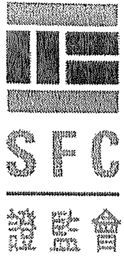


SECURITIES AND FUTURES COMMISSION
證券及期貨事務監察委員會

SC Ref.No.SC(1)-W13(C)

WRITTEN STATEMENT OF MR MARTIN WHEATLEY CHIEF EXECUTIVE OFFICER – SECURITIES AND FUTURES COMMISSION

10 June 2009

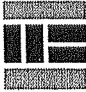


TABLE OF CONTENTS

GENERAL REMARKS 3

Introduction 3

Background 3

Regulatory regime 5

Element 1 - Disclosure-based regime 5

Element 2 - Conduct regulation to ensure suitability 9

Element 3 - Licensing requirements 11

Element 4 - Intermediary supervision 12

Element 5 - Investor education 18

Element 6 - Enforcement 20

SPECIFIC QUESTIONS 23

Q1. 23

Q2. 28

Q3. 30

Q4. 31

Q5. 34

Q6. 37

Q7. 39

Q8. 41

Q9. 43

Q10. 46

Q11. 48

Q12. 49

Q13. 51

Q14. 53

Q15. 54

Q16. 55

Q17. 56

Q18. 58

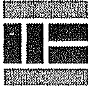
Q19. 60

Q20. 61

Q21. 64

Q23. 65

Q24. 66



Q25. 68

Q26. 69

APPENDIX 1

Glossary of Terms 73

APPENDIX 2

Regulatory Objectives and Functions of the SFC under the SFO 75

APPENDIX 3

Seventeenth and Eighteenth Schedule to the Companies Ordinance................................79

APPENDIX 4

Procedure for Registration of Prospectuses..85

APPENDIX 5

Procedure for Seeking Authorisation of Marketing Material relating to Debentures (including Structured Notes) 86

APPENDIX 6

Table of Licensed And Registered Persons 87

APPENDIX 7

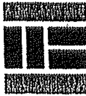
Table of Investor Education Work on Retail Structured Products and Investment Advisers 88

APPENDIX 8

SFC Press Release 152

APPENDIX 9

Comments from HKMA on various Codes and Guidelines published by The SFC 155



WRITTEN STATEMENT OF MR MARTIN WHEATLEY
CHIEF EXECUTIVE OFFICER - SECURITIES AND FUTURES COMMISSION

GENERAL REMARKS

Introduction

1. The letter from the Clerk to the Subcommittee dated 22 May 2009, raises a number of questions which I have been asked to address. The replies to these questions are set out at pages 23 to 72 of this statement. However, I should start by explaining the legislative and regulatory framework within which the Securities and Futures Commission ("SFC" or "Commission") operates, and how this evolved. In this statement I have responded to the questions raised by the Subcommittee to the best of my knowledge and belief.

2. For ease of reference I will refer to authorised financial institutions which are registered with the SFC to carry on one or more regulated activities as "RIs" and corporations licensed by the SFC to carry on one or more regulated activities as "LCs". Lehman Brothers Holdings Inc. and its subsidiaries will collectively be referred to as "Lehman".

Background

Enactment of the Securities and Futures Ordinance ("SFO")

3. The SFO was enacted in March 2002 although it did not come into effect until 1 April 2003. Our statutory functions ("powers and duties") in s.5 of the SFO include provisions that require the SFC, so far as reasonably practicable, to –

"(a) take such steps as it considers appropriate to maintain and promote the fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry;

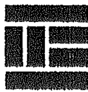
(e) encourage the provision of sound, balanced and informed advice regarding transactions or activities related to financial products;

(i) promote understanding by the public of the securities and futures industry and of the benefits, risks and liabilities associated with investing in financial products;

(j) encourage the public to appreciate the relative benefits of investing in financial products through persons carrying on activities regulated by the Commission under any of the relevant provisions;

(k) promote understanding by the public of the importance of making informed decisions regarding transactions or activities related to financial products and of taking responsibility therefor; and

(l) 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."[1]

Amendments to the Companies Ordinance ("CO")

4. The Financial Market Development Task Force ("FMDTF") was established in December 2001 following initiatives announced by the Financial Secretary in his 2001 Budget Speech. In June 2002, the FMDTF issued its first report recommending, inter alia, "clarifying" the existing CO provisions to facilitate debt issuers' publishing "offer awareness materials" to increase public awareness of debt offerings.

5. In response the SFC published three sets of guidelines to facilitate offers of shares and debentures in February and March 2003 –

   (a) Guidelines on the content and manner of publication of certain publicity and disclosure materials that may be issued to the public in Hong Kong;

   (b) Guidelines facilitating offers of shares or debentures on a repeat or programme basis using separately registered programme and issue prospectuses; and

   (c) Guidelines providing for relaxations so that faxed copies of experts' consent letters and a bulk print proof of the prospectus may be accepted for registration under the CO in certain circumstances.

6. Product development was further encouraged by the Companies Ordinance (Exemption of Companies and Prospectuses from Compliance with Provisions)(Amendment) Notice 2003 which exempts the issuer of debentures from providing certain information in the prospectus that is irrelevant to investors and/or that will impose an undue burden on the issuer[2].

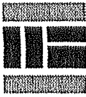
7. The Companies (Amendment) Bill 2003 was also introduced which, among other things, entrenched the regulatory approach set out in the Guidelines regarding offer awareness materials and the use of a "dual prospectus" structure for programme offerings. In addition, the Bill also expressly excluded from the definition of "prospectus" documents containing or relating to offers and invitations that fall within 12 categories set out in the 17th Schedule to the CO – "the safe harbours" (for ease of reference these are listed in Appendix 3). After a period of public consultation and scrutiny by the Bills Committee, the Bill was enacted as the Companies (Amendment) Ordinance 2004 on 22 July 2004 and came into effect on 3 December 2004.

Amendment to the Stock Exchange Listing Rules

---

[1] See Appendix 2 for the full text of the SFC's regulatory objectives, functions and powers and general duties.

[2] For instance, a prospectus is exempted from compliance with paragraphs 4, 5 and 22 of the Third Schedule to the CO regarding, amongst others, (i) the number of founders or management or deferred shares; (ii) directors' qualification shares and (iii) any borrowing power exercisable by directors respectively.



8. In July 2002 amendments to the Stock Exchange Listing Rules were approved by the SFC and a new Chapter 15A was added providing for the listing of structured products on the Stock Exchange of Hong Kong.

Regulatory regime

9. Our regulatory regime, which is directed at promoting an understanding of financial products and securing an appropriate degree of protection for members of the public investing in financial products, rests on 6 elements[3] –

   (a) Disclosure;

   (b) Conduct regulation to ensure suitability;

   (c) Licensing/registration of intermediaries and their representatives;

   (d) Supervision of intermediaries;

   (e) Investor education; and

   (f) Enforcement action against those who do not comply with the requirements.

10. I will now briefly consider each of these elements.

Element 1 - Disclosure-based regime

11. A disclosure-based regime, as opposed to a regime under which products are regulated, is adopted in all other leading jurisdictions like the US, the UK and other countries within the EU, Australia and Singapore. A disclosure based regime is one where the prospectus for an issue discloses sufficient details on product features and risks for an individual to form a balanced view of the product at the time of the issue of the prospectus. That is coupled with the obligation of the intermediary to properly explain the product, and ensure that it is suitable taking account of the individual's circumstances.

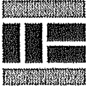
12. Similar to an IPO, before shares and debentures can be offered by a company to the public in Hong Kong for subscription or purchase, the company has to prepare a prospectus which –

   (a) Complies with the disclosure requirements of the CO;

   (b) Has been authorised for registration by the SFC; and

---

[3] Some of these elements have been variously described as "pillars" at paragraph 2.2.1 of the SFC's Report of 31 December 2008 to the Financial Secretary (where the pillars were "disclosure and suitability") and in paragraph 7 of the Monetary Authority's Written Statement of 26th March 2009 where the pillars were "day-to-day regulation and enforcement". Whilst views on the weight to be given to each element may vary, a more detailed consideration of each element aids in understanding the regime.



(c) Has been registered by the Registrar of Companies prior to publication, circulation or distribution in Hong Kong.

13. Lehman Minibonds (Credit Linked Notes – "CLNs"), Lehman Pyxis Notes (Equity Linked Notes – "ELNs") and Lehman ProFund Notes (Fund Linked Notes "FLNs") as well as structured products issued by others where Lehman was a reference entity[4] were all structured as "debentures"[5] and therefore fell within the "prospectus regime" under the CO[6].

"Complies with the disclosure requirements of the CO"

14. Under the CO an issuer is required to disclose in a prospectus all of the matters specified in the Third Schedule to the CO, unless an exemption applies. The Third Schedule includes the important requirement (at paragraph 3 of Part I of the Third Schedule to the CO) that the prospectus must contain :

> "*Sufficient particulars and information to enable a reasonable person to form as a result thereof a valid and justifiable opinion of the shares or debentures and the financial condition and profitability of the company at the time of the issue of the prospectus, taking into account the nature of the shares or debentures being offered and the nature of the company, and the nature of the persons likely to consider acquiring them*".

15. Equally it is the duty of issuers and others concerned in the issue (under pain of potential civil liability and criminal sanction) to ensure that the prospectus does not contain false or misleading statements or statements which are false or misleading through the omission of a material fact.

"Has been authorised for registration by the SFC"

16. When authorising a prospectus the SFC first checks that the document contains the information specified in the Third Schedule to the CO. Normally we ask that –

(a) the first page of the prospectus contains only essential information;

(b) there is a summary of the key information in the prospectus;

(c) the content of the prospectus is arranged in a logical order;

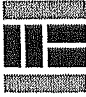
(d) similar information is grouped together under descriptive headings;

---

[4] These were arranged by -
DBS Bank Ltd - Constellation Notes : CLNs
Morgan Stanley & Co. International Ltd. - Octave Notes : CLNs
UBS Securities Asia Ltd. - Retail – Aimed Callable Investment Notes : CLNs

[5] Under Section 2 of the CO, "debentures" includes debenture stock, bonds and any other securities of a company whether constituting a charge on the assets of the company or not.

[6] Other products, such as equity linked deposits and equity linked investments, were structured as deposits or contracts and fell to be regulated under s.105 of the SFO.



(e) there is minimal repetition; and

(f) the prospectus is written in plain language.

