

WRITTEN STATEMENT OF MR Y K CHOI, JP
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GENERAL REMARKS

Introduction

1. In response to the questions raised by the Subcommittee in its Clerk's letter dated 27 April 2009, I have prepared the following replies. I have sought assistance from my colleagues in the Hong Kong Monetary Authority (HKMA) in perusing relevant files and records of the HKMA and obtaining factual information from the Administration and the Securities and Futures Commission (SFC) in preparing the replies. I have in this statement responded to the questions raised by the Subcommittee to the best of my knowledge and belief.

(a) **Responsibilities of the Deputy Chief Executive of the HKMA in relation to the regulation of banks' securities business**

2. The Monetary Authority (MA) has internally authorised specified staff of the HKMA to exercise on his behalf and in his name some of the powers conferred upon him by various ordinances (including the Securities and Futures Ordinance (SFO) and the Banking Ordinance (BO)). As the Deputy Chief Executive of the HKMA responsible for banking-related matters, I am authorised by the MA to be in charge of the full range of banking policy, banking development and banking supervision issues, including day-to-day regulation and enforcement of regulated activities conducted by registered institutions (RIs). Although such powers and duties are normally exercised or performed by other authorised officers of the HKMA, I am generally responsible

to the MA for ensuring that the relevant powers and duties are exercised reasonably and in good faith.

(b) **Regulatory policy on banks' sale of financial products**

3. The Government's regulatory policy in providing an appropriate measure of investor protection and on intermediaries' (including banks') sale of financial products in Hong Kong prescribes, as the HKMA understands it, a disclosure-based system with four key elements. First, sufficient information, including the nature and risks of the investment product being offered, is disclosed in the investment product documentation by the issuer. Secondly, suitability assessments are conducted by intermediaries selling or recommending such products to the general public to ensure that investors understand the nature and risks of the products and that the products are suitable for the investors. Thirdly, through these two processes, the intention is to enable investors to make informed investment decisions. Finally, once the nature and relevant risks of the investment products have been properly disclosed and suitability assessment properly conducted, investors take responsibility in an informed way for their investment decisions. As stated in paragraphs 8.6 and 8.8 of the Report of the Hong Kong Monetary Authority on Issues Concerning the Distribution of Structured Products Connected to Lehman Group Companies ("HKMA's Review Report"), the HKMA believes that the disclosure-based policy is appropriate for Hong Kong and should be retained.

(c) **Regulatory co-operation between the HKMA and the SFC**

4. Under the regulatory regime stipulated in the SFO and the BO, the HKMA acts as the front-line regulator of regulated activities conducted

by RIs, using the standards promulgated by the SFC as the basis of regulation. In order to ensure a level playing field between RIs and licensed corporations, the HKMA exchanges views with the SFC under the arrangements set out in the revised Memorandum of Understanding (MoU) signed by the two regulators on 12 December 2002 to ensure that regulatory standards are interpreted and applied by the HKMA in a way that is in line with the SFC's interpretation and application of those standards. In addition to regular meetings between the HKMA and the SFC pursuant to the MoU, there are on-going contacts at the working level through meetings, telephone conversations and email communication to discuss issues of common regulatory interest. Exchanges of staff have also been arranged between the two regulators to permit experience sharing and to further strengthen cooperation. Such coordination and communication also aim to avoid duplication of regulatory effort thereby reducing regulatory cost.

(d) **Conduct regulation at point of sale**

5. The regime adopted by the HKMA for regulating RIs' regulated activities, including at the point of sale, rests on two pillars: day-to-day regulation and enforcement. The HKMA carries out day-to-day regulation (including on-site examinations and off-site reviews) to help ensure that RIs conduct their regulated activities according to the legal and regulatory requirements. Where the day-to-day regulatory process or any complaint received reveals possible misconduct, the incident is referred to the HKMA's securities enforcement team for investigation and disciplinary proceedings or referral to the SFC as appropriate.

(e) **On-site examinations and off-site surveillance on banks**

6. During the period from April 2003 to 31 December 2008, the HKMA conducted 170 on-site examinations of RIs that covered, in whole or in part, the conduct of the securities business by RIs. The HKMA's on-site examination activities are supplemented by the off-site surveillance work of individual case teams. Each RI is assigned to a case officer (or a team of officers for larger institutions) who is responsible for the overall supervision of the RI which includes conducting on-going off-site reviews of the relevant institution.

(f) **Manpower for supervising banks' securities business**

7. In view of the growing securities business of RIs since 2004, the HKMA has stepped up its regulatory efforts with regard to RIs' securities business and deployed more supervisory and enforcement resources to this area. The number of the HKMA staff involved in the regulation of RIs' regulated activities, including on-site examinations, off-site surveillance and the enforcement function, increased from 75 in 2003 to 119 in mid-September 2008. The modality of day-to-day regulation has also been enhanced, such as by the introduction of thematic examinations in 2005 for more in-depth regulation of specific aspects of regulated activities, in order to enhance overall regulatory effectiveness. Where appropriate, the HKMA issued additional guidance to the industry. From 2003 to September 2008 before the collapse of the Lehman Brothers group (LB), the HKMA issued a total of 15 circulars in relation to RIs' regulated activities.
8. In the light of the rapidly deteriorating market conditions which affected significantly the credit risk outlook in the market, the HKMA has, since late 2007, devoted additional regulatory resources to

credit-linked products distributed to retail investors, namely, retail credit-linked notes (CLNs), although this type of products only constituted a small proportion of the amount of structured products distributed by RIs at that time. In addition to performing a survey from December 2007 to early 2008 to gather information about the sale by RIs of retail CLNs, the HKMA also conducted thematic examinations of RIs' selling of retail credit-linked investment products in 2008.

9. Since the collapse of LB in mid-September 2008, the HKMA has received a large number of complaints relating to possible mis-selling of LB-related structured products by RIs. The HKMA is devoting substantial additional resources to and cooperating fully with the SFC in investigating these cases.
10. The HKMA fully appreciates the importance of completing the investigations as quickly as possible and facilitating the SFC in its investigations. The HKMA is, however, also aware of the need to ensure that the investigations are conducted fairly. Currently, there are over 200 staff members working on complaints related to LB. A further 40 contract staff are expected to report for duty in the coming 6 weeks or so while another 140 contract staff are being recruited for this purpose. The situation is reviewed on an on-going basis to identify whether there are ways to speed up the process further. Where there are cases with evidence of mis-selling, the HKMA will liaise with the SFC for disciplinary actions to be taken against the RIs or staff concerned. Meanwhile, the HKMA has been encouraging RIs to resolve their disputes with affected investors by voluntary settlement. Up to 6 May 2009, about 4,800 cases have already been settled by the relevant RIs while around 1,800 cases are in the process of negotiation for settlement. The HKMA will, to the best of its ability and within

its powers, handle all the complaints as expeditiously and fairly as possible.

(g) **Sale of financial products through private placement**

11. The private placement issue was raised in paragraph 8.16 of the HKMA's Review Report. As set out in that paragraph, sales by private placements do not require a prospectus or the SFC's authorisation of offering documentation, which would otherwise be required for an offer to the public. The HKMA's related recommendation aims at reviewing the appropriateness of such a regime given the latest market developments, and whether the existing exemptions from the requirement for the SFC's authorisation of offering documents for investments should be tightened up.
12. I shall now turn to the specific issues raised by the Subcommittee in its Clerk's letter of 27 April 2009 addressed to me.

SPECIFIC REPLIES

Responsibilities of DCE/HKMA in relation to regulation of banks' securities business

1. *According to HKMA's Annual Report 2008, Mr CHOI, as DCE/HKMA, is "in charge of the full range of banking policy, development and supervision issues". Please advise on the following:*

- (a) DCE's powers and responsibilities, particularly those relating to regulation of banks' securities business;*
- (b) the division of responsibilities among the Executive Directors under DCE in relation to regulation of banks' securities business; and*
- (c) DCE's participation or involvement, if any, in relevant committees (e.g. the Financial Stability Committee, the Council of Financial Regulators or others) tasked to oversee, inter alia, banks' conduct of securities business.*

Item (a)

- 1.1 Assisted by three Executive Directors (see the response to item (b) below), I am in charge of the full range of banking policy, banking development and banking supervision issues, including day-to-day regulation and enforcement of regulated activities conducted by RIs. Annex 1 to the response of the MA dated 27 April 2009 to item (a) of the Subcommittee's information requests (follow-up to the hearing on

17 April 2009) enclosed with the letter of the Clerk to the Subcommittee dated 20 April 2009 (SC Ref. No. M17) sets out specific powers and duties the MA has authorised me and other officers to exercise under the SFO and the BO. Although such powers and duties are normally exercised or performed by the authorised officers of the HKMA, I am generally responsible to the MA for ensuring that the relevant powers and duties are exercised reasonably and in good faith.

