteholders depends on the receipt of monies from the underlying debt securities, which are purchased using the proceeds paid by the noteholders. ▪ <i>“Because a structured note may carry novel features, thus, it is important for prospective investors to read the offering document or the term sheet to understand its terms and conditions. When in doubt, consult your investment adviser on</i>



	Details of IE activity	Key messages (and hyperlinks)
		<p><i>its suitability as an investment."</i></p> <p>(Note: this article was online for twelve months but is no longer online)</p>
5.	<p>Things to know for ELNs 股票掛鉤票據特點</p> <p>6 Jan 2004, Chinese</p>	<ul style="list-style-type: none"> Investors should read the offer documents and/or the terms and conditions to understand the features of ELNs.
6.	<p>Frequent credit events lower the interest of CLNs 信貸事件愈多 掛鉤票據息率愈低</p> <p>7 Jan 2004, Chinese</p>	<ul style="list-style-type: none"> The payment of interest/principal under CLNs will be affected by the occurrence of "credit events" which, in general, include bankruptcy and inability to pay. Depending on the terms and conditions of the CLNs, investors will (i) get a reduced interest payout or (ii) get no interest payout upon the occurrence of a credit event. In some cases the CLNs will be early redeemed upon the occurrence of a credit event. The early redemption amount is dependent on the amount of the sale proceeds of the relevant debt instruments, and investors could get an amount which may be less than the principal amount in the event of early redemption. First-to-default CLNs – the credit event that leads to redemption is referenced to the first credit event amongst all underlying entities. In some cases the issuer will use the proceeds to purchase collaterals which are bonds that generate cashflow for the purpose of meeting its obligations. CLNs/ELNs often involve complicated currency/interest swap arrangements which usually exist when the notes and the relevant bonds are denominated in different currencies, and investors are warned that if the swap counterparty defaults, (i) the issuer might not be able to honour its obligations under the notes and (ii) the amount for repayment will be reduced by the fees incurred as a result of the termination of the swap agreement.
7.	<p>Evaluating the issuer of a structured product 評估結構性票據的發行商</p> <p>8 Jan 2004, Chinese</p>	<ul style="list-style-type: none"> Although ELNs and CLNs are usually linked to reputable corporations, investors should note that those corporations do not have any obligation at all and the obligation to pay interest/principal is borne by the issuer. If the issuer is an SPV, it may use the proceeds to



	Details of IE activity	Key messages (and hyperlinks)
		<p>purchase collaterals which are bonds that generate cashflow for the purpose of meeting its obligations.</p> <ul style="list-style-type: none"> ▪ Limited recourse – investors' claims are only confined to the amount recovered from the realisation of the relevant bonds. ▪ Investors should check the terms and conditions and see whether the issuer is entitled to some special rights, e.g. the right to extend the investment tenor and the right to early redeem the notes. ▪ Investors should not confuse the existence of a guarantor with "capital-guarantee"/"principal-guarantee".
8.	<p>Your rights as a structured product holder 持有結構性票據的權益</p> <p>9 Jan 2004, Chinese</p>	<ul style="list-style-type: none"> ▪ Investment in ELNs or CLNs is not the same as investing in the underlying securities or assets and hence investors of ELNs/CLNs are not entitled to the rights resulting from the ownership of such underlying securities/assets. ▪ The value of the notes will be affected if the value of the underlying securities changes or if the credit rating of the reference entities is downgraded. ▪ Investments in unlisted ELNs/CLNs are not covered by the Investor Compensation Fund. ▪ Investors should note that there may be no secondary market for unlisted ELNs/CLNs and even if a secondary market exists, their trading prices will fluctuate depending on various factors. ▪ Investors of structured notes are exposed to, among others, the issuer's credit risk. ▪ Not all retail notes/bonds are capital-guaranteed. Investors should read the offering documents carefully and understand the features of the notes. They should seek advice from their own financial advisors if in doubt.
9.	<p>Sean's experience in credit-linked notes 阿遜投資信貸掛鉤票據實錄</p>	<ul style="list-style-type: none"> ▪ CLN is a type of structured notes. The payment of interest and/or principal will be affected by the occurrence of a "credit event". Examples of "credit event" include bankruptcy or inability to pay debts.



	Details of IE activity	Key messages (and hyperlinks)
	9 Jan 2004, Chinese	<ul style="list-style-type: none">▪ Before investing in CLNs, investors should (i) check the issuer's financials and the mechanism of the transaction (e.g. whether investors are subject to limited recourse), (ii) understand how interest and principal will be paid, (iii) check whether the notes are guaranteed, (iv) understand whether the notes will be early redeemed or whether the tenor will be extended, and (v) understand that there may be no secondary markets for CLNs.▪ If the issuer is an SPV, it may use the proceeds to purchase collaterals which are bonds that generate cashflow for the purpose of meeting its obligations.▪ Limited recourse – investors' claims are only confined to the amount recovered from the realisation of the relevant bonds.▪ The existence of a guarantor and "principal-guaranteed" are two different matters.▪ Investors should note that there may be no secondary market for certain CLNs and even if a secondary market exists, their trading prices will fluctuate depending on various factors.▪ Investors should read the offering documents carefully and understand the features of the notes. They should seek advice from financial advisors if in doubt.