17. We also review the draft and identify information which a reasonable investor would want to see in the document. In reviewing prospectus disclosures, it is important that the nature and risks of the product in question are adequately disclosed. Much will depend upon the particular product in question but, for example, it should normally state :

(a) whether the product is principal protected;

(b) the terms and conditions of the notes including the tenor, the coupon rate, minimum investment amount;

(c) (if it be the case) that there is no assurance as to an active trading market in the notes;

(d) in the case of limited recourse programmes, that the claims of investors against the issuer are limited to the realised value of the collateral securing the notes;

(e) if the notes are not listed, that they are not covered by the investor compensation fund;

We then provide our comments to the issuer / its advisers asking them to clarify or make representations on issues raised, and review and comment on subsequent iterations of the draft until we have no further comment on the draft. Please refer to the flowchart in **Appendix 4** which describes the procedure for registration of prospectuses under the CO.

Marketing materials[7]

18. Marketing materials relating to debentures (including structured notes such as Minibonds) can be submitted for authorisation[8] -

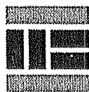
(a) as an extract from or abridged version of a prospectus under section 38B(2A)(b) of the CO and for the ancillary artwork and legends under section 105(1) of the SFO; or

(b) otherwise under section 105(1) of the SFO only.

19. Marketing materials are designed to raise investors' interest in an offer. Marketing materials cannot, and do not, replace prospectuses and therefore will not contain all relevant information for investors to make an informed investment decision. In reviewing the marketing materials, the SFC refers to

[7] The Companies (Amendment) Ordinance 2004 came into effect and the revised s.38B provided for SFC approval of marketing materials from 3 December 2004. Prior to that date marketing materials did not normally require approval from the SFC but were issued by intermediaries using exemptions from s.103 of the SFO.

[8] Under s.103(3) certain materials are exempt from requiring authorisation e.g. publications falling within s.38B(2) of the CO such as an extract from or an abridged version of an authorised prospectus.



the *Guidelines on Use of Offer Awareness and Summary Disclosure Materials in Offerings of Shares and Debentures under the CO* which have been published by the SFC. The Guidelines require, among other things, that the marketing materials must not contain anything that is inconsistent with the information contained in the prospectus, and that the contents must not be false, biased, misleading or deceptive.

20. Upon receipt of the draft marketing materials, the SFC reviews the drafts to ensure that the marketing materials do not contain anything that is inconsistent with the information contained in the prospectus and that, in general, appropriate warnings are included in each of the marketing materials – for example -

- investment involves risks (and, where applicable, the product is not principal protected);
- prospective investors should read the relevant offering documents for detailed information about the issuer/guarantor and the offer before investing; and
- SFC's authorisation of the marketing material does not imply the SFC's endorsement or recommendation of the product.

21. Please refer to the flowchart in **Appendix 5** which describes the procedure for seeking authorisation of marketing material relating to debentures.

Product regulation versus disclosure regulation

22. It has been suggested that we should not have authorised documentation for Minibonds as they are too complex for many investors to understand. This is not the regulatory structure that we have in Hong Kong –

(a) As a matter of general policy, a paternalistic approach has not been adopted in Hong Kong or in any of the major financial centres.

(b) Product regulation would reduce investor choice.

(c) We do not believe that the SFC is better placed than the market to judge the commercial merits of products or whether products deliver customer value.

(d) Prudent investors do not put all of their eggs in one basket. Limiting products to those which are suitable for all classes of investors would deprive some customers, who wish to invest only a small portion of their money in risky or complex products, of the potential returns that they offer.

(e) Product regulation may also lead to a degree of moral hazard as investors may conclude that every product which is approved must be a "safe" investment whereas all investment involves risk.

23. Instead we fulfil our role of protecting investors by seeking to ensure that there is sufficient disclosure for him or her to make an informed investment decision (with the assistance of intermediaries). As will be explained in the next section, it is the duty of the intermediary selling the product to properly

explain the product and not to recommend the product if it is unsuitable. A private investor is not expected simply to rely on disclosure in the prospectus alone but is meant to have help from the selling agent in understanding the product. In addition we have issued a large amount of information warning investors about points to consider before investing in structured products.

24. No prospectus can be issued by a company unless it has been authorised for registration by the SFC and registered at the Companies' Registry. Authorisation did not mean that Minibonds were suitable for <u>all</u> investors. Suitability could only be determined at the point of sale when the particular circumstances of the investor were known.

25. There has been some debate in the media over whether Minibonds are "bonds" or "notes" or "derivatives" and it has been suggested that we should not have authorised the use of the name "Minibond". There is no precise definition of what constitutes a "bond" or a "note". "Minibonds" could legitimately be described as debentures, bonds, structured bonds, notes, credit-linked notes or derivatives. In our investor education articles we say that structured notes are different from traditional "plain vanilla" bonds, but it is implicit that they are a variety of bonds.

26. "Minibonds" is the name under which they were marketed and the law did not prohibit Lehman from using that name. It is not an incorrect ~~or~~ description of the product. What is important is whether the product was accurately described and explained in the prospectuses and sale process.

Element 2 - Conduct regulation to ensure suitability

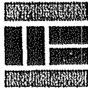
27. Disclosure alone will not be able to protect investors and should not be looked at in isolation. It must be supported by a range of other measures including conduct regulation at point-of-sale, effective enforcement against those who fail to comply and appropriate investor education.

28. Regulating intermediary conduct at the point of sale is critical. Only at this point is it possible to understand the investment objectives and risk profile of a particular investor and to determine whether a particular product is suitable for him -

> "Investor suitability is exclusively an issue for distributors, since it must be considered in the context of confidential information provided by the client to the distributor[9]."

29. Under s.169 of the SFO the SFC may publish codes to give guidance relating to the practices and standards with which LCs and RIs and their representatives (regulated persons) are ordinarily expected to comply in carrying on regulated activities. The Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission ("Code of Conduct") published by the SFC has been modelled on principles developed and recognized by the International Organization of Securities Commissions

[9] http://www.isda.org/press/pdf/Retail-Structured-Products-Principles.pdf



and other principles the SFC believes to be fundamental to the undertaking of a licensed or registered person's business. Paragraph 4.3 of the Code of Conduct (Internal control, financial and operational resources) is supplemented by the Management, Supervision and Internal Control Guidelines dated April 2003 ("ICG") published under s.399 of the SFO.

30. A failure to comply with a Code published under s.169, or guidelines published under s.399, of the SFO is a serious matter that calls into question whether a regulated person is fit and proper to remain licensed or registered. The SFC is expressly required to have regard to the Code of Conduct made under s.169, and guidelines made under s.399, of the SFO in determining whether there has been "misconduct" which will render a licensed person liable to disciplinary sanctions (see s.193(3)). Under s.194 or 196 of the SFO a regulated person can have his license or registration suspended or revoked and, in addition he may be liable to a fine of up to $10 million or 3 times the amount of profit gained, or loss avoided as a result of his misconduct.[10]

31. Under the Code of Conduct[11], RIs and LCs are required to comply with a series of general principles which are supplemented by specific requirements set out in subsequent paragraphs. Key messages are acting in the best interest of clients and treating clients fairly -

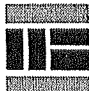
> **GP1. Honesty and fairness**
> In conducting its business activities, a licensed or registered person should act honestly, fairly, and in the best interests of its clients and the integrity of the market.
>
> **GP2. Diligence**
> In conducting its business activities, a licensed or registered person should act with due skill, care and diligence, in the best interests of its clients and the integrity of the market.
>
> **GP5. Information for clients**
> A licensed or registered person should make adequate disclosure of relevant material information in its dealings with its clients.
>
> **GP6. Conflicts of interest**
> A licensed or registered person should try to avoid conflicts of interest, and when they cannot be avoided, should ensure that its clients are fairly treated.

32. In May 2007 the SFC issued some Frequently Asked Questions ("FAQs") to clarify how LCs and RIs should ensure suitability when making a recommendation or solicitation. These were drawn from the existing requirements of the Code of Conduct and the ICG and explained that RIs and LCs must -

---

[10] Details of disciplinary action for breaches of the Code of Conduct are set out below in the Enforcement section.

[11] First issued in February 1994 and revised from time to time, principally in April 2003 when the SFO came into effect. The SFC also issued the Management, Supervision and Internal Control Guidelines dated April 2003 to explain the internal control related requirements under the Code of Conduct and the FAQs in May 2007 to clarify how investment advisors should ensure suitability when making a recommendation or solicitation.



(a) Know their clients – to collect from each client information that includes their investment knowledge, investment horizon, risk tolerance (including risk of loss of capital) and capacity to make regular contributions and meet extra collateral requirements, where appropriate (see GP4 and para 5.1 to 5.3 of Code of Conduct);

(b) Understand the investment products they recommend to clients (i.e. they must conduct product due diligence) (see GP2 and para 3.4 of Code of Conduct and Section VII para 3 of the ICG and para 3a of the Appendix to the ICG);

(c) Provide reasonably suitable recommendations by matching the risk return profile of each investment product with the personal circumstances of each client to whom it is recommended (see GP2, para 3.4, 3.10 & 5.2 of Code of Conduct);

(d) Provide all relevant material information to clients and help them make informed investment decisions (see GP 5 of Code of Conduct);

(e) Employ competent staff and provide appropriate training (see GP3 and para 4.1 of Code of Conduct and Section III para 1 and 3 of the ICG); and

(f) Document and retain the reasons for each product recommendation made to each client (see Section VII para 3 of ICG and para 3c of the Appendix to the ICG).

33. Paragraph 5.3 of the Code of Conduct makes particular reference to derivative products –

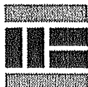
> "A licensed or registered person providing services to a client in derivative products, including futures contracts or options, or any leveraged transaction should assure itself that the client understands the nature and risks of the products and has sufficient net worth to be able to assume the risks and bear the potential losses of trading in the products."

34. Minibonds and the other Lehman-related structured products incorporate derivatives and paragraph 5.3 of the Code of Conduct would have applied to require that any RI or LC selling these products should have assured itself that the client understood the nature and risks of the products and had sufficient net worth to be able to assume the risks and bear the potential losses of trading in the products.

35. It is therefore through a combination of disclosure and suitability assessment we aim to enable investors to make informed investment decisions.