- 1.2 I am also the Chairman of the internal Disciplinary Committee, which considers and makes recommendations to the MA on whether, and if so what, disciplinary sanctions should be imposed for cases involving misconduct in which sufficient evidence has been gathered during investigation including referral to the SFC for it to consider possible disciplinary or other action where appropriate.

Item (b)

- 1.3 There are three departments under my purview, namely, the Banking Supervision Department (BSD), the Banking Policy Department (BPD) and the Banking Development Department (BDD), each of which is headed by an Executive Director.
- 1.4 The Executive Director of BSD is responsible for the supervision of authorized institutions (AIs), including the day-to-day regulation of securities business of RIs, and ensuring the financial soundness of individual AIs and of the stability of the banking system as a whole in Hong Kong. The Executive Director of BPD is responsible for formulating supervisory policies to promote the safety and soundness of the banking sector. The Executive Director of BDD is responsible for formulating policies to promote the development of the banking industry. His responsibilities also include taking enforcement action

in relation to the regulated activities of RIs.

Item (c)

- 1.5 A summary of the relevant committees in which I participate (though not being a member) and of which the scope covers the regulation of RIs' securities business is set out below.

The Council of Financial Regulators ("the Council")

- 1.6 I regularly attend the meetings of the Council to discuss issues related to the regulation and supervision of financial institutions and other issues that are relevant to the objectives of the Council. The Council aims at, among other things, facilitating co-operation and co-ordination among financial regulators in Hong Kong, sharing information and views on regulatory and supervisory issues and important trends in the financial systems, particularly those which may have a cross-sectoral impact, and maintaining financial stability in Hong Kong.

The Banking Advisory Committee (BAC) and The Deposit-taking Companies Advisory Committee (DTCAC)

- 1.7 I regularly participate in the joint meetings of the BAC and the DTCAC to brief members, and seek their views, on the HKMA's observations on current market developments and trends in the banking sector and its policy responses. Joint meetings of the committees are held on a quarterly basis to discuss, among other things, current issues in the banking sector and the latest banking trends and developments, including issues on the regulation of securities business of RIs.

Regulatory policy on RIs' sale of financial products

2. *According to the Report of the Hong Kong Monetary Authority on Issues Concerning the Distribution of Structured Products Connected to Lehman Group Companies (HKMA's Review Report), HKMA, as the frontline supervisor of RIs, oversees their governance, systems and internal controls in accordance with standards established by SFC with a view to ensuring the proper conduct of their "regulated activities" under the Securities and Futures Ordinance (Cap. 571) (SFO). Please advise:-*

- (a) whether HKMA has recognized that as the frontline supervisor it has assumed the responsibilities under section 5(1) of SFO, in particular paragraph (1), namely, to secure an appropriate degree of protection for members of the public investing in or holding financial products, having regard to their degree of understanding and expertise in respect of investing in or holding financial products, and such responsibilities are separate and distinct from those of a prudential regulator (as elaborated in paragraphs 1.7 and 1.8 of HKMA's Review Report);*
- (b) if the answer to (a) is in the affirmative, what policy or policies have HKMA adopted to discharge such responsibilities, particularly the protection for the investing public;*
- (c) what concrete measures have been taken by HKMA in implementing such a policy or policies during the period from April 2003 to September 2008; and*

- (d) what mechanism has been put in place to monitor whether the measures taken were effective in achieving the objectives for which such measures were devised.*

Item (a)

- 2.1 The HKMA, as the frontline regulator of the securities business of RIs, performs its regulatory functions in accordance with the standards established by the SFC with a view to ensuring the proper conduct of RIs' regulated activities under the SFO. In this context, some of the responsibilities set out in section 5(1) of the SFO are reflected in section 7 of the BO. For example, the function to promote, encourage and enforce the proper conduct, competence and integrity of persons carrying on regulated activities set out in section 5(1)(d) of the SFO is reflected in section 7(2)(c) of the BO and the function of suppressing illegal, dishonourable and improper practices in the securities and futures industry set out in section 5(1)(n) of the SFO is also reflected in section 7(2)(d) of the BO.
- 2.2 With regard to section 5(1)(l) of the SFO, the SFC has a specific function to secure an appropriate degree of protection for members of the public investing in or holding financial products, having regard to their degree of understanding and expertise in respect of investing in or holding financial products. Although investor protection is not an express statutory function of the HKMA, this function can be construed from the relevant provisions of the BO. For example, in deciding whether a relevant individual (ReI) or an executive officer (EO) is guilty of misconduct, the HKMA should take into account whether the act or omission of such ReI or EO (as the case may be) relating to the carrying on of any regulated activity is, or is likely to be, prejudicial to the

interest of the investing public or to the public interest¹. Therefore, in its day-to-day regulation of the securities business of RIs, investor protection is one of the key focuses of the HKMA. The same is true in the discharge of the HKMA's investigatory and enforcement functions in relation to such business.

2.3 However, the HKMA does not assume all the responsibilities of the SFC under section 5(1) of the SFO because not all the responsibilities set out in the subsection are relevant to the work of the HKMA. For example, the HKMA has no responsibility to supervise, monitor and regulate the activities carried on by recognized exchange companies and recognized clearing houses.

2.4 The protection of the interests of investors is not separate and distinct from the role of the HKMA as a prudential regulator. If a bank and its staff are guilty of misconduct or no longer fit and proper to conduct regulated activities, this may adversely affect the bank's reputation and customers' confidence in it, which may give rise to prudential concerns about the safety and soundness of the bank. Under the BO, the HKMA is required to take all reasonable steps to ensure that the banks operate in a responsible, honest and business-like manner. The HKMA is also required to take all reasonable steps to ensure that the banks' business (including their securities business) is conducted with integrity, prudence and the appropriate degree of professional competence. It is expected that in exercising the relevant functions of the MA under the BO, the interests of investors will also be adequately protected.

Item (b)

2.5 One of the policy objectives for the financial system set out in the

¹ Sections 58A(1), 58A(6)(b)(ii), 71C(4) and 71C(12)(c)(ii) of the BO.

Financial Secretary's statement of 27 June 2003 which was issued following the exchange of letters between the MA and the Financial Secretary on their respective functions and responsibilities in monetary and financial affairs is to provide "an appropriate measure of protection to users of financial services". A similar policy objective also appeared in the preparation and passage of the SFO².

- 2.6 In its approach to providing an appropriate or reasonable level of investor protection, the regime adopts a disclosure-based approach which is in common with other jurisdictions, such as the UK, the US, Australia and Singapore. It requires disclosure of the nature and risks of the product (by both the product issuer and the intermediary selling or recommending the product to the investor) and an assessment by intermediaries of the suitability of the product for the investor, so as to enable the investor to make an informed decision and take responsibility for it.
- 2.7 As the frontline regulator of RIs, the HKMA adopts the standards set by the SFC, supplemented by additional guidance or requirements promulgated by the HKMA from time to time to help ensure that RIs comply with the SFC's standards and regulatory requirements. The HKMA's policies in respect of investor protection include close cooperation with the SFC with a view to: (i) avoiding regulatory gaps as well as minimising regulatory overlap and cost; and (ii) maintaining a level playing field among all intermediaries by adopting the standards set by the SFC.

² A consultation paper issued by the Administration in April 2000 made reference to the following in connection with "offers of investments":

...
(c) promoting sound business standards and ensuring a reasonable level of investor protection.

Item (c)

- 2.8 In implementing the policies in respect of investor protection as mentioned in item (b) above, the HKMA adopts the same regulatory approach as that of the SFC. As briefly mentioned under the section on general remarks above, such an approach comprises two pillars: day-to-day regulation and enforcement. In its day-to-day regulation of RIs, the HKMA applies the standards set by the SFC, and issues circulars to provide practical guidance on the required standards and expected industry practices in the conduct of regulated activities. In terms of methodology, the HKMA conducts on-site examinations and off-site reviews of RIs' regulated activities. Where incidents involving possible misconduct or breach of the relevant legal or regulatory requirements are identified in the day-to-day regulatory work or through customer complaints, such cases are referred to the HKMA's securities enforcement team for investigation, which may lead to disciplinary proceedings by the HKMA or referral to the SFC for any action that it might consider appropriate. If sufficient evidence is found after investigation into those cases, the RI concerned and its staff are subject to the same range of disciplinary sanctions as in the case of firms or individuals regulated directly by the SFC.