Item 3 on Document 2

- 5.7. In paragraph 1.13 of my written statement, I stated that I had not participated or been involved in any committee that deals specifically with the regulation of RIs' conduct of securities related business. My answer was not intended to, and should not be interpreted as, a confirmation of the existence of certain committees. As stated at paragraph 1.14 of my written statement submitted to the Subcommittee on 10 June 2009, pursuant to the MOU, the HKMA and the SFC hold regular meetings to discuss matters of mutual interest related to the performance of their regulatory and supervisory functions.

S1-Appendix 10



Items 4, 5 and 6 on Document 2

- 5.8. HKMA is the frontline regulator of banks. It is more appropriate for such a question to be addressed by the HKMA.

Item 7 on Document 2

- 5.9. HKMA has published numerous articles on the risks of structured products.

Item 8 on Document 2

- 5.10. "Leverage" is the magnification of gains and losses by only paying for part of the underlying value of the instrument or asset. Retail Credit-linked notes such as Minibonds are fully pre-funded investments embedded with CDS. Investors' maximum loss is the amount they originally invested i.e. there is no leverage in a strict sense. Minibond investors are however exposed to the default risks of the issuer, the swap guarantor, the reference entities and those named in the underlying portfolio of the CDO collateral.

Item 9 on Document 2

- 5.11. Whether a CDS is a high risk commitment on its seller depends on many factors including the financial situation, risk tolerance level, investment experience and investment objectives of the seller as well as the investment amount in the product. A CDS investor is exposed to the default risk of the CDS reference entity. By analogy, a corporate bond investor is exposed to the default risk of the bond issuer.
- 5.12. SFC's Code of Conduct, as clarified by the FAQs on suitability obligations published in May 2007, imposes an obligation on intermediaries to ensure product suitability by matching the risk return profile of each recommended investment product with each client's personal circumstances. They are also required to help each client make informed decisions by providing explanations using simple and plain language.

S1-Appendix 11
M4



Document 3

Level Playing Field vs Consistent:

When referring to supervision of RIs, HKMA has mentioned several times about the idea of "level playing field" in his report to the FS and in our previous hearings whereas SFC uses the words "consistent measures" instead,

My questions:

1. What are the differences between these two phrases?
2. Do these terms mean "treat the unequal equally" OR "treat the unequal unequally"? (Please bear in mind that RIs and LCs are unequal subjects).
3. Do you think that HKMA and SFC should treat RIs and LCs unequally or equally?
4. Have you ever suggested to HKMA to use "mystery shopper"?
5. Have you ever thought of using "mystery shopper" to LCs?
6. If no, why not?
7. From your administrative knowledge, please state which of the following are acceptable to be used or must be used under the idea of "level playing field" in the supervision of RIs and LCs:
 - 7a. Same law, codes and rules to be applied for both?
 - 7b. Same frequency of inspection and examinations for both?
 - 7c. Same means and technique to collect evidence for both?
 - 7d. Same sampling techniques for every sampling done to both?
 - 7e. Same care, diligence, and skill used for the duty of supervising, monitoring and regulating both?
 - 7f. Same reasoning used for applying the law, rules, and codes to both?
 - 7g. Same prime objective of "protecting investors" for both?
8. Have you established any guidelines on achieving the idea of "level playing field"? If not how do you guarantee that the "level playing field" idea will be carried?

Items 1, 2, 3 and 7 on Document 3

- 5.13. If the "*level playing field*" is defined such that RIs and LCs are playing by the same set of rules, this is not inconsistent with the regulatory objective to ensure that the intermediaries are subject to "*consistent*" regulatory measures.
- 5.14. For instance, under the SFO, the SFC has published the Code of Conduct which sets out the practices and standards with which LCs and RIs and their representatives are ordinarily expected to comply in carrying on regulated activities. S1-Appendix 11
- 5.15. On the other hand, the SFC and the HKMA entered into the Memorandum of Understanding in December 2002 to strengthen their co-operation. S1-Appendix 10
Operational staff interact with each other through regular communications on operational matters to ensure consistency in applying the standards in the Code of Conduct and in other requirements. Senior staff of the two regulatory



authorities meet formally from time to time to discuss matters to ensure the same standards are applied.

Item 4 on Document 3

- 5.16. No. HKMA, being the frontline regulator of banks, has the responsibility to exercise supervisory powers over RIs on a daily basis.

Items 5 and 6 on Document 3

- 5.17. As part of the SFC's supervisory approach, we have deployed various techniques and methods such as investor surveys and thematic inspections to identify non-compliance and deficiencies in relation to the selling practices of LCs. For details, please refer to the response to Question 17 in my written statement submitted to the Subcommittee on 10 June 2009. W13(C)
- 5.18. We take the view the current approach, even without "mystery shopper" tool, is effective in identifying non-compliance and deficiencies in relation to the selling practices of licensed corporations that were inspected.

Item 8 on Document 3

- 5.19. Through regular communications, meetings, mutual consultations, exchange of regulatory information as well as exchange of staff, SFC works closely with the HKMA to ensure consistency in applying the standards in the Code of Conduct and in other requirements. S1-Appendix 11