Element 3 - Licensing requirements

36. The SFO prohibits the distribution and marketing of financial products <u>except</u> by corporations which are licensed by the SFC or RIs that are registered with



the SFC to carry on regulated activities. We ensure that the representatives of LCs are suitably qualified. Registration of banking staff is the responsibility of the Hong Kong Monetary Authority ("HKMA"). Please refer to **Appendix 6** which sets out the licensing and registration arrangements for LCs, RIs and their respective staff.

Registration of banks as RIs

37. When a bank applies to carry on regulated activities the SFC is required (by s.119(2) SFO) to refer the application to HMKA and is required to have regard to advice from HKMA whether it is satisfied that the bank is a fit and proper person to be registered (s.119(4)(a) of the SFO). It is then provided that the SFC may rely on the HKMA's recommendation in making its decision (s.119(3) SFO).

Registration of banking staff

38. The HKMA alone is responsible for approving the appointment of executive officers ("EOs") of RIs (s.125(2) of the SFO in conjunction with s.71C and D of the Banking Ordinance ("BO")). These are the persons responsible for directly supervising the conduct of regulated activities of RIs and the HKMA must be satisfied that the person appointed –

    (a) is a fit and proper person to be so approved (s.129(1) of the SFO); and

    (b) has sufficient authority within the institution (s.71C(2) of the BO).

39. Front line staff of RIs engaged to carry out regulated activities, called "relevant individuals", are not licensed by the SFC and must be entered on a register maintained by HKMA under s.20 of the BO in order to carry on regulated activities. It is a condition of registration that an individual whose name is entered on the register as engaged by an RI in respect of a regulated activity is a fit and proper person to be so engaged (s.119(8)(a)(ii) SFO.) Hence primary responsibility for establishing that they are fit and proper rests with the RI rather than HKMA.

40. The HKMA is not acting as the SFC's agent in performing these duties as the SFC has no statutory powers to approve EOs and to register relevant individuals. The powers are vested in the HKMA.

Element 4 - Intermediary supervision

Regulatory structure

41. The SFC is responsible for the supervision of LC's, their responsible officers and their representatives.

42. HKMA is responsible for the supervision of RIs. The HKMA supervises all aspects of RIs' operations and alone has the power to initiate an inspection of an RI under s.180 of the SFO (see s.180(17)) and/or s.55 of the BO

(examination and investigation of authorized institutions). The SFC has no power to supervise the conduct of regulated activities by banks to secure compliance with the Code of Conduct and other codes, and must rely on the HKMA to exercise its powers in relation to banks under the BO (e.g. s.7(2)(g) of the BO (functions of HKMA) and s.55 of the BO (examination and investigation of authorised institutions)). Section 5(3) of the SFO provides that the SFC in performing any of its functions in relation to an RI may rely on the supervision of such RI by HKMA.

43. It is only where the SFC has reason to inquire whether an RI is guilty of misconduct or is not fit and proper that it may carry out an investigation (after consultation with the HKMA) and, potentially, take disciplinary action.

Supervision of banking staff

44. The SFC has no power to supervise staff of RIs. That power resides solely with the HKMA as part of its powers under the BO (e.g. s.55 of the BO).

45. Under s.71C of the BO the HKMA may take disciplinary action in respect of EOs for contravention of the provisions of the SFO or the Code of Conduct (after consultation with the SFC) and alone may revoke or suspend their registration.

46. Under s.58A of the BO the HKMA may take disciplinary action in respect of Relevant Individuals for contravention of the provisions of the SFO or the Code of Conduct (after consultation with the SFC) and alone may revoke or suspend their registration.

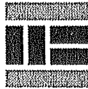
HKMA's role

47. Once again, the HKMA is not acting as the SFC's agent in performing these duties as the SFC has no statutory powers to supervise RIs, EOs and relevant individuals and cannot delegate such powers. The powers are vested in the HKMA.

MOU

48. The Memorandum of Understanding ("MOU") signed between the SFC and HKMA in December 2002 clarifies and confirms the roles and responsibilities of the SFC and the HKMA under each major functional aspect of the regulatory regime as well as the arrangement between the two parties in relation to the exchange of relevant information and notification or referral of relevant matters. Whilst the SFC and the HKMA have distinct and separate responsibilities, the MOU is intended to ensure that both LCs and RIs and their staff are subject to consistent regulatory measures.

49. If the HKMA becomes aware of a material breach by an RI or its staff of any applicable provision of the SFO or any rules, codes or guidelines made or published by the SFC under the SFO, the MOU provides that HKMA should refer the matter to the SFC. The SFC may (after consultation with the HKMA) commence an investigation under s.182 of the SFO. Where the SFC finds that the RI or its staff was guilty of misconduct, or if it is of the opinion that the person is not fit and proper, the SFC may (after consultation with the HKMA)



impose various sanctions under s.196(2) of the SFO. The sanctions range from a public reprimand to a fine not exceeding the greater of (i) $10,000,000; or (ii) 3 times the amount of the profit gained or loss avoided by the regulated person as a result of his misconduct or the conduct which leads the SFC to form the opinion that he is not fit and proper.

Broker supervision

50. The SFC supervises LCs through offsite monitoring and onsite inspection. Offsite monitoring mainly involves reviewing and analysing financial returns submitted to the SFC by LCs every month. Onsite inspections involve physically attending LCs' offices. Over the last 3 years, SFC has conducted approximately 140 onsite inspections of LCs each year. The onsite inspection teams are responsible for assessing general compliance with applicable requirements by LCs. This involves, inter alia -

    (a) Assessing the LC's management, supervision and internal controls and considering whether they are commensurate with its business operation;

    (b) Conducting walk-through tests of process/order flows to assess proper functioning and effectiveness of the internal control systems;

    (c) Verifying financial positions and client assets held; and

    (d) Performing sample testing of transactions so as to detect any non-compliance with the Code of Conduct and other regulatory requirements.

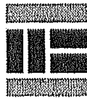
Thematic inspections

51. The inspection teams are also responsible for conducting specific thematic inspections of LCs to look into topical issues or concerns over particular market practices. The SFC regularly analyses market-wide risks and trends emerging from current business and operating environment and, in about 2004, noted a rising trend for Hong Kong investors to invest in investment products other than the more traditional listed securities.

52. As a result, in the same year, we decided to gauge the range of prevailing market practices by inspecting a representative group of 15 investment advisory firms to assess their compliance with the SFO, and the Code of Conduct. The securities dealers were not included in the thematic review because they were mainly engaged in dealing in listed securities for their clients rather than selling investment products.

53. The report on the thematic inspection issued by the SFC in February 2005 ("the 2005 Report") sets out the regulatory concerns at the time, by –

    (a) presenting the findings of our theme inspection on selling practices adopted by investment advisory firms;
    (b) discussing some of the issues that arose out of our investigations and which we believe pose serious regulatory concerns; and
    (c) clarifying some of the existing requirements.



54. The 2005 Report explains that, in Hong Kong, an investment advisory firm may be an LC, an RI or an insurance intermediary. The SFC's inspection and investigation initiatives had, so far, been limited to reviewing the selling practices of LCs which were under the SFC's direct supervision.

55. The 2005 Report identified areas of unsatisfactory practice noted during the review and served as a set of benchmarks giving all licensed investment advisers a roadmap on how to ensure they would stay within the regulatory requirements. In particular the 2005 Report explained at paragraph 19 and 20 -

> *"19. In order to ensure that investment recommendations and advice to clients are reasonably suitable, an IA [i.e., investment adviser] should*
>
> *(a) know the client's financial situation, investment experience and investment objectives (II.1)*[12]*;*
> *(b) conduct adequate due diligence on the products and their providers to assess the risks (II.2);*
> *(c) make recommendations that are reasonably suitable given the client's specific circumstances (II.3);*
> *(d) help the client make informed decisions by giving the client a proper explanation of the basis of the investment recommendation, as well as the nature and extent of the risks (II.4); and*
> *(e) employ competent staff and provide appropriate training (II.5).*
>
> *20. We have investigated a number of cases in which clients have complained that the nature of and the risks associated with a financial product were not adequately explained to them. We have determined that some of these complaints are valid and reveal serious shortcomings in the performance of certain IAs. In particular, we have found that on occasions, the risks associated with products have been misrepresented, so that clients are led to believe they are investing in a lower risk product when, if properly described, the product is higher risk and therefore not suitable for conservative investors. As a point of reference, we have provided (in paragraph 39) three cases in which the basis of investment recommendation appears questionable given the clients' specific circumstances."*

56. The 2005 Report was copied to all RIs by a Circular issued by HKMA on 1 March 2005 which commented -

> *"Registered Institutions (RIs) should be aware that the regulatory requirements and recommendations detailed in the Report apply equally to the investment advisory activities of RIs. <u>RIs should study the Report carefully and put in place systems and controls to ensure compliance with the recommendations set out in the Report.</u> Some examples of the regulatory concerns identified in the Report include:*
>
> *a. Some investment advisers did not provide sufficient explanation or information to help their clients to make informed decisions. In some cases, the risks associated with the products were*

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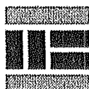
[12] These references are to sections of the 2005 Report.



misrepresented, and clients were led to believe that they were investing in some low risk products. Also, there were cases where the investment advisers concerned did not have reasonable justification for making an investment recommendation to their customers.

b. There were cases where unauthorized investment funds were offered to clients who did not appear to qualify as professional investors. In addition, some investment advisers had failed to conduct adequate due diligence on those unauthorized investment funds before recommending them to their clients.

c. Some investment advisers had not obtained sufficient information on their clients' financial situation, investment experience, investment objectives and risk tolerance level for the purpose of the customer suitability test.

d. Some client agreements contained waivers and disclaimers of liability which might not fully comply with the Control of Exemption Clauses Ordinance."

Retail Investor Surveys

57. The SFC conducted a Retail Investor Survey from September to November in 2005. The purpose of the survey was to estimate the retail participation in different investment products and explore the investment behaviour of retail investors in Hong Kong. Of 5,210 adults interviewed 146 (or 2.8%) said that they invested in structured products during the two years preceding the survey.

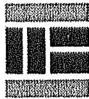
58. According to another survey which covered the period from 1 June 2003 to 15 June 2005, a total of 118 retail structured notes were issued by 23 issuers. Equity linked notes and credit linked notes dominated the retail structured notes market, whilst hybrid securities and index linked notes were relatively less common. Equity linked notes accounted for approximately 65% by number of issues and by issue size and credit linked notes accounted for approximately 28%.