Item (d)

- 2.9 In order to carry out the HKMA's regulatory role effectively, the HKMA maintains close co-ordination and communication with the SFC to ensure consistency in interpretation and application of the SFC's regulatory standards. In addition to regular meetings held between the HKMA and the SFC pursuant to the MoU, there are ongoing contacts at the working level through meetings, telephone conversations and email communication to discuss issues of common regulatory interest.

2.10 In addition to the cooperation with the SFC to ensure effective performance of its regulatory role, the HKMA performs regular reviews (at least once a year) of the adequacy of resources allocated to the regulation of RIs' regulated activities. The HKMA also conducts on-going review of the supervisory approach over RIs' conduct of regulated activities taking into account its supervisory experience, the number of customer complaints received and changing market conditions. As a result of such reviews, the HKMA has enhanced its supervisory approach by introducing thematic examinations and compliance self-assessments.

2.11 In the light of changing expectations among investors, particularly following the collapse of LB, the HKMA has reviewed aspects of the current regulatory framework and approach for the sale of investment products by RIs. The results of our review, including the 19 recommendations on further enhancing the protection of retail investors, are set out in the HKMA's Review Report submitted to the Financial Secretary on 31 December 2008. Implementation (and consultation, where appropriate) of the recommendations is currently underway and we will continue to work closely with the Administration, the other regulators and the financial services industry to consider and introduce further enhancements if necessary.

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Regulatory co-operation with the Securities and Futures Commission (SFC)

3. *Under the current regulatory regime, HKMA supervises the regulated activities of Registered Institutions (RIs) according to the standards and regulatory requirements set by SFC. Please advise:*

(a) *Given the phenomenal growth in the securities business carried on by RIs since 2003 and persistent low interest for deposits, has HKMA seen any need to devise new codes/guidelines or revise existing ones in consultation with SFC with a view to strengthening investor protection? If yes, please provide the details; if no, the reasons; and*

(b) *Whether SFC has given any advice to HKMA, or HKMA has consulted SFC, on HKMA's monitoring of the implementation by RIs of those standards and regulatory requirements; if yes, please provide the details; if no, the reasons.*

Item (a)

3.1 The role of the HKMA, as the frontline regulator of securities business of RIs, is to take all reasonable steps to ensure that RIs operate in a responsible, honest and business-like manner. The HKMA is also required to take all reasonable steps to ensure that such business is conducted with integrity, prudence and the appropriate degree of professional competence.

3.2 In discharging these functions, the HKMA continuously assesses whether investors are adequately protected, given the changing market conditions and increasing participation of RIs in securities business.

Accordingly, the HKMA has, since 2005, stepped up its regulatory efforts with regard to RIs' selling of financial products, including issuing supplementary guidance or requirements in the form of circulars to RIs, undertaking thematic on-site examinations of the sale of investment products by RIs and requiring large, complex RIs or RIs which are active in conducting regulated activities (including all active retail banks) to conduct independent self-assessment of their compliance with regulatory requirements.

- 3.3 As set out in paragraph 7.2.1 (e) of the MoU between the SFC and the HKMA, the HKMA, where appropriate, issues guidelines or guidance notes to elaborate on the application of the SFO and the BO, as well as the rules, codes, guidelines or other guidance made or published by the SFC, with respect to the carrying on of regulated activities by RIs. In addition, according to paragraph 7.1.3 of the MoU, the HKMA will consult the SFC regarding guidelines it proposes to make or issue under the BO, in so far as such guidelines apply to RIs in relation to the carrying on of their regulated activities. In addition to the relevant guidelines issued under the BO, from 2003 to 2008 before the collapse of LB, the HKMA issued 15 related circulars to RIs with a view to strengthening investor protection.

Item (b)

- 3.4 As set out in the response to item (c) of Question 2 above, the HKMA monitors RIs' implementation of the regulatory standards and requirements through its day-to-day regulation including on-site examinations and off-site reviews. To ensure consistency in interpretation and application of the SFC's regulatory standards in carrying out its regulatory role, the HKMA exchanges views with the SFC through the regular MoU meetings and other contacts at the

working level.

- 3.5 As a general practice, the HKMA exchanges views with, and where necessary seeks advice from, the SFC on issues identified during securities-related thematic examinations in order to ensure that a consistent approach and the same regulatory standards are applied to licensed corporations and RIs. To further strengthen the regulatory co-operation between the two regulators, a round of thematic examinations on investment advisory activities was conducted concurrently with the SFC in 2006 on the basis of common objectives and co-ordinated review programmes. Reciprocal secondment of inspection staff was also arranged in this round of thematic examinations in order to further strengthen co-operation. The HKMA had shared with the SFC the general observations and good industry practices identified in the thematic examinations before issuing a circular to all RIs on 1 March 2007.
- 3.6 With regard to the day-to-day off-site reviews of RIs' carrying on of regulated activities, there are also ongoing discussions and exchange of views at the working level between the HKMA and the SFC concerning issues of common regulatory interest. For example, the HKMA seeks the SFC's advice during the day-to-day handling of applications of EOs and RIs to ensure consistency in the interpretation and application of the SFC's relevant regulatory standards in relation to fitness and propriety (including competence). As regards the annual independent self-assessment of regulatory compliance conducted by selected RIs, the results and issues identified during the self-assessment process have been shared with the SFC since 2005.

4. *According to section 4.6.5 of the module “Supervision of Regulated Activities of SFC-Registered Authorized Institutions” (SC Ref No. M1) of HKMA’s supervisory policy manual (SPM), RIs should provide proper procedures and training for frontline staff, who should explain to the customers the nature of investment products, fees and charges and underlying risks before they enter into any transaction in the products, and should remind the customers of avoiding hasty investment decisions. Please advise:*

(a) *Apart from section 4.6.5 of the SPM module, which has the heading of “Regulatory requirements for marketing collective investment schemes”, and therefore appears to be applicable only to collective investment schemes that require authorization from SFC, whether there are any other guidelines or regulatory requirements dealing with the marketing of investment products which do not require SFC’s authorization and, in particular, over-the-counter structured products (e.g. Minibonds); if yes, please provide the details; if no, the reasons; and*

(b) *when and what measures (if any) have been taken by HKMA before September 2008 to ensure that individual RIs have carried out measures comparable to those stated in section 4.6.5 of the SPM module in their sale of investment products which do not require SFC’s authorization.*

Item (a)

4.1 Notwithstanding that section 4.6.5 of the Supervisory Policy Manual (SPM) module SB-1 “Supervision of Regulated Activities of SFC-Registered Authorized Institutions” was put under the heading of “Marketing CIS [collective investment schemes] in general”, the

requirement in that section, as indicated in the wording used, is applicable to the marketing of all investment products to vulnerable customers. During the day-to-day regulatory process, the HKMA indeed applies the standards set out in the section to all investment products when conducting on-site examinations and off-site reviews of RIs under the SFO regime. Based on the HKMA's supervisory experience, RIs have not requested clarification of such requirements or shown ambiguities in applying these requirements to the marketing of all types of investment products to the more vulnerable customers.

- 4.2 Additional guidance on precautionary measures to be taken when selling investment products to vulnerable customers was given in the HKMA's circular dated 3 March 2006.

Item (b)

- 4.3 The HKMA carries out day-to-day regulation through on-site examinations and off-site reviews to help ensure that RIs' conduct of regulated activities is in compliance with the legal and regulatory requirements, including those mentioned in item (a) above. Where the day-to-day regulatory process or any complaint received reveals possible misconduct, the matter is referred to the HKMA's securities enforcement team for investigation and disciplinary proceedings or referral to the SFC as appropriate.

Conduct regulation at point of sale

Bank staff engaged in the sale of structured financial products

5. *HKMA maintains an on-line public register of “relevant individuals”, who are the persons (including the sales staff) through whom RIs conduct regulated activities. Please advise:*

- (a) whether the sale of structured financial products to clients must be done by “relevant individuals”; if yes, please provide the number of cases per year of RIs’ violation of this requirement from April 2003 to September 2008;*
- (b) the number and nature of complaints (if any) received by HKMA on a year-by-year basis since April 2003 against “relevant individuals” of each RI which has sold any of Lehman Brothers-related Minibonds or other structured financial products, and the number of substantiated complaints; and*
- (c) disciplinary actions taken by HKMA against the “relevant individuals” in relation to the mis-selling of investment products between April 2003 and September 2008.*

Item (a)

5.1 The sale of structured financial products involves the performance of a regulated function in relation to a regulated activity under section 114(3) of the SFO and therefore must be carried out by a ReI registered for that regulated activity with the HKMA. Any person who, without reasonable excuse, contravenes section 114(3) of the SFO commits an

offence and may be subject to prosecution by the SFC.