59. In June 2006, we engaged the Social Sciences Research Centre of the University of Hong Kong (SSRC) to conduct Structured Product Investor Survey ("2006 Survey"). The results of this survey were published in November 2006. Key points identified were that -

(a) In the survey, 207 structured product investors were successfully interviewed.

(b) When asked about their investment objectives many (42.0%) said that they bought structured products for perceived higher returns, comparing to bank deposits of a similar term .

(c) Most investors (84.5%) considered structured products were "medium" "high" and "very high risk". But 13.5% viewed structured products as "low" or "very low risk".



(d) Most investors (87.9%) bought their structured products through banks (presumably RIs).

60. Only around 11% of investors in equity-linked, credit-linked or index-linked products recalled having received, read and fully understood the offering documents. Those who had problems understanding the documents said that they contained too much jargon. Where sales representatives were involved, investors were generally satisfied with the product explanations provided. However, a significant number of investors (45.5%) did not recall receiving advice from their sales representatives.

61. Whilst the survey revealed that few investors bought their structured products through LCs (brokers – 17.4%, IAs – 4.3% and other channels – 1.4%), we continued our efforts to educate investors, whether they intended to buy the products through RIs or LCs.

62. On finding that few investors received, read and fully understood the offering documents we responded immediately with more reminders. On the same day as the publication of the 2006 Survey we issued a Dr Wise article on retail structured notes to remind prospective investors of issues that they should consider before investing in these products and a circular to alert issuers and their selling agents to the results of the survey. We also requested that the issuers and selling agents pay particular attention to ensuring that investors understand the risks of these products.

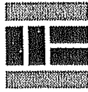
SFC's 2006 Paper - Regulatory Challenges and Responses

63. In light of the market condition and internal analysis, the SFC issued the document "Regulatory Challenges and Responses" in March 2006. One of the challenges identified was the increased exposure of retail clients to complex and structured products, and that there is a risk to investors if they do not properly understand these products or if they are not being properly advised. The SFC set out the steps that we would take:

- Monitor how investment advisers comply with applicable requirements and where necessary propose changes to improve standards
- Enforce the regulatory obligations of product providers and intermediaries
- Work with the Government and other agencies to address gaps and inconsistencies in the regulation of sales practices of functionally similar products
- Review our practices internally to address gaps and inconsistencies in the regulation of functionally similar investment products
- Further enhance our investor education work and promote informed investing.

Further thematic inspections

64. A second round of thematic inspections was conducted in 2006 with a view to assessing the prevailing selling practices adopted by 10 other licensed investment advisers and reviewing whether any improvement had been made



since the issuance of the last report. This time, the inspection was done in parallel with the HKMA's inspection of the selling practices of selected RIs.

65. The second thematic review revealed similar issues and deficiencies. The SFC has since taken appropriate enforcement action in relation to 5 of these 10 investment advisers covered in this thematic review. In one particular case, the Responsible Officer was suspended for 12 months and the firm was reprimanded and fined HK$170,000 for internal controls and supervisory failures

66. To help raise the standard of the industry, the SFC issued guidance on 8 May 2007 on requirements relating to the suitability of advice in the Code of Conduct and issued the second thematic review report on 31 May 2007. This was also circulated to the RIs by HKMA.

67. The SFC has continued to review selling practices and inspected 13 licensed investment advisers between June 2007 and 31 December 2008. Investigation works stemming from these reviews are currently under way. Two further cases have been referred for appropriate enforcement action as a result.

Element 5 - Investor education

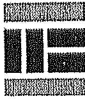
68. The SFC vigorously exercises its statutory mandate to promote investor education - educating and empowering investors to protect themselves is a top priority. We strive to keep investors educated, informed and alert to the risks of investing. This includes promulgating a proper investment attitude, promoting better investor understanding about the markets (including market mechanics and how various participants interact), products and investment risks and factors they should consider in making their investment decisions.

69. We also encourage investors to ask questions at the point of sale, in particular, the maximum losses in the worst case scenarios and whether there will be any penalty should they need to sell their investments before the end of the investment term. We believe that a more inquisitive investor culture not only helps an investor make informed choices, but also keeps market participants on their toes, especially in the area of new products. In addition, by broadening the scope and depth of investment knowledge among the investing public, investors can use this knowledge to make informed choices and manage their risks.

70. In order to raise retail investors' understanding of their own rights and responsibilities and the investment products sold to them, the focus and scope of our investor education ("IE") work includes -

(a) Providing generic information on key features and the associated downside risks of the products, particularly when new products are launched;

(b) Promulgating a list of elementary questions that investors should ask when they receive investment recommendations;



(c) Explaining the duties of intermediaries at the time of sale and post-sale;

(d) Promoting the importance of checking out information in a product's offering document instead of relying on marketing materials and advice of financial celebrities;

(e) Reminding investors to take responsibility for their own investment decisions and not to sign their rights away if they do not understand the terms and conditions and risks of the product; and

(f) Increasing awareness of the steps investors should take to file a complaint when they encounter wrongdoing.

71. A total of 120 IE initiatives related to structured products and the duties of investment advisers were conducted in the period from April 2001 to mid September 2008 before the collapse of Lehman[13]. These included articles in printed media, investor leaflets, e-newsletters (i.e. the Monthly Focus), on-line education resources, television and radio programmes, as well as videos on public buses. These are listed in chronological order in **Appendix 7**. Items of note are described below.

72. Some of the initiatives explained the structure and risks of credit-linked notes ("CLNs"), while others reminded investors that structured products are not equivalent to time deposits and that investors should not rely on marketing materials only. The IE initiatives also reminded investors that they must understand the terms and conditions of the product and avoid any investments whose risk level is beyond what the investors can accept.

73. Other initiatives advised investors about steps they can take to protect their own interests and find a suitable investment product when assessing a product recommendation made by an intermediary, and the importance of reading and understanding client agreements and disclaimers provided by investment advisers.

74. Intensive IE work on structured notes (including CLNs) was conducted in December 2003 and January 2004, including issuing eight articles and a press release about advice to investors on structured notes. These articles explain how CLNs and equity linked notes ("ELNs") work and certain product features, as well as warnings about credit risk, counterparty default risk and other risks associated with the product. These included: the thinly-capitalized nature of special purpose vehicles as issuers; the potential lack of a secondary market and ability to redeem early; the possible existence of complex swap arrangements; the use of funds to buy debt securities or other assets as collaterals to secure the product; the limited recourse nature of the product (i.e. investors' claims are only confined to the amount recovered from the realization of the collateral); and that investors should not confuse the existence of a guarantor with "capital-guarantee" / "principal-guarantee".

75. We also issued a circular to all intermediaries together with the above-mentioned press release reminding them of their obligation under paragraph

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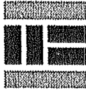
[13] For initiatives relating to IAs, this number includes initiatives from April 2003 to mid September 2008



5.3 of the Code of Conduct to assure themselves that their clients would understand the nature and risks of the products and have sufficient net worth to assume the risks and bear the potential loses of trading in the products. Intermediaries were also reminded of suitability of recommendations.

76. In 2004, our television series "Foundations in Wealth Management" included an episode which examined structured products and reminded investors to read offering documents to familiarize themselves with product features, associated risks and to consider product suitability.

77. The July 2005 Dr Wise column, entitled "Should You Invest In Structured Notes?" explained how the features and risks of structured notes differ from plain vanilla bonds.

78. One of the episodes in our 2006 TV drama series "Investment Challenge" also explained the features and risks of equity-linked investments. The series was aimed at tackling risks arising from complex and structured products and mis-selling to retail investors.

79. Later in 2006, we conducted the 2006 Survey to investigate retail investors' investment objectives in structured products and their level of understanding towards such products. In view of the survey findings we stepped up our efforts in explaining product features and risks, clarifying misconceptions and reminding investors to ask the right questions when considering potential investments. These include issuing, on the day the survey findings were published, a press release and a Dr Wise article as well as a circular to all issuers of unlisted retail structured products to alert them to the findings of the survey and suggest them to inform their selling agents and distributors of the findings, pay particular attention to ensuring that prospective investors understand their structured products, including the underlying risks.

80. Following the survey and in view of the increasing availability of these products in the market, we continued to enhance our IE work on complex structured products, in particular in relation to equity-linked products because our research indicated that the issue size of equity-linked products was much greater than that of CLNs[14]. Subsequently, our Retail Investors Survey in 2008 found that of those surveyed relatively few investors wrongly perceived such products as a long-term investment or a tool to help them preserve their capital.

Element 6 - Enforcement

81. A breach of the provisions of the Code of Conduct may lead to disciplinary action including suspension or revocation of license/registration and fines of up to HK$10 million or 3 times the profit made or loss avoided (whichever is the greater).

[14] For example, in 2006, the total issue size of equity linked products (i.e. ELNs and ELIs) (~HKD124.5 billion) was about 21 times more than that of CLNs (~HKD5.9 billion). In 2007, the total issue size of equity-linked products (~HKD238.4 billion) was at least 80 times more than that of CLNs (~HKD2.9 billion). The CLN market has also decreased by more than 50%.

82. Between April 2003 and 15 September 2008, the SFC completed 527 disciplinary inquiries for suspected breaches of the Code of Conduct by brokers or their representatives. Following these inquiries 430 persons/companies were disciplined (some persons/companies had more than one sanction imposed on them). Of these, 23 had their licence revoked, 164 had their licence suspended and 54 were prohibited from applying for a licence (e.g. if their licence had lapsed during the inquiry). In total, 102 were fined and 188 were publicly reprimanded. The largest fine imposed was HK$38 million. 168 cases involved a settlement agreement. The largest settlement negotiated was an ex gratia payment of HK$255 million to clients in the Towry Law case.

83. Between the date of the collapse of Lehman on 15 September 2008 and 5 May 2009 the SFC received approximately 7,960 complaints against RIs selling Minibonds and Lehman related structured products and 115 complaints against LCs selling these products. We understand that HKMA has received 21,045 complaints as at 27 May 2009.

84. The SFC has commenced investigations into ~~21~~ 19 RIs and ~~5~~ 6 LCs involved in selling Minibonds and Lehman related products. The low incidence of complaints relating to LCs (about 1% of the total) may reflect the fact that, as indicated by the 2006 Survey, few LCs were involved in the sale of structured products.

85. These investigations are complex, wide-ranging, likely to discover similar issues and trends, require centralised co-ordination and need to follow a consistent approach. Accordingly in the first instance we have dealt with each RI and LC scrutinizing the selling process within each organization on a top-down basis examining key issues such as the management controls, due diligence process, the training and supervision of sales staff, record keeping and the procedures used at point of sale especially the way in which suitability was determined.

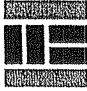
86. This approach also enables us to answer the obvious forensic question that arises from so many complaints, namely whether there is systemic problem in the sale of these products to be identified and remedied.

87. We are not allowed to comment publicly on any investigation relating to Lehman related Minibonds or structured financial products even to complainants. The SFC has entered into an agreement with Sun Hung Kai Investment Services Ltd ("SHKI") relating to sales since 2002 of Lehman Minibonds to its clients. A press release issued on 22 January 2009 explains that –

(a) The SFC issued a reprimand to SHKI in respect of internal systems and controls relating to its sales since 2002 of Lehman Minibonds to its clients; and

(b) SHKI had agreed with the SFC to make a voluntary offer to purchase all outstanding Lehman Minibonds bought by eligible SHKI clients at a price equal to the principal amount invested by them.

A copy of the press release of 22 January 2009 is attached as **Appendix 8**.



88. The decision to issue a reprimand follows an investigation by the SFC which raised a number of concerns with SHKI. Specifically, the SFC's concerns were with respect to:

    (a) the adequacy of product due diligence on Lehman Minibonds before they were distributed to eligible clients;

    (b) the adequacy of training given to SHK retail sales staff on Lehman Minibonds to enable them to understand the product and all its material risks;

    (c) the assessment of the level of risk for each particular series of Minibonds, the communication of those risk ratings to its retail sales staff and the measures that ought to have been taken to ensure that its sales staff gave reasonably suitable advice by matching the risk-return profile of each series of Lehman Minibonds with the personal circumstances of each eligible client; and

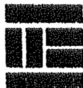
    (d) the record-keeping of investment advice given to eligible clients and any queries raised by them.

89. On 5 April 2009 the SFC has also issued a reprimand to KGI Asia Ltd ("KGI") over similar concerns in respect of its internal systems and controls relating to its sale of Lehman Minibonds to its clients following an investigation by the SFC. KGI has agreed with the SFC to make a voluntary offer to purchase all outstanding Lehman Minibonds subscribed for or bought by its clients at a price equal to the principal amount invested by them.

90. We are pleased with the outcomes that have been achieved so far in 2 cases involving LCs and we believe the approach adopted has produced a result which is in the best interests of the investors.

91. However, In the absence of a voluntary compromise under section 201 of the SFO, the SFC cannot compel a Regulated Person to compensate an investor, where an adverse disciplinary decision has been made. We believe that powers to impose a compensation order as a disciplinary sanction, which we recommend in paragraph 40 of our report to the Financial Secretary, are necessary and would broaden the disciplinary sanctions available to the SFC for the benefit of investors.

92. I shall turn to the specific questions raised by the Subcommittee in its Clerk's letter dated 22 May 2009.



SPECIFIC QUESTIONS

Q1. Please provide information on:

(a) the duties and powers (statutory or otherwise) of CEO/SFC, particularly those relating to the regulation of securities-related business conducted by Registered Institutions (RIs)

1.1 There are few duties and powers expressly conferred on the CEO by the SFO but many powers of the SFC under the SFO are delegated to all executive directors ("EDs"), including the CEO. The powers that are delegated are covered in the reply to question 1(b). However, as the duties and powers of the SFC relating to the regulation of securities-related business conducted by RIs are very limited the delegated powers and duties of the CEO are also limited.

<u>SFC's regulation of banks' securities-related business</u>

1.2 The HKMA is the regulator of all banks conducting business in Hong Kong including those that carry on business in regulated activities[1].

1.3 When a bank wishes to carry on regulated activities it must be registered with the SFC. The bank will apply to the SFC for registration but the SFC is required to refer the application to the HKMA. The HKMA considers the application, then consults the SFC on the merits of such application and advises the SFC whether it is satisfied that the bank is a fit and proper person to be registered. The SFC must have regard to the HKMA's advice on the fitness and properness of the bank, and may rely wholly or partly on it in deciding whether or not to register the bank. In practice, the SFC invariably relies on the HKMA's advice because this arises out of HKMA's detailed and considered assessment of all of the relevant information, including information that is supplied to it by the SFC, unless the SFC has information or concerns to the contrary. Were the SFC to do otherwise, this would give rise to duplication of effort and might potentially undermine the role that HKMA was intended to play in this process.

Banking staff

1.4 The HKMA alone is responsible for approving the appointment of executive officers of banks. These are the persons responsible for directly supervising the conduct of regulated activities of banks and the HKMA must be satisfied that the person appointed is a fit and proper person and has sufficient authority within the bank. In this regard, the SFC is asked to advise whether it has any fitness and properness concerns based on the information in the SFC's system and to provide any feedback to the HKMA accordingly, but the SFC plays no role in deciding whether or not a person should be given executive officer status. The HKMA advises the SFC of the names of the

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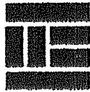
[1] There are 9 types of regulated activity under the SFO - Type 1 : dealing in securities; Type 2 : dealing in futures contracts; Type 3 : leveraged foreign exchange trading; Type 4 : advising on securities; Type 5 : advising on futures contracts; Type 6 : advising on corporate finance; Type 7 : providing automated trading services; Type 8 : securities margin financing; Type 9 : asset management.



executive officers whom it has approved. All of these individuals are identified in the SFC's public register as being the executive officers of the RIs which employ them.

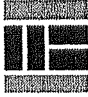
1.5 Front line staff of banks engaged to carry out regulated activities, called "relevant individuals", are not licensed by the SFC and are simply listed on the register maintained by the HKMA. The HKMA does not formally license or approve relevant individuals as such. Instead, it requires the senior management of each bank to ensure that the staff, through whom it performs regulated activities, meet the requisite level of competence, qualifications and fitness and properness as stipulated in the SFC's Fit and Proper Guidelines, the Guidelines on Competence and the Guidelines on Continuous Professional Training. When a bank submits a request that a person be included in the HKMA's register, the HKMA provides the SFC with the identity of the person in question and asks whether it has any fitness and properness concerns. Again, the SFC provides any feedback to the HKMA based on the information in the SFC's system but plays no role in deciding whether or not to include a person's name in the HKMA's register. ~~Although SFC is advised by the HKMA of the~~ The names of the relevant individuals ~~whose names have been included in its registers, the names of relevant individuals~~ do not appear in SFC's public register of licensed persons.

Supervision

1.6 After registration, the HKMA is the supervisor of RIs, their executive officers, relevant individuals and persons involved in the management of any regulated activity. The HKMA alone is responsible for the day-to-day supervision of the carrying on of regulated activities by RIs, including on-site inspections, review of information submitted by RIs and handling of complaints against RIs. The SFC has no power to supervise the conduct of regulated activities by banks to secure compliance with the Code of Conduct and other codes, and must rely on the HKMA to do this exercising its powers in relation to banks under the BO (e.g. s.7 of the BO (functions of HKMA) and s.55 of the BO (examination and investigation of authorised institutions)) and the SFO (s.180). Section 5(3) of the SFO provides that the SFC in performing any of its functions in relation to a bank as a RI may rely on the supervision of such bank by the HKMA.

Investigation and enforcement

1.7 The SFC has a role in investigation and enforcement of matters involving RIs, their executive officers, relevant individuals and persons involved in the management of any regulated activity. However, it is only where the SFC has reason to inquire whether an RI is guilty of misconduct or is not fit and proper that it may carry out an investigation (after consultation with the HKMA) and, potentially, take disciplinary action. Following disciplinary proceedings, the SFC may impose one or more sanctions (such as revocation /suspension of licence or registration, prohibition orders, fines and reprimand) where appropriate. However, in case of a relevant individual and an executive officer of a RI, the power to remove or suspend that individual's particulars from the HKMA's register (and withdraw or suspend the consent given to an executive officer) rests with the HKMA. Before exercising any disciplinary power against registered institutions and their staff, the SFC has to consult the



HKMA under section 198(2) of the SFO. Similarly, before the HKMA removes or suspends a relevant individual's particulars from the HKMA's register (and withdraws or suspends the consent given to an executive officer), the HKMA has to consult the SFC.

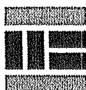
MOU

1.8 In December 2002 the HKMA and the SFC entered into an MOU with the objective that both banks and licensed corporations and their staff should be subject to consistent regulatory measures. The MOU sets out the roles and responsibilities of the HKMA and the SFC under each major functional aspect of the regulatory regime as well as the arrangement between the two parties in relation to the exchange of relevant information and notification or referral of relevant matters and investigations.

<u>CEO/SFC duties and powers</u>

1.9 The post of CEO was created in 2006 following the passage of the Securities and Futures (Amendment) Ordinance 2006 to separate the posts of the Chairman and CEO. I have been appointed by the HKSAR Chief Executive as the CEO of the SFC since 23 June 2006. As the CEO, I have the executive responsibility for the day-to-day running of the SFC and specific functions or duties delegated by the Board from time to time. My key responsibilities are set out below:

(a) implementing the strategy agreed by the SFC Board, in whose formulation the CEO of the Commission will have played a major part, and facilitating the effective functioning of the Board;
(b) reporting to the Board regularly with appropriate, timely and quality information so that the Board can discharge its responsibilities effectively;
(c) informing and consulting the Chairman and the Board on all matters of significance to the SFC including helping ensure that key issues are discussed by the Board in a timely manner, that the Board has adequate support and is provided with all the necessary information on which to base decisions;
(d) developing and delivering the strategic objectives agreed with the Board including helping to set the agenda and establish priorities for the SFC;
(e) recommending to the Board significant operational changes and major capital expenditures where these are beyond the delegated authority;
(f) assigning responsibilities clearly to senior management and supervising the work of other Executive Directors;
(g) overseeing the day-to-day regulatory work of the Commission and ensuring that the Commission is equipped with the necessary staffing, financial and risk management systems for its mission;
(h) tendering advice to the Chief Executive of the HKSAR under section 11(1) of the SFO after consulting the Chairman and any other member of the Commission as appropriate;
(i) signing the annual accounts of the SFC and the Investor Compensation Fund;



(j) sharing with the Chairman the task of convening meetings of the Board and the Advisory Committee;

(k) recruiting, developing and retaining talented people to work at the SFC and in particular establishing a strong management team which is fair and fully evaluated;

(l) communicating throughout the SFC the strategic objectives agreed with the Board, including those in the corporate plan, and ensuring that these are achieved in practice;

(m) sharing with the Chairman and other members of the SFC senior management the responsibility of communicating the SFC's messages externally; and

(n) as CEO of the Commission, representing the SFC officially at the local and international level, as appropriate, including attending meetings of the committees and subcommittees of the Legislative Council when requested.