- 5.2 The number of RIs' staff identified as having violated the registration requirement under section 114(3) of the SFO each year (which are related to all types of investment products and not confined to the sale of structured products) is summarised in Table 1 below:

Table 1

Year	Number of RIs' staff identified as having violated the registration requirement
2003 (Apr to Dec)	0
2004	9
2005	28
2006	4
2007	19
2008 (up to 14 Sep)	2
Total	62

Item (b)

- 5.3 Section 120 of the BO imposes restrictions on the MA's ability to disclose supervisory information of the type requested that was obtained in the course of the exercise of the MA's functions under the BO. Nevertheless, section 120(5)(a) provides one of the gateways through which the MA may disclose such information provided that it is disclosed in the form of a summary so as to prevent particulars relating to the business of any particular AI being ascertained from it.
- 5.4 To assist the Subcommittee in its inquiry, the number of cases in relation to possible mis-selling identified or received by the HKMA on a year-by-year basis during 1 April 2003 to 14 September 2008 against ReIs of the 19 RIs³ which sold LB-related Minibonds and structured

³ According to the list of RIs in the "Table Showing Information Required In Respect of Outstanding Lehman Brothers-related Products (Up to 8 December 2008)" submitted to the Legislative Council Subcommittee (SC Ref. No. M1(C)).

financial products and were the subject of LB-related complaints as well as those relating to other RIs is summarised in Table 2 below. It should be noted that about half of those cases identified or received in 2008 are still being processed by the HKMA's securities enforcement team and/or the SFC.

Table 2

Year		Number of customers involved in possible mis-selling cases *	
		From day-to-day regulation	From customer complaints
2003 (Apr to Dec)	<i>The 19 RIs</i>	0	0
	<i>Other RIs</i>	12	5
2004	<i>The 19 RIs</i>	0	1
	<i>Other RIs</i>	0	15
2005	<i>The 19 RIs</i>	0	9
	<i>Other RIs</i>	1	6
2006	<i>The 19 RIs</i>	2	6
	<i>Other RIs</i>	0	4
2007	<i>The 19 RIs</i>	3	5
	<i>Other RIs</i>	4	0
2008 (up to 14 Sep)	<i>The 19 RIs</i>	37	18
	<i>Other RIs</i>	13	37
Total		72	106
		178	

* In addition to the 178 cases mentioned above, there are also other possible mis-selling cases referred to the HKMA's securities enforcement team after 14 September 2008 based on the thematic examinations performed by the HKMA before that date.

5.5 Among the 178 cases mentioned in Table 2 above, cases involving 9 customers were found to be substantiated by the HKMA following investigation and were referred to the SFC for appropriate action.

5.6 After 14 September 2008 (i.e. after the collapse of LB), the HKMA received 20,913 complaints concerning LB-related products up to 7 May 2009. Apart from 445 cases referred to the SFC so far to facilitate its top-down investigation of the RIs being complained of, the HKMA has formally opened investigations on 5,708 complaints and is currently seeking further information on 13,791 complaints. 990 complaints have been found to lack sufficient prima facie evidence to support further action.

Item (c)

- 5.7 Among the cases reported to the HKMA's securities enforcement team through the day-to-day regulation and customer complaints between April 2003 and September 2008, cases involving 9 customers in relation to possible mis-selling of investment products have been investigated by the HKMA's securities enforcement team and referred to the SFC for appropriate actions. Disciplinary actions have been taken by the SFC against a former ReI of a RI in respect of cases involving 6 customers, and the person concerned was banned from re-entering the industry for 32 months from 26 November 2008 to 25 July 2011 and fined \$260,000. The remaining 3 customers' cases were identified during one of the HKMA's on-site examinations. The HKMA has completed the relevant investigation concerning 3 ReIs, a former ReI and an executive officer of the RI and the 3 customers' cases have already been referred to the SFC for its decision on disciplinary action to be taken against the staff concerned.

6. *According to a press release issued by HKMA on 1 April 2003 on its on-line register of securities staff of authorized institutions, Mr Y K Choi (then Acting Deputy Chief Executive of HKMA) said that the public register of relevant individuals enabled members of the public to find out whether they were dealing with a fit and proper person in relation to any regulated activity conducted through a RI. Please advise:*
- (a) The specific qualifications or experience required of a relevant individual responsible for the sale of structured financial products, such as credit-linked notes;*
 - (b) The number of relevant individuals registered with the HKMA for each year from April 2003 to September 2008; and*
 - (c) Whether the relevant bank staff are required by any guidelines or other regulatory requirements to identify themselves as relevant individuals when selling financial products to investors; if yes, please provide the details; if no, the reasons.*

Item (a)

- 6.1 The specific requirements on the competence of all ReIs, which are equally applicable to licensed representatives of licensed corporations, are set out in the Fit and Proper Guidelines and the Guidelines on Competence issued by the SFC as described below.
- 6.2 According to the note in paragraph 5.1.1 of the Fit and Proper Guidelines, ReIs should be equipped with the skills, knowledge and professionalism necessary to perform their duties, which include an

understanding of the financial products they deal in or advise on and the market in which the service is provided. The level of knowledge expected varies according to the level of responsibility and the type of regulated activity to be carried out.

- 6.3 In addition, the Guidelines on Competence set out the matters which will be normally considered in assessing whether a person is competent to carry on any regulated activity. According to paragraph 2.2 of the Guidelines on Competence, a ReI has to meet the same competence requirements as those applicable to a licensed representative. In general, unless an exemption applies, a ReI is required to possess a recognized academic qualification (e.g. degree in a designated field, such as Finance, Accounting, etc) or a recognized professional qualification (e.g. Certified Financial Planner) and to pass the recognized local regulatory framework paper (e.g. Paper 1 (Fundamentals of Securities and Futures Regulation) of the Licensing Examination for Securities and Futures Intermediaries administered by the Hong Kong Securities Institute (HKSI) in respect of Type 1 (dealing in securities) and Type 4 (advising on securities) regulated activities).
- 6.4 If an individual does not possess a recognized academic / professional qualification, this can be compensated by relevant industry experience and/or recognized industry qualification. The requirement on the compensating relevant industry experience and/or recognized industry qualification varies depending on the background of the individual. For example, unless an exemption applies⁴, if an individual has passed Chinese or English and Mathematics in the Hong Kong Certificate of Education Examination (or equivalent), he/she is required to possess

⁴ For example, an exemption applies where an individual has been a licensed representative under the SFO within the past 3 years and now proposes to be a relevant individual in the same regulated activity.

either relevant industry experience of at least 2 years in the past 5 years or to pass the recognized industry qualification paper(s)⁵.

- 6.5 It should be noted that the industry qualification requirements in the SFC's Guidelines on Competence depend on the type of regulated activity to be engaged in, rather than the specific type of financial products that the person is to deal in or advise upon.
- 6.6 Apart from the above basic requirements on competence, paragraph 4.1 (Fit and proper staff) of the Code of Conduct for Persons Licensed by or Registered with the SFC ("the Code of Conduct") and item 9 of the SFC's Questions and Answers on Suitability Obligations also impose specific requirements on RIs to ensure that ReIs responsible for the sale of structured financial products have adequate training or experience to act in this capacity.

Item (b)

- 6.7 Please refer to Table 3 for the number of ReIs from April 2003 to September 2008:

Table 3

	As at 1 April 2003 (date of SFO commencement)	As at 31 December 2004	As at 31 December 2005	As at 31 December 2006	As at 31 December 2007	As at 30 September 2008
Total number of ReIs (including EOs) of RIs	19,304	20,791	22,570	24,887	27,269	29,504

⁵ In respect of Type 1 and Type 4 regulated activities, examples of recognized industry qualification papers are both of Paper 7 (Financial Markets) and Paper 8 (Securities) of the HKSI Licensing Examination for Securities and Futures Intermediaries.

Item (c)

- 6.8 In the circular entitled “New securities supervisory regime – Register to be maintained by the HKMA and specific guidance in relation to relevant individuals” issued by the HKMA on 27 February 2003, there is a specific section which set out the requirements on the identification of ReIs. The section is extracted below for reference:

“Identification of relevant individuals

According to paragraph 8.1 of the Code of Conduct for Persons Registered with the SFC⁷, a registered person is required to provide clients with, among other things, the identity and status of employees acting on its behalf with whom the client may have contact. As such, we expect that RIs implement effective measures to enable clients to identify staff who are relevant individuals, particularly at retail branches. Set out below are some suggested ways in which a RI can achieve this:

Issuing “information card”

RIs may issue an “information card” to each relevant individual with clear identification on the card specifying (preferably in both English and Chinese) the following information:

- Name of the relevant individual;
- Registration number assigned to the relevant individual by the HKMA; and

- Name of regulated activities in which the relevant individual is engaging.