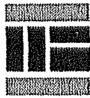
(b) whether there is any delegation of CEO's authority to other key executives of SFC, and the division of responsibilities among such executives, in relation to the regulation of RIs' securities-related business; and the type of actions which may be carried out by these officers under delegated authority, if any (e.g. preparation for and issuance of regulatory guidelines applicable to RIs' securities-related business and decisions of taking enforcement actions against RIs); and

1.10 The Commission has delegated most functions which are delegable under the SFO to all EDs in 2003. The Commission has also authorised each ED to sub-delegate those functions to staff within his or her Division and Committees as he/she considers necessary for the efficient discharge of such functions.

1.11 Among the powers delegated to EDs, those in Parts V, VII, VIII and IX of the SFO are relevant to the regulation of licensed corporations and, to a limited extent, RIs. Part V together with Schedules 5 and 6 to the SFO deal with the licensing of persons intending to carry on one or more regulated activities. Part VII and Schedule 7 together deal with the establishment of the Code of Conduct regulating the business conduct of licensed corporations and RIs. Part VIII deals with the Commission's powers of supervision and investigation, and Part IX deals with the Commission's disciplinary powers.

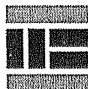
1.12 It should be noted that functions relating to the making of rules are non-delegable and are reserved at the Board level. In addition, the Commission has reserved at the Board level the power to publish and amend codes of conduct for the purpose of giving guidance relating to the practices and standards with which intermediaries and their representatives must comply in carrying on the regulated activities for which the intermediaries are licensed or registered.

(c) the participation or involvement, if any, of CEO/SFC and other key executives in relevant committees (e.g. the Financial Stability Committee and the Council of Financial Regulators) relating to the regulation of RIs' conduct of securities-related business



1.13 I, as CEO/SFC, have not participated or been involved in any committee that deals specifically with the regulation of RIs' conduct of securities related business. The regular high level meetings in which I participate include the Financial Stability Committee (**FSC**) meeting and the Council of Financial Regulators (**CFR**) meeting.

1.14 Pursuant to the MOU, the HKMA and the SFC hold regular meetings to discuss matters of mutual interest relating to the performance of their regulatory and supervisory functions.



Q2. Since the commencement of the Securities and Futures Ordinance (SFO) and the Banking (Amendment) Ordinance 2002 (BAO) in April 2003, have there been any significant changes in the organizational set-up and staffing arrangement within SFC for taking up the regulatory functions relating to RIs' regulated activities? If yes, please provide the details of the changes, including the resources committed, and explain why such changes have been necessary; if no, the reasons.

2.1 As mentioned in item 1(a) above, the SFC's regulatory functions in relation to RIs' regulated activities are confined mainly to two areas: registering RIs, and enforcement actions. The role of the SFC even in respect of these areas is limited.

2.2 HKMA is the frontline regulator of banks that carry on business in regulated activities.

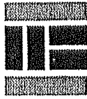
2.3 When a bank applies to carry on regulated activities the SFC is required to refer the application to the HKMA and the HKMA then consults the SFC on the merits of such application and advises the SFC whether it is satisfied that the bank is a fit and proper person to be registered. The SFC is required by s.119(3) of the SFO to have regard to the HKMA's advice on the fitness and properness of the bank, and may rely wholly or partly on it in deciding whether or not to register the bank.

2.4 The HKMA alone is responsible for approving the appointment of EOs who are responsible for directly supervising the conduct of regulated activities of banks and the HKMA must be satisfied that the person appointed is a fit and proper person and has sufficient authority within the bank. In this regard, the SFC is only asked to advise whether it has any fitness and properness concerns in the SFC's system, but the SFC plays no role in deciding whether or not a person should be given EO status.

2.5 Front line staff of banks (called "relevant individuals") who are engaged to carry out regulated activities are not licensed by the SFC.

2.6 As at 31 May 2009, there were only 102 RIs, compared to 1,560 licensed corporations with a total of around 35,200 licensed staff employed by these corporations. Given the relatively small population of RIs and the relatively small amount of licensing work generated by them, the SFC's Licensing Department has had no significant organizational changes relating to RIs.

2.7 The SFC has a role in investigation and enforcement of matters involving RIs, their executive officers, relevant individuals and persons involved in the management of any regulated activity. However, it is only where the SFC has reason to inquire whether an RI (its executive officers, relevant individuals and persons involved in the management of any regulated activity) is guilty of misconduct or is not fit and proper that it may carry out an investigation (after consultation with the HKMA) and, potentially, take disciplinary action. Following disciplinary proceedings, the SFC may impose one or more sanctions (such as revocation /suspension of licence or registration, prohibition orders, fines and reprimand) where appropriate. However, in case of a relevant individual and an executive officer of a RI, the power to remove

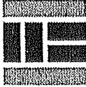


or suspend that individual's particulars from the HKMA's register (and withdraw or suspend the consent given to an executive officer) rests with the HKMA. Before exercising any disciplinary power against RIs and their staff, the SFC has to consult the HKMA under section 198(2) of the SFO.

2.8 Between April 2003 and 15 September 2008, the HKMA referred 9 cases of suspected misconduct to the SFC.

2.9 During the same period, the SFC completed 527 disciplinary inquiries for suspected breaches of the Code of Conduct by brokers or their representatives. Following these inquiries 430 entities were disciplined (some entities had more than one sanction imposed on them). Of these, 23 had their licence revoked, 164 had their licence suspended and 54 were prohibited from applying for a licence (e.g. if their licence had lapsed during the inquiry). In total, 102 were fined and 188 were publicly reprimanded. The largest fine imposed was HK$38 million. 168 cases involved a settlement agreement. The largest settlement negotiated was an ex gratia payment of HK$255 million to clients in the Towry Law case.

2.10 So far as enforcement is concerned, the increase in SFC's Enforcement Division headcount over this period from 89 as at March 2003 to 107 as at March 2009 was not attributable to regulatory functions relating to RIs given the small number of referrals by the HKMA to the SFC.



Q3. As stated by the Secretary for Financial Services and the Treasury (SFST) in his written statement produced to the Subcommittee (paragraph 6 of W1(C)), the Administration makes every effort to ensure that the financial regulators are sufficiently resourced and appropriately empowered to perform their functions. Please advise:

(a) Given the phenomenal growth in banks' securities-related business since 2003, whether and how SFC has been equipped with the necessary professional support/expertise and resources to keep pace with market developments such as the sale of structured financial products to retail investors; and

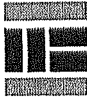
3.1 Between 2002/03 and 2008/09, the SFC has increased its headcount from 415 to 507 to cope with the increasing market activities, the growing number of intermediaries and the growing activities of SFC licensees. However, such increase was not attributable to regulatory functions relating to RIs given that our major regulatory focus is on SFC licensees rather than RIs which are regulated by the HKMA. For instance, there have been a small number of referrals by the HKMA to the SFC, a relatively small population of RIs and relatively small amount of licensing work generated by them. As at 31 May 2009, there were only 102 RIs, compared to 1,560 licensed corporations with a total of around 35,200 licensed staff employed by these corporations.

3.2 Around 65% of our executive grade staff possess professional designation in law or accounting. Their professional knowledge and market expertise have enabled the SFC to keep pace with market developments and innovations.

(b) whether SFC has been sufficiently empowered under SFO to perform its regulatory functions relating to banks' securities-related business, including the investigation into cases of alleged non-compliance.

3.3 As has been mentioned above, the SFC's regulatory functions relating to banks' securities-related business, including the investigation into cases of alleged non-compliance, are limited. Within these limitations, if the SFC has reason to inquire whether an RI, or a member of its staff, is guilty of misconduct or is not fit and proper the SFC may carry out an investigation and, potentially, take disciplinary action.

3.4 Under section 182(4) of the SFO, the SFC is required to consult with the HKMA before initiating an investigation into suspected misconduct by RIs and their staff.



Forewarning of risks associated with investment in structured financial products

Q4. Between April 2003 and mid-September 2008 (i.e. before the collapse of Lehman Brothers (LB)), did SFC conduct, on its own or in collaboration with the Hong Kong Monetary Authority (HKMA), any review or analysis of increased regulated activities undertaken by RIs, including the potential risks that investors were exposed to, with a view to ascertaining whether the regulatory regime was adequate for investor protection?

Retail investors and other surveys

4.1 The SFC did not conduct any direct review of RI activities.

4.2 The SFC conducts retail investor surveys from time to time to help direct our investor educational efforts. All the key findings to our surveys were published. Particulars of some relevant surveys were provided below. We also brought to the attention of the FSTB and HKMA findings to our surveys that are relevant to them.

4.3 The 2005 survey showed that the most popular type of investment was in Hong Kong stocks (28.3%) and only 2.8% of investors surveyed had participated in structured products. This coincided with our comments shared with the Government and fellow regulators in September 2005.

Consumer Council Mystery Shopper Survey on financial advisers (May 2006)

4.4 In 2005 we discussed with the Consumer Council their conducting a mystery shopper survey on financial advisers and the results of the survey were published in the Council's Choice magazine in May 2006.

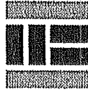
Survey on Engagement of IAs (September 2006)

4.5 The Survey on Engagement of Investment Advisers (published September 2006) indicated that 88% of investors were satisfied with the services of their IAs, but 57% of investors wanted more suitable product recommendations.

Structured Products Investor Survey (November 2006)

4.6 The Structured Products Investor Survey (published November 2006) showed that around half of those who purchased unlisted retail structured products did not fully understand the nature of these products. The survey showed that most investors (87.9%) bought their structured products through banks.

4.7 In view of the survey findings we stepped up our efforts in explaining product features and risks, clarifying misconceptions and reminding investors to ask the right questions when considering potential investments. On the same day as the SFC published these survey findings (28 November 2006), we took the following actions :



- the issuance of a press release highlighting the findings of the survey and warning that it is risky for investors to buy an investment product which they do not fully understand;
- the publication of a Dr Wise article titled "Retail Structured Notes - Buyer Beware", reminding prospective investors to understand the features and risks of any retail structured note before investing in it and highlighting the increasing sophistication of the products available; and
- the issuance of a circular titled "Enhance Prospective Investors' Understanding of Structured Products" to bring to the attention of all issuers of unlisted retail structured products the survey findings and also suggesting them to inform their distributors of the findings and of our requirement for them to ensure that all investors in the products have a good understanding of the underlying risks.