A relevant individual may identify himself to a client by presenting the “information card” if so requested. Alternatively, the information can be included in the relevant individual’s business card.

Designated counters at branches for conducting regulated activities

RIs may establish designated counters at branches to conduct regulated activities (e.g. securities dealing services). There should be clear and prominent indication at such counters showing the designated services which can be rendered. RIs should ensure that only relevant individuals are permitted to man these counters.

It should be noted that the above examples are by no means exhaustive. Different RIs may have different ways of enhancing transparency and complying with the Code of Conduct requirement. The HKMA will adopt a pragmatic approach and take into account the practical aspects when considering the adequacy of measures adopted by RIs.

Footnote 7 : This code will be renamed as “Code of Conduct for Persons Licensed by or Registered with the SFC” in the light of the new regime. ”

- 6.9 The above circular has been provided to the Subcommittee as Annex 10 of the MA’s written statement (SC Ref. No. W6(C)).

“Mystery shopper” surveys

7. *Regarding “mystery shopper” surveys on RIs, please advise:*

- (a) *HKMA’s evaluation (if any) of the effectiveness of “mystery shopper” surveys conducted by RIs voluntarily since April 2003;*
- (b) *Whether the staff at the operational level have reflected to the HKMA management the usefulness or need of conducting “mystery shopper” surveys on RIs. Please also provide the details of the discussion, including the participants, on the Consumer Council’s “mystery shopper” survey on financial advisers which took place on 9 May 2006 (Annex 6 of W6(C)); and*
- (c) *As HKMA has recommended in its Review Report that a mystery shopper programme be instituted periodically, what are HKMA’s plans and the funding earmarked for this purpose?*

Item (a)

- 7.1 The HKMA conducted a round of thematic examinations on the investment advisory activities of RIs in 2006. During the examinations, the HKMA noted that “mystery shopper” inspections were conducted by certain RIs on the selling practices of frontline staff to ensure compliance with internal policies and procedures, and relevant regulatory requirements. Although such practice is not a regulatory requirement set out in the codes or guidelines⁶ issued by the

⁶ Including, in particular, the Code of Conduct, and the Questions and Answers on Suitability Obligations.

SFC, the HKMA shared the observation with the industry as one of the good practices in a circular issued on 1 March 2007⁷. Moreover, one of the recommendations set out in the HKMA's Review Report is that RIs should institute a "mystery shopper" programme to test their sales processes.

- 7.2 While the HKMA considers that "mystery shopper" programme is a useful tool for RIs, it is important to note that RIs cannot solely rely on "mystery shopper" inspections to prevent all possible mis-selling cases from happening and the inspections should only form a part of the internal control system of RIs.

Item (b)

- 7.3 As mentioned in the MA's response dated 27 April 2009 to item (i) of the Subcommittee's information requests (follow-up to the hearing on 17 April 2009) enclosed with the letter of the Clerk to the Subcommittee dated 20 April 2009 (SC Ref. No. M17), during one of the meetings of the HKMA's Event Review Committee in November 2003, members considered whether it would be appropriate to send a supervisory staff as a "mystery shopper" to ascertain the selling approach of a RI. At that time, the HKMA decided not to send "mystery shoppers" to RIs in order to maintain a supervisory approach that was consistent with that adopted by the SFC.
- 7.4 As set out in the HKMA's Review Report, one of the recommendations is that the HKMA will institute a "mystery shopper" programme to test the sales processes of RIs. The report nevertheless also points out that there may be some limitations in the operation of a "mystery shopper"

⁷ Circular of "Thematic Examinations on Investment Advisory Activities" issued by the HKMA on 1 March 2007.

programme for the securities business of RIs in that it is difficult for a “mystery shopper” programme to cover all aspects of a selling process which might involve several face-to-face meetings between a customer and an intermediary. In any event, the HKMA is now working with the SFC on the details of the implementation of this measure.

- 7.5 During the MoU meeting between the SFC and the HKMA held on 9 May 2006, the SFC briefed the HKMA about its comments given to the Consumer Council on the draft report of the “mystery shopper” survey on financial advisers conducted by the Consumer Council. The discussion during the meeting focused on the comments of the SFC and the HKMA on the draft survey report and did not cover areas such as the effectiveness of “mystery shopper” surveys and/or whether “mystery shopper” programme should be implemented by the regulators. The meeting was attended by representatives from the securities supervision and enforcement teams of the SFC and the HKMA.

Item (c)

- 7.6 As regards the recommendation of instituting a “mystery shopper” programme in the HKMA’s Review Report, the HKMA (i) requires all RIs to implement a periodic “mystery shopper” programme and (ii) will institute its own “mystery shopper” programme to test RIs’ sales procedures. On (i), the HKMA issued a circular on 9 January 2009 requiring RIs to put in place appropriate “mystery shopper” programme as soon as possible but no later than the end of March 2009. On (ii), the HKMA is working with the SFC to jointly develop an external “mystery shopper” programme in the second half of 2009. Funding requirement is to be determined having due regard to the programme details (including scope, sample size and frequency) which are being

considered. The limitations in the operation of a “mystery shopper” programme for the securities business of RIs mentioned in paragraph 7.4 above are also relevant considerations in developing the programme.

Risks associated with structured financial products

8. *According to paragraph 3.15 of HKMA's Review Report, within RIs, the assessment of the risk rating of an investment product is made at the institutional level, generally through a system administered with the involvement of a risk management function independent of the sales function. Please advise:*
- (a) *whether all RIs have implemented the separation between risk management function and sales function since April 2003; if no, please provide the details of RIs that have not done so and HKMA's follow-up actions taken; and*
- (b) *whether HKMA has discussed with SFC on the need for intermediaries (including RIs) to fulfill an obligation of apprising the clients of changes in the risk assessments of the products which they have purchased. If yes, please provide the details of such discussion; if no, the reasons.*

Item (a)

- 8.1 With regard to the segregation between the risk management function and the sales function, the scope of most of the HKMA's securities-related on-site examinations has covered this area⁸. Section 120 of the BO imposes restrictions on the MA's ability to disclose supervisory information of the type requested that was obtained in the course of the exercise of the MA's functions under the BO. Nevertheless, section 120(5)(a) provides one of the gateways through which the MA may disclose such information provided that it is disclosed in the form of a summary so as to prevent particulars relating

⁸ The segregation between the risk management function and the sales function was not covered in the thematic examinations on system capacity and contingency planning for on-line securities trading services.

to the business of any particular AI being ascertained from it. To assist the Subcommittee in its inquiry, a summary of the findings in respect of RIs' segregation between the risk management function and the sales function identified during the HKMA's on-site examinations is provided below.

8.2 During the period from April 2003 to December 2008, the HKMA's securities-related on-site examinations revealed that in relation to the sale of investment products, the examined RIs had implemented adequate segregation between the risk management function and the sales function with the exception of one case. In that particular case, product due diligence in respect of one particular type of investment products did not follow the internal requirement of segregation between the risk management function and the sales function. Together with other findings identified in the examination, the case has already been referred to the HKMA's securities enforcement team for appropriate action and it would not be appropriate for the HKMA to disclose details of the examination findings in this regard while the case is being processed by the HKMA's securities enforcement team.

8.3 The findings in the above on-site examination were also drawn to the attention of the RI's senior management together with recommendations on appropriate rectification measures. Upon the recommendation of the HKMA, the RI concerned has suspended the sale of the related type of investment products. The HKMA case officer has been following up with the RI concerned to ensure that appropriate remedial actions are taken within the timeframe agreed with the HKMA. Furthermore, upon completion of the implementation of the HKMA's recommended measures, the HKMA will review the effectiveness of these measures during the next round of on-site examination on the RI concerned.

Item (b)

- 8.4 The HKMA did not discuss this matter with the SFC before the collapse of LB. According to the HKMA's understanding, during the period from April 2003 to 14 September 2008, there was no legal or regulatory requirement that imposed a duty on an intermediary to inform those customers who had already purchased an investment product through the intermediary when it decided to adopt a higher risk rating for the product concerned subsequent to the transaction. Whether an intermediary has a duty to communicate changes of its risk rating of individual products to customers is a matter to be determined by the scope of the agreed services to be provided in accordance with the client agreement.
- 8.5 The Code of Conduct and the "Report on Selling Practices of Licensed Investment Advisers" issued by the SFC in February 2005 ("the SFC's Report") are also relevant references in this regard. As set out in paragraphs 6.2(d) and 6.4 of the Code of Conduct and paragraph 44 of the SFC's Report, the SFC expects that a client agreement should contain a description of the nature of services to be provided to or available to the client. Further, as recommended in point 6 of Appendix 3 to the SFC's Report, where there is an ongoing relationship between an intermediary and its client, where appropriate, any changes relating to that client's investments should be communicated to the client.
- 8.6 According to the HKMA's supervisory experience, the services provided by retail banks to retail customers, as set out in the relevant client agreements, are generally not characterised as offering continuous advice on investment products after initial sale. Nevertheless, the onus rests with the RIs to fulfil their responsibilities and obligations in accordance with the respective terms and conditions

(including the nature of services provided by the RIs) of the client agreements. The HKMA had also issued a circular “The Securities and Futures Commission’s Report (the Report) on Selling Practices of Licensed Investment Advisers” on 1 March 2005, in which RIs were required to study the SFC’s Report carefully and put in place systems and controls to ensure compliance with the recommendations set out in the SFC’s Report.

- 8.7 After the collapse of LB, the HKMA confirmed with the SFC at the working level that our understanding of the relevant regulatory requirements was consistent with the SFC’s interpretation. Nevertheless, in the light of changing public expectation about investor protection as stated in paragraph 8.32 of the HKMA’s Review Report, the HKMA recommended that where the continuous review by a RI of the risk ratings of the investment products it sells results in a higher risk rating being attributed to a product, the institution should disclose this to customers to whom it recommended and sold the product.

On-site examinations and off-site surveillance on RIs

9. *Please advise on the following:*

- (a) *How often are Tier 1 and Tier 2 on-site examinations conducted on RIs during the period from April 2003 to September 2008?*
- (b) *What are the criteria for determining whether certain RIs should be examined more frequently than others under the risk-based approach adopted by HKMA?*
- (c) *Details of how a typical on-site examination is conducted, including the number of HKMA's supervisory staff involved, duration, practice and procedure, and a list of the documents/materials that RIs must produce to HKMA for inspection;*
- (d) *Details of a thematic on-site examination on the sales practice of a RI, and a description of each step/stage of the examination and the categories of documents/ materials inspected;*
- (e) *A list showing the frequency of examinations (both Tier 1 and Tier 2) on each RI involved in the sale of Lehman Brothers-related Minibonds and structured financial products from April 2003 to September 2008; and*
- (f) *From April 2003 to September 2008, whether HKMA have sufficient manpower to carry out on-site examinations as it deemed necessary.*

General Information

- 9.1 During the period from April 2003 to December 2008, the HKMA conducted 170 on-site examinations on RIs that included in whole or in part review of aspects of their securities business as shown in Table 4 below.

Table 4

Type of Examinations	Number of RIs Covered in Different Rounds of Examinations						
	2003 (Apr to Dec)	2004	2005	2006	2007	2008	Total
Tier-1 examinations	-	8	5	5	10	9	37
Tier-2 examinations	11	6	5	7	7	1	37
Thematic examinations							
● Retail Wealth Management Business	-	-	13	22	18	-	53
● Investment Advisory Activities	-	-	-	10	-	-	10
● Controls to Ensure Fitness and Propriety of Relevant Individuals	-	-	-	-	11	-	11
● Investment Advisory and Dealing Activities in Credit-linked Investment Products	-	-	-	-	-	4	4
● Compliance Function in relation to Regulated Activities under the Securities and Futures Ordinance	-	-	-	-	-	2	2
● Investment Advisory and Dealing Activities in Stock Accumulators	-	-	-	-	-	5	5
● System Capacity and Contingency Planning for On-line Securities Trading Services	-	-	-	-	-	11	11
Total	11	14	23	44	46	32	170

Item (a)

- 9.2 Please refer to Table 4 above for the frequency of Tier-1 and Tier-2 on-site examinations conducted on RIs during the period from April 2003 to December 2008.

Item (b)

- 9.3 The major criteria under a risk-based approach for determining the target RIs to be subject to on-site examinations include:

- (i) supervisory experience of the RI such as the results of previous on-site examinations and off-site reviews;
- (ii) the development of the securities business of the RI, particularly if a new regulated activity or new business under a particular regulated activity has been engaged recently;
- (iii) whether the RI has been actively selling investment products to retail customers;
- (iv) the number of complaints received against, and any incidents of supervisory concern that have happened to, the RI;
- (v) the result of the annual independent self-assessment conducted by the RI;
- (vi) the information reported in the “Return of Securities Related Activities” submitted by the RI concerned on a semi-annual basis; and
- (vii) input from the SFC, if any.

Item (c)

9.4 Securities-related on-site examinations comprise (a) Tier-1 examinations covering the high level controls of RIs over their regulated activities; (b) Tier-2 detailed examinations on the internal controls and status of compliance with regulatory requirements; and (c) thematic examinations reviewing a particular activity or function across a selection of RIs. As the focus areas vary between different types of on-site examinations, the specific practices and procedures are not exactly the same for all on-site examinations.

9.5 A typical on-site examination is normally conducted by an examination team consisting of 3 members and the field work generally lasts for around 3 to 8 weeks depending on the complexity of the business and

internal control environment of the target RI.

9.6 In general, during an on-site examination, the HKMA typically:

- (i) reviews the applicable policies, procedures, management reports and internal audit reports;
- (ii) evaluates the effectiveness of the internal control process;
- (iii) discusses existing operational practices with relevant management and staff at different levels; and
- (iv) conducts sample checks of securities-related transactions to evaluate the effectiveness of relevant internal controls and compliance with the Code of Conduct and other relevant requirements.

9.7 In respect of Tier-2 and thematic examinations covering selling practices, the examination team may select frontline staff and interview them in the form of a mock selling process in order to assess the adequacy of their knowledge on the investment products and ability to explain the nature and risks of products distributed by them.

9.8 The documents and materials requested from the target RI by the examination team normally include MIS reports for management control purposes, internal audit reports, and policies and procedures in relation to account opening, client suitability assessment, product development and handling of customer complaints. Other transaction-related documents and materials are also required to be provided by the target RI for our sample testing, including account opening forms, account records, transaction documents, client investment profiles, and voice-log records (if any) etc.

9.9 After completion of the field work during an on-site examination, the

HKMA communicates the findings of the examination and related recommendations through issuing an examination report to the RI concerned. Following the receipt of the HKMA's examination report, the RI will provide a written implementation plan setting out the specific actions to be taken to rectify the issues identified with specified implementation timeframe. Once the implementation plan is agreed with the HKMA, the relevant case officer of the HKMA's BSD will monitor, on an ongoing basis, the implementation of the recommended measures by the RI.

Item (d)

- 9.10 The main objectives of thematic examinations are to review and compare the conduct of a particular type of activity or function across a selection of RIs within a specified period of time; and to identify good practices as well as common issues to share with the industry. In general, the HKMA identifies the themes for such examinations before the start of each year having regard to, among other things, the recent evolving trends and issues, major supervisory concerns, prevailing market conditions and input from the SFC. New themes could be added during the year as new trends or risks emerge. After a theme has been determined, the HKMA then selects the target RIs which are considered to be relevant to the theme (e.g. retail banks, private banks) for the thematic examinations having regard mainly to whether they are actively involved in the activity or function to be examined.
- 9.11 The detailed steps of the examination and the types of documents inspected during a thematic examination are similar to those related to a typical on-site examination described in item (c) above except that the examination duration and the focus of sample selection for testing will vary depending on the "theme" of each round of thematic examinations.

Item (e)

- 9.12 Both Tier-1 and Tier-2 on-site examinations are intended to cover various aspects of the regulated activities conducted by RIs and it is not a usual practice for these examinations to focus on any particular investment products such as LB-related Minibond and structured financial products. For the list of Tier-1 and Tier-2 on-site examinations conducted from April 2003 to December 2008, please refer to table 4 in paragraph 9.1 above.

Item (f)

- 9.13 The growing securities business of RIs since 2003 has led to a greater focus on investor protection and the increasing number of on-site examinations on regulated activities, including Tier-1 on-site examinations, Tier-2 on-site examinations and thematic examinations, from 11 examinations in 2003 to 46 examinations in 2007 (see table 4 in paragraph 9.1 above). The selling practice of investment products has also become one of our key regulatory objectives. As a result, more thematic examinations focusing on the selling practice of investment products have been conducted since 2005.
- 9.14 The number of HKMA staff involved in the regulation of RIs' regulated activities (including on-site examinations, off-site reviews and enforcement function) increased from 75 in 2003 to 119 in mid-September 2008. With such deployment of resources, the HKMA was able to complete the intended supervisory tasks (including on-site examinations) each year in relation to RIs' securities business except in 2008 where a number of planned on-site examinations were cancelled due to other competing and unanticipated work priorities. Overall, given the supervisory experience and information available to

the HKMA at the time, the HKMA considers that its deployment of supervisory resources to carrying out on-site examinations of RIs' regulated activities from April 2003 to September 2008 was sufficient and appropriate.