4.8 Altogether we conducted 107 separate publicity initiatives related to unlisted structured products and the duties of investment advisers in the period from April 2003 to September 2008 prior to the collapse of Lehman Brothers (see **Appendix 7**). These initiatives included articles in printed media, investor leaflets, electronic newsletters), on-line education resources, television and radio programmes and videos on public buses.

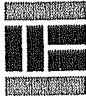
Regulatory challenges and responses

4.9 In light of the market condition and our internal analysis, the SFC issued the document "Regulatory Challenges and Responses" in March 2006. One of the challenges identified was "*the increased exposure of retail clients to complex and structured products, and differences in how financial products are regulated*". The SFC has set out the steps that it would take to:

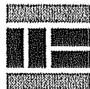
- Monitor how investment advisers comply with applicable requirements and where necessary propose changes to improve standards;
- Enforce the regulatory obligations of product providers and intermediaries;
- Work with the Government and other agencies to address gaps and inconsistencies in the regulation of sales practices of functionally similar products;
- Review our practices internally to address gaps and inconsistencies in the regulation of functionally similar investment products; and
- Further enhance our investor education work and promote informed investing.

Thematic inspection of selling practices of investment advisers (conducted in 2004 and 2006)

4.10 In about 2004, noting a rising trend for Hong Kong investors to invest in investment products other than the more traditional listed securities, the SFC conducted the first thematic inspection on 15 selected licensed investment advisers to gauge the range of prevailing market practices. A final draft of the report was sent to HKMA on 24 January 2005. We published our report on 23 February 2005 identifying areas of unsatisfactory practice noted during the review.



4.11 A second round of thematic review was conducted in 2006 with a view to assessing the prevailing selling practices adopted by 10 sampled licensed investment advisers and reviewing whether any improvement had been made since the issuance of the last report. This time, the inspection was done in parallel with the HKMA's inspection of the selling practices of selected RIs. We sent to HKMA the final draft of the second thematic review report on 21 May 2007. We finally published it on 31 May 2007.



Q5. Before the bankruptcy of LB, CEO/SFC had raised regulatory concerns about financial innovation and the popularity of credit-linked structured products. For example, he urged regulators to strengthen supervisory oversight, enhance co-operation and information sharing, as well as strengthen operational frameworks to better deal with financial stress (p.5 of S3). Before the Minibonds incident, did CEO/SFC draw HKMA's or the Administration's attention to, or discuss with them, his regulatory concerns in this respect? Should regulators have assessed the impact of cross-national financial problems on the local investing public?

5.1 SFC actively monitors the development of the securities market. We have through various channels alerted the Administration, the regulators and the public of financial innovation including structured products as detailed below:

Retail Investors and other surveys

5.2 The SFC conducts retail investor surveys from time to time to help direct our investor educational efforts. All our previous survey findings were published. Particulars of some relevant surveys are provided below. We also brought to the attention of the FSTB and HKMA the findings of our surveys that were relevant to them.

5.3 The 2005 survey showed that the most popular type of investment was in Hong Kong stocks (28.3%) and only 2.8% of investors surveyed had participated in structured products. This coincided with our comments shared with the Government and fellow regulators in September 2005.

Consumer Council Mystery Shopper Survey on financial advisers (May 2006)

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Survey on Engagement of IAs (September 2006)

5.5 The Survey on Engagement of Investment Advisers (published September 2006) indicated that 88% of investors were satisfied with their IAs services, but wanted more suitable product recommendations.

Structured Product Investor Survey (November 2006)

5.6 The 2006 Survey showed that around half of those who purchased unlisted retail structured products did not fully understand the nature of these products. The survey showed that most investors (87.9%) bought their structured products through banks.

5.7 In view of the survey findings we stepped up our efforts in explaining product features and risks, clarifying misconceptions and reminding investors to ask the right questions when considering potential investments. A press release highlighting the findings of the survey was issued on 28 November 2006 in which the SFC commented that it is risky for investors to buy an investment product which they do not fully understand. A circular entitled "Enhance

Prospective Investors' Understanding of Structured Products" was issued to all issuers of unlisted retail structured products on the same day bringing them to the attention of the survey findings. We reminded their selling agents and/or distributors to ensure that all purchasers of their products have a good understanding of the underlying risks. Our response to the survey was also shared with the Government on the same date.

5.8 Altogether we conducted 146 separate publicity initiatives related to unlisted structured products and the duties of investment advisers in the period from April 2001 to March 2009 (Note: 120 for the period from April 2001 to mid September before the collapse of Lehman Brothers and for initiatives relating to IAs, the total number of 146 includes initiatives from April 2003 to March 2009.) (see **Appendix 7**). These initiatives included articles in printed media, investor leaflets, electronic -newsletters, on-line education resources, television and radio programmes and videos on public buses.

Thematic inspection of selling practices of investment advisers (conducted in 2004 and 2006)

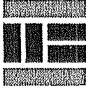
5.9 In about 2004, noting a rising trend for Hong Kong investors to invest in investment products other than the more traditional listed securities, the SFC conducted the first thematic inspection on 15 selected licensed investment advisers to gauge the range of prevailing market practices. A final draft of the report was sent to HKMA on 24 January 2005. We published our report on 23 February 2005 identifying areas of unsatisfactory practice noted during the review.

5.10 A second round of thematic review was conducted in 2006 with a view to assessing the prevailing selling practices adopted by 10 sampled licensed investment advisers and reviewing whether any improvement had been made since the issuance of the last report. This time, the inspection was done in parallel with the HKMA's inspection of the selling practices of selected RIs We sent to HKMA the final draft of the second thematic review report on 21 May 2007. We finally published it on 31 May 2007.

Impact of global events on HK

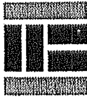
5.11 The SFC monitors major market segments and identifies possible systemic risks with a view to maintaining and promoting the stability and orderliness of the market. When Lehman Brothers' rating was downgraded to A2 in July 2008 and the ratings of Morgan Stanley and UBS were also downgraded around that time, we provided general information to the investing public to alert them to possible market volatility. However the collapse of Lehman Brothers Holdings, even in light of the then imminent subprime crisis and credit crunch, was totally unexpected as the US Government had bailed out Bear Stearns earlier and there was no prior warning that Lehman Brothers Holdings would not be treated in a similar manner. Nevertheless, we still warned investors on potential market volatility, as well as on potential regulatory concerns arising from global market developments, in a general manner, and we continue to do that by way of speeches delivered by our senior executives and by our ongoing investor education efforts.

5.12 For instance, starting in 2005, the SFC warned on the increasing complexity



of structured products available in the market and emphasised the increasing need for professional advice relating to product suitability. General findings from our theme inspections of intermediaries were shared where deficiencies in the sales process and internal controls were highlighted. Intermediaries were reminded to review their systems and continue to observe their duties and obligations under the Code of Conduct.

5.13 In terms of general market movements, the SFC has previously warned on the market volatility and increased risks that the globalisation of economies might bring. Specifically, ever since the subprime crisis broke out in 2007, the SFC has warned on the impact and contagion effect of the subprime crisis on Asia and Hong Kong.



Q6. Under section 5(1)(l) of SFO, one of SFC's functions is to secure an appropriate degree of protection for members of the public investing in or holding financial products. Amidst widespread reports on the financial difficulties faced by LB in 2008, did SFC assess, or issue any alert on, the possible impact of the failure of LB on local investors holding LB-related financial products? If yes, please provide the particulars of such assessment(s) made and the alert(s) issued; if no, the reasons.

6.1 Our regulatory regime, which is directed at promoting an understanding of financial products and securing an appropriate degree of protection for members of the public investing in financial products, rests on 6 elements –

(a) Disclosure;

(b) Conduct regulation to ensure suitability under the Code of Conduct;

(c) Licensing/registration of intermediaries and their representatives;

(d) Supervision of intermediaries;

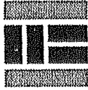
(e) Investor education; and

(f) Enforcement action against those who do not comply with the requirements.

6.2 We fulfil our role of protecting investors by seeking to ensure that there is sufficient disclosure in the offer documentation for him or her to make an informed investment decision at the time of issue of the offer document. It is the duty of the intermediaries selling the product to properly explain the product and not to recommend the product if it is unsuitable.

6.3 In addition, we issue from time to time circulars to intermediaries to remind them of their obligations under the Code of Conduct, and conduct thematic inspections of selling practices of licensed investment advisers in 2004 and 2006 respectively to assess and monitor the level of compliance from LCs and invite HKMA to conduct concurrent inspections of RIs. We also conduct surveys on retail investors (2005), structured products (2006) and engagement of investment advisers (2006) to identify areas of regulatory concern for us to direct our investor education and inspection efforts.

6.4 We also make an ongoing effort to educate the public about the risk and concerns of investment in general. The features and risks of specific types of products and the promotion of informed investing have been active in our investor education work on unlisted structured products and use of investment advisers' services since 2003. Altogether we conducted 146 separate publicity initiatives related to unlisted structured products and the duties of investment advisers in the period from April 2001 to March 2009 (Note: 120 for the period from April 2001 to mid September before the collapse of Lehman Brothers and for initiatives relating to IAs, the total number of 146 includes initiatives from April 2003 to March 2009, see **Appendix 7**). These initiatives included articles in printed media, investor leaflets, electronic newsletters, on-line education resources, television, radio



programmes and videos on public buses.

6.5 Since the outbreak of the subprime crisis in 2007, there was widespread concern about the financial status of a number of firms, one of which was Lehman. When Lehman's rating was downgraded to A2 in July 2008 and the ratings of Morgan Stanley and UBS were also downgraded around that time, we provided general information to the investing public to alert them to possible market volatility. However the collapse of Lehman Brothers Holdings, even in light of the then imminent subprime crisis and credit crunch, was totally unexpected as the US Government had bailed out Bear Stearns earlier and there was no prior warning that Lehman Brothers Holdings would not be treated in a similar manner. Nevertheless, we still warned investors on potential market volatility, as well as on potential regulatory concerns arising from global market developments, in a general manner, and we continue to do that by way of speeches delivered by our senior executives and by our ongoing investor education efforts.