- 9.15 The HKMA has made a number of recommendations on further enhancing the protection of retail investors and the current regulatory framework and approach in the HKMA's Review Report. As part of the implementation process of these recommendations, the HKMA is reviewing the existing staffing resources with a view to ensuring that it has sufficient manpower to support the implementation process of these recommendations as well as the conduct of on-site examinations in future.

10. *According to HKMA's circular on Thematic Examinations on Investment Advisory Activities issued on 1 March 2007 (SC Ref. No. M12), HKMA found that most of the RIs examined had adequate controls over high risk areas including the avoidance of mismatch of client risk tolerance level and product risk rating, and selling of investment products to vulnerable clients such as the elderly. In addition, all the retail banks examined have implemented reasonable controls over the selling of unauthorized investment products. Against this background, please advise on the following:*

- (a) Whether the financial products covered by the thematic examinations included credit-linked notes (such as Minibonds and Constellation notes); and*
- (b) If the above findings of the thematic examinations are correct, HKMA's explanation for the large number of complaints about mis-selling of Lehman Brothers-related Minibonds and structured financial products and whether there were "blind spots" in such examinations that render certain irregularities unnoticed.*

Item (a)

- 10.1 The scope of the round of thematic examinations on Investment Advisory Activities covered all major types of investment products distributed by the RIs examined (including CLNs) and other products such as equity-linked products, unit trusts and mutual funds. The focus of the examinations, however, was to review the overall selling practices of RIs of investment products instead of focusing on any particular type of investment products (such as CLNs) or any issuer-specific products.

Item (b)

- 10.2 During the on-site examinations, the HKMA normally selects and reviews a sample of securities-related transactions involving various investment products conducted by the examined RIs. The HKMA adopts a risk-based approach when determining what investment products and the number of transactions to be chosen for review. The criteria used for sample selection include the popularity of the investment product (i.e. high sales volume), the number of customer complaints about possible mis-selling of the product, the proportion of the product sold to vulnerable customers, and the sales commission attached to the product.
- 10.3 In the past few years, CLNs only represented a small portion of structured products sold to retail customers by retail banks. For example, between 2007 and 2008, CLNs only accounted for approximately 1% of the total nominal amount of structured financial products sold by retail banks to retail customers⁹. By comparison, equity-related structured products were much more widely distributed through RIs.
- 10.4 Regarding the number of complaint cases, there had been only a few complaint cases relating to the possible mis-selling of CLNs received by the HKMA prior to the collapse of LB. From April 2003 until 14 September 2008, the HKMA had received 5 complaint cases relating to suspected mis-selling of CLNs (including 2 complaint cases involving LB-related Minibonds). From the survey on the distribution of retail CLNs by retail banks conducted in late 2007 with the 16 selected RIs, it was noted that there were only 2 complaint cases relating to the sale of credit-linked products received by the

⁹ According to a survey conducted by the HKMA in 2009 on retail structured products sold by retail banks.

selected RIs between 2006 and 2007.

- 10.5 Based on the information obtained during our on-site examinations, the sales commission attached to LB-related Minibonds and structured financial products is generally in line with that applicable to other investment products distributed by RIs.
- 10.6 As a result of the above factors, on-site examinations conducted by the HKMA before 2008 which covered the selling practices of investment products generally would tend to cover a larger sample of equity-related structured products than CLNs.
- 10.7 Notwithstanding the small market share and small number of complaint cases reported on the sale of credit-linked products, the HKMA stepped up its regulatory efforts on such products between late 2007 and mid September 2008 in view of the significant changes in market conditions arising from the sub-prime crisis. A survey on the distribution of retail CLNs by retail banks was conducted in late 2007 and 11 examinations on the theme of “Investment Advisory and Dealing Activities in Credit-linked Investment Products” were planned for 2008. Due to other competing and unanticipated work priority, however, the HKMA only managed to complete 4 of those examinations before the collapse of LB. Possible mis-selling cases involving a total of 52 customers were identified during the examinations. All the cases have been referred to the HKMA’s securities enforcement team for investigation as appropriate.

11. *According to paragraph 4.22 of HKMA's Review Report, under off-site surveillance, each AI is assigned to the overall supervision of one case officer at HKMA (or a team of officers for large AIs). If a RI is assessed to be of higher risk in terms of non-compliance, the responsible case officer may request a Tier 2 detailed examination on the RI. Please provide details of how a Tier 2 examination is conducted, a list of RI(s) which were subject to Tier 2 examination between April 2003 and September 2008; and whether any irregularities in RIs' sale of structured financial products were identified by off-site surveillance; if yes, please provide the details and any follow-up actions taken.*

11.1 With regard to the details of how a Tier-2 detailed examination of a RI is conducted, please refer to the response to Question 9 (c).

11.2 In relation to the list of RIs which were subject to Tier-2 examination between April 2003 and September 2008, section 120 of the BO imposes restrictions on the MA's ability to disclose supervisory information of the type requested that was obtained in the course of the exercise of the MA's functions under the BO. Nevertheless, section 120(5)(a) provides one of the gateways through which the MA may disclose such information provided that it is disclosed in the form of a summary so as to prevent particulars relating to the business of any particular AI being ascertained from it. To assist the Subcommittee in its inquiry, the number of Tier-2 on-site examinations is set out in Table 4 under paragraph 9.1 above.

11.3 Regarding off-site surveillance, each RI is assigned to the overall supervision of one case officer at the HKMA (or a team of officers for larger institutions). Case officers are responsible for conducting on-going off-site reviews of the individual institutions to supplement

the work of on-site examinations. These reviews cover a wide range of issues, including the financial conditions of the RIs, the policies and systems in managing risks, statistical returns, etc. Through these reviews, case officers are also required to ensure that issues identified through on-site examinations, including those related to the conduct of securities business, are properly addressed and recommendations made are duly implemented within the timeframe agreed with the HKMA.

- 11.4 In addition, since 2005, an increasing number (50 in 2008) of large, complex RIs or RIs which are active in conducting regulated activities (including all active retail banks) are required to commission an annual assessment by an independent unit (for example, their compliance department) to review the RIs' compliance with the regulatory requirements. The review report has to be signed off by the chief executive of the RIs before submitting to the HKMA. These self-assessment reports are jointly examined by the case officers of the respective RIs and the securities supervision team of the HKMA. The summary results and related follow-up actions of the assessment reports are shared with all participating RIs of the compliance self-assessment process. For the summary results for 2005 to 2007, please refer to the MA's response dated 13 May 2009 to item (e) of the Subcommittee's information requests (follow-up to the hearing on 14 April 2009) enclosed with the letter of the Clerk to the Subcommittee dated 17 April 2009.

12. *Paragraph 4.23 of HKMA's Review Report states that all RIs must submit semi-annually to HKMA a "Return of Securities Related Activities". From April 2003 to September 2008, please advise whether HKMA detected any issues, trends or irregularities from these returns which triggered regulatory concerns of HKMA as the frontline supervisor; if yes, please provide the details.*

12.1 All RIs are required to submit semi-annually to the HKMA a "Return of Securities Related Activities" ("the Return") on the position for the 6-month period ended 30 June or 31 December. In general, the Return captures:

- (i) the scope of business activities under each type of regulated activity;
- (ii) statistics on customer accounts, the number of branch-offices, the aggregate volume of transactions, the aggregate size of portfolios under management by the institution, and the income arising from each regulated activity; and
- (iii) the percentage of client orders received through the Internet and other electronic channels.

12.2 Based on the information provided by all RIs in the semi-annual return, the HKMA analyses the trends of business activities in relation to regulated activities for every RI and for the banking industry as a whole. The information collected has been used as one of the criteria for determining the target institutions for securities-related on-site examinations and the focus areas of each of these on-site examinations. Moreover, on the basis of the information collected through the Return, the HKMA has identified the general trend of growing business

activities of RIs in the past few years. Accordingly, the HKMA has, since 2005, stepped up its regulatory efforts with regard to banks' selling of investment products, including undertaking more thematic on-site examinations of the sale of investment products by RIs, issuing related circulars to the banking industry, and requiring large, complex RIs or RIs which are active in conducting regulated activities (including all active retail banks) to conduct independent self-assessment of regulatory compliance.

- 12.3 Based on the information collected under the Return, the HKMA has identified a growing trend in the regulated activities of RIs. For instance, the ratio of income from regulated activities to the total income of RIs increased from 10% in 2004 to 18% in 2007.

13. *Before the Minibonds incident, did HKMA identify during its on-site examinations the use of misleading names for investment products, such as using the term “bond” to describe derivatives like Minibonds and Constellation Notes, and the term “債券” as the Chinese translation of “Notes”, in the prospectuses and marketing materials for such products? If yes, did DCE report this matter to MA? Did HKMA alert SFC of such?*

13.1 Under the current regulatory regime, the HKMA does not have the authority or power to re-assess whether sufficient information is adequately disclosed by the issuer in the investment product documentation (including prospectuses and marketing materials) which has been authorized by the SFC. To avoid any regulatory overlap or duplication of the regulatory process, it is not appropriate for the HKMA to be involved in any re-assessment of the SFC’s authorisation process of the investment product documentation.

13.2 The objective of the HKMA’s on-site examinations is not to re-assess the SFC’s authorised investment product documentation, but to ensure that the selling practice of RIs is in compliance with the regulatory requirements and that proper and adequate disclosure of the nature and risk of the products has been made to the customers concerned. In this process, the assessment of the adequacy of the disclosure of nature and risks should take into account all the relevant information shown in the product documentation, as well as how the information has been used and imparted to the customer in the selling process.

Manpower for supervising banks' securities business

14. *Paragraph 4.7 of HKMA's Review Report states that HKMA employs in its Banking Supervision Department (BSD) some 140 supervisory staff responsible for supervising all AIs in Hong Kong. Within BSD, there is a specialist team dedicated to supervising AIs' securities business known as the Securities Supervision Team which has a supervisory staff headcount of 11. Within the Banking Development Department (BDD) of HKMA, there are two Securities Enforcement Teams with a combined staff headcount of nine responsible for enforcement related matters. Please advise on the following:*
- (a) *The changes, if any, from April 2003 to September 2008, in the headcount of (i) supervisory staff for supervising all AIs in Hong Kong in BSD, (ii) supervisory staff of the Securities Supervision Team of BSD and (iii) staff of the two Securities Enforcement Teams under BDD;*
 - (b) *The qualifications required for the categories of staff mentioned in (a) (i),(ii) and (iii) and their respective duties; and*
 - (c) *Apart from the 11 supervisory staffs, what other levels of staff are employed in the Securities Supervision Team?*

Item (a)

- 14.1 In April 2003, the number of HKMA staff involved in the regulation of RIs' regulated activities was 75, comprising 7 staff in the securities supervision team, 7 staff in the securities enforcement team and 61 general banking supervision staff. This increased to 119 in mid-September 2008, comprising 11 staff in the securities supervision

team, 9 staff in the securities enforcement team and 99 general banking supervision staff.

Item (b)

14.2 The qualifications required for (i) supervisory staff in BSD, (ii) supervisory staff of the securities supervision team of BSD and (iii) staff of the securities enforcement team under BDD and their respective duties are set out in Table 5 below:

Table 5

	General Qualifications	Duties
Supervisory staff in BSD	<ul style="list-style-type: none"> • University degree in banking, accountancy, finance or related field. • Qualifications from relevant professional bodies in banking, accountancy, finance or related field an advantage. • Relevant experience in banking, securities operations or auditing field. 	<ul style="list-style-type: none"> • To supervise day-to-day operations of AIs including, where applicable, their regulated activities, through conducting on-site examinations and undertaking off-site reviews.
Securities supervision team of BSD	<ul style="list-style-type: none"> • University degree in banking, accountancy, finance or related field. • Qualifications from relevant professional bodies in banking, accountancy, finance or related field an advantage. • Relevant experience in banking, securities operations or auditing field. • Priority is given to individuals who have qualifications and working experience relevant to the securities industry. 	<ul style="list-style-type: none"> • To supervise day-to-day securities business of RIs through conducting on-site securities examinations and undertaking off-site reviews.

	General Qualifications	Duties
Securities enforcement team of BDD	<ul style="list-style-type: none"> • University degree, preferably in finance, accounting or law. Relevant advanced degree or professional qualification a definite advantage • Relevant experience in: (a) investigation of misconducts, corruption offences or commercial crimes related to the financial industry, or dealing with matters relating to those misconducts, offences or crimes; and (b) disciplinary or regulatory proceedings, preferably in the financial industry. 	<ul style="list-style-type: none"> • To exercise the disciplinary powers under the BO in respect of the securities business of RIs.

Item (c)

- 14.3 Apart from the 11 staff of the Securities Supervision Team, there were 2 supporting staff deployed on a shared basis with other teams to provide administrative support to the specialist team.

15. *Given the significant growth in RIs' securities business and the launch of complex financial products since 2003, please provide HKMA's views on whether HKMA is equipped with the necessary manpower and expertise to oversee the proper conduct of such business by RIs.*

15.1 The HKMA employs some 140 supervisory staff in its BSD. These staff are responsible for supervising the banking businesses and where applicable, regulated activities, of all AIs in Hong Kong. In conducting their supervisory functions, they will, where appropriate, carry out checks on AIs' securities business to test regulatory compliance, assess effectiveness of control systems and identify possible control deficiencies and misconduct. Within BSD, the Securities Supervision Team – a specialist team dedicated to supervising AIs' securities business – has a supervisory staff headcount of 11 (in 2008). In addition, within BDD, there are two Securities Enforcement Teams, which have a combined staff headcount of 9, responsible for enforcement related matters. We consider that we have the staff resources and expertise to regulate the regulated activities of RIs.

15.2 To keep pace with the market and investment product developments, the HKMA always emphasizes the importance of providing adequate training to its supervisory staff. A total of 22 internal and external training sessions in relation to various investment products (including credit-linked derivative products) and regulation of selling practices of investment products were arranged from 2003 to 14 September 2008 (i.e. before the collapse of LB) for the supervisory and securities enforcement staff. Among these sessions, 10 were held by the SFC. The HKMA also maintains close communications with the SFC and shares knowledge and experience with the SFC on regulating the

securities-related activities. There have been reciprocal staff secondment arrangements in the supervision and enforcement functions between the SFC and the HKMA.

Sale of financial products through private placement

16. *HKMA's Review Report (paragraph 8.16) recommends that a review of the private placement regime should be undertaken to ensure that the regime is appropriate in the light of market developments. Please advise on the following:*

- (a) *whether HKMA's on-site examination or off-site surveillance had identified any deficiencies in the private placement regime between April 2003 and September 2008; and*
- (b) *the number of complaints (if any) received by HKMA about RIs' sale of financial products by way of private placement from April 2003 to September 2008, and the results of HKMA's investigation into such complaints.*

Item (a)

16.1 The issue raised in paragraph 8.16 of the HKMA's Review Report should be considered against the proper perspective. As set out in that paragraph, sales by private placements do not require a prospectus or the SFC's authorisation of offering documentation, which would otherwise be required for an offer to the public. The HKMA's related recommendation aims at reviewing the appropriateness of such a regime given the latest market developments, and whether the existing exemptions from the requirement for the SFC's authorisation of offering documentation for investments should be tightened up.

16.2 The objective of the HKMA's day-to-day regulatory process on RIs is to ensure the compliance of RIs with the legal and regulatory requirements

in their conduct of regulated activities. Therefore, the focus of the HKMA's on-site examinations and off-site surveillance has been on the sale practices of RIs in relation to investment products (including those offered under private placement regime) instead of the private placement regime itself.

- 16.3 For most of the RIs examined so far, the controls and sale practices in relation to investment products offered under the private placement regime were generally acceptable and no common issues across the banking industry were found. Based on the HKMA's findings in the thematic examinations in 2008 on investment advisory and dealing activities in stock accumulators, suspected mis-selling cases involving 71 customers were identified. These cases have been referred to the HKMA's securities enforcement team for appropriate action and therefore it would not be appropriate for the HKMA to disclose the examination findings at this stage.

Item (b)

- 16.4 From 1 April 2003 to 14 September 2008, the HKMA received complaints involving 55 customers about possible mis-selling of investment products sold by RI through the private placement channel. The allegations of these customer complaints had nothing to do with the private placement regime, but were generally about improper sale practices used by the ReIs and/or RIs concerned. Among these complaints, cases involving 46 customers have been assessed by the internal Event Review Committee. Among these customers, cases involving 39 customers were closed due to insufficient evidence, and investigation into cases involving 3 customers has been completed. The completed investigation cases (involving 3 customers) were closed and the HKMA decided not to take any disciplinary action or to refer the

cases to the SFC due to insufficient evidence to substantiate the suspected improper practices. Investigation on the remaining 4 customers' cases is in progress.