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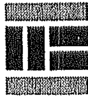


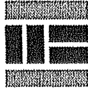
Q7. The prospectuses and associated marketing materials for LB-related structured financial products offered to the public have been authorized by SFC in accordance with the relevant provisions in the Companies Ordinance (CO) and SFO. Please list in tabular form the regulatory regime into which the prospectuses (both programme and issue-specific prospectuses) and marketing materials of the following products have fallen, and provide the reasons for such regulatory arrangements:

(a) Minibonds;
(b) Pyxis Notes;
(c) ProFund Notes;
(d) Constellation Structured Retail Notes;
(e) Retail-Aimed Callable Investment Notes; and
(f) Octave Notes.

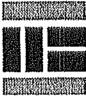
7.1 The regulatory regimes into which the prospectuses and marketing materials of the following notes have fallen are as follows:

Names of notes	Type of notes	Issuer	Arranger	Regulatory regime of offer documents	Regulatory regime of marketing materials
Minibonds	Credit-linked notes	Pacific International Finance Ltd	Lehman Brothers Asia Limited ("LBAL")	Part XII of the CO	Before 3 Dec 04[16]: Part IV of the SFO On or after 3 Dec 04: Section 38B of the CO and/or Part IV of the SFO
Pyxis Notes	Equity-linked notes	Pyxis Finance Ltd	LBAL	Part XII of the CO	Before 3 Dec 04: Part IV of the SFO On or after 3 Dec 04: Section 38B of the CO and/or Part IV of the SFO

[16] Before the coming into force of the existing section 38B(1) of the CO on 3 December 2004, arrangers or distributors of the notes issued advertisements pursuant to section 103(2)(a) of the SFO without prior authorisation by the SFC (and prior to the commencement of the SFO on 1 April 2003, section 4(3)(a)(i) of the now repealed Protection of Investors Ordinance).



ProFund Notes	Fund-linked notes	Atlantic International Finance Ltd	LBAL	Part XII of the CO	Section 38B of the CO and/or Part IV of the SFO
Constellation Structured Retail Notes	Credit-linked notes	Constellation Investment Ltd	DBS Bank Limited	Part XII of the CO	Before 3 Dec 04: Part IV of the SFO On or after 3 Dec 04: Section 38B of the CO and/or Part IV of the SFO
Retail-Aimed Callable Investment Notes	Credit-linked notes	SPARC Ltd	UBS Securities Asia Limited	Part XII of the CO	Section 38B of the CO and/or Part IV of the SFO
Octave Notes	Credit-linked notes	Victoria Peak International Finance Ltd	Morgan Stanley & Co International Limited	Part XII of the CO	Before 3 Dec 04: Part IV of the SFO On or after 3 Dec 04: Section 38B of the CO and/or Part IV of the SFO



Q8. With reference to Minibonds, Constellation Notes and Pyxis Notes, please state concisely what the issuer must disclose in the relevant prospectuses and marketing materials, as well as how such information should be presented (please also provide the source of each relevant regulatory requirement). Was SFC required under the existing regime to take into consideration the target clientele and/or the sales channel of the products when determining whether there was adequate disclosure of information in the documentation concerned? If yes, please provide the sources of such requirements; if no, the reasons.

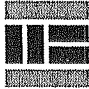
8.1 If a financial product falls within the wide definition[17] of "debenture" in section 2 of the CO, the offer document (called a prospectus) must be authorised and registered under section 38D or 342C of the CO before the product can be offered to the public in Hong Kong for subscription or purchase. As Minibonds, Constellation Notes and Pyxis Notes are structured as debentures, the relevant prospectuses have to comply with the registration and applicable disclosure requirements in the CO. Essentially this means that the prospectuses must contain the matters specified in the Third Schedule to the CO unless otherwise exempted. In reviewing prospectus disclosures, it is important that the nature and risks of the product in question are adequately disclosed.

8.2 In accordance with section 38(1A) or section 342(2A), the relevant prospectuses must contain a statement in a prominent position advising the reader to take independent professional advice in case of doubt about any of its contents. Apart from the specific matters required under section 38(1) or section 342(1) to be set out in the relevant prospectuses by applicable paragraphs[18] in the Third Schedule, paragraph 3 of the Third Schedule requires the issuer to provide "sufficient particulars and information to enable a reasonable person to form as a result thereof a valid and justifiable opinion of the shares or debentures and the financial condition and profitability of the company at the time of issue of the prospectus, <u>taking into account the nature of the shares or debentures being offered and the nature of the company, and the nature of the persons likely to consider acquiring them</u>". The underlined wording was added to paragraph 3 of the Third Schedule on 3 December 2004. The effect of the additional wording in paragraph 3 and whether it changes the standard of disclosure required is a matter of interpretation by the courts. To date, the SFC is not aware of any Hong Kong cases on point. However, the SFC's view is that if the issuer has specific target groups of prospective investors in mind, then it is the issuer's responsibility to draw the intended group to the attention of the SFC. Otherwise, the assumption would be that the product is to be marketed to every sector of the public. Where a prospectus states that a particular product is designed for a particular group or type of investors, or that it is not designed for some, then the SFC believes that would be a positive identification of the group of persons likely to consider acquiring the product.

8.3 The issuer of Minibonds did not identify the nature of any specific group of

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

[18] Certain paragraphs in the Third Schedule are applicable only to offers of shares in a company.



persons likely to consider acquiring Minibonds. However, in view of the fact that Minibonds were mainly sold at retail banks, the SFC's assumption was that the product was to be marketed to the public in general subject to suitability assessment of each prospective investor by the relevant intermediary. Shortly after the commencement of the amendment to paragraph 3 of the Third Schedule to the CO described in 8.2 above, the Minibond issuer adopted a new format of the prospectus which was shorter and clearer and more user-friendly for the reasonable investor public – see Minibond prospectus for series 18 dated 7 March 2005.

8.4 Like Hong Kong, all comparable jurisdictions also adopt a disclosure-based approach coupled with conduct regulation on intermediaries. This approach, together with the need to have a range of investment products available in the market to those investors with different risk profiles, financial circumstances and investment objectives, means that reliance must be placed on intermediaries who have direct interface with each particular investor to assess suitability. Otherwise, the public would be deprived of the freedom to choose different investment products.

8.5 As for marketing materials, they are designed to raise investors' interest in an offer and do not take the place of the prospectus. Investors are directed in the marketing materials to read and understand the prospectus before investing. By definition, marketing materials are not prospectuses and therefore will not contain all relevant information for investors to make an informed investment decision. In reviewing marketing materials, reference is made to the Guidelines on Use of Offer Awareness and Summary Disclosure Materials in Offerings of Shares and Debentures under the Companies Ordinance which have been published by the SFC. The Guidelines require, among other things, that the marketing materials must not contain anything that is inconsistent with the information contained in the prospectus, and that the contents must not be false, biased, misleading or deceptive.

Q9. As indicated in paragraphs 25.1 and 25.2 of the "Issues raised by the Lehmans Minibonds crisis – Report to the Financial Secretary" issued by SFC (the Review Report) (LC Paper No. CB(1)552/08-09(01), the prospectus regime under CO has been in place for decades but has primarily catered for equity or traditional debt capital raising issues. Innovative financial instruments structured as debentures could not have been contemplated when the law was first enacted. Up to mid-September 2008, what were SFC's regulatory concerns and the problems identified from the proliferation, since 2003, of structured financial products such as LB-related Minibonds, which were structured as "debentures" under CO.

9.1 The SFC conducts retail investor surveys from time to time to help direct our efforts to protect investors. For instances, our 2005 survey indicated a small percentage of investors surveyed had participated in structured products. Our 2006 survey on engagement of investment advisers indicated that investors generally wanted more suitable product recommendation, whilst our structured product investor survey published in November 2006 showed that around half of those who purchased unlisted retail structured products did not fully understand the nature of these products. In light of the market condition and internal analysis, the SFC issued the document "Regulatory Challenges and Responses" in March 2006. One of the challenges identified was the increased exposure of retail clients to complex and structured products, and differences in how financial products were regulated. SFC has set out the following strategies to address such concern.

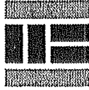
(i) **to monitor how investment advisers comply with requirements for competence, disclosure and quality of advice and where necessary propose changes to improve standards**

(ii) **to enforce the regulatory obligations of product providers and intermediaries**

9.2 In respect of these strategies the SFC has published the Code of Conduct to govern business dealings of licensed corporations including their selling practices and provided further guidance by way of circulars. The SFC also issued FAQs in May 2007 to clarify how investment advisers should ensure suitability when making a recommendation or solicitation.

9.3 The SFC conducts inspection of licensed corporations to assess their general compliance with applicable legal and regulatory requirements including those that are in the SFO and the Code of Conduct.

9.4 During our thematic inspections of selling practices of licensed investment advisers in 2004 and 2006 respectively, the SFC has identified issues and deficiencies in selling practices (e.g. insufficient knowledge of clients, lack of proper product due diligence, lack of justification on making a recommendation). We issued two thematic inspection reports on the selling practices of investment advisers and provided their key inspection findings first in February 2005 and then in May 2007. We also investigated the suspected breaches and deficiencies and took enforcement action following the investigations where appropriate (including prosecution, disciplinary



action and the issue of warning/compliance advice letters).

(iii) to work with Government and other agencies to address gaps and inconsistencies in the regulation of sales practices of functionally similar products

9.5 SFC exchanges information with HKMA on an ongoing basis. Operational staff interact with each other through communications on day-to-day 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 consistent standards are applied.

9.6 In September 2004, SFC invited HKMA to conduct concurrent thematic inspections on RIs.

(iv) to review our practices internally to address gaps and inconsistencies in the regulation of functionally similar investment products

9.7 The SFC has proposed to move the regulation of public offers of structured notes from the CO prospectus regime to Part IV of the SFO so that public offers of all structured products would be regulated under the SFO. The SFC has received broad support for the proposal and is working towards publishing a consultation paper as soon as possible to seek market participants' views on its implementation details including the feasibility of specific codes for certain products.

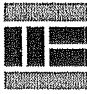
(v) to further enhance our investor education work and promote informed investing

9.8 We make an ongoing effort to educate the public about the risk and concerns of investment in general. The features and risks of specific types of products and the promotion of informed investing have been active in our investor education work on unlisted structured products and use of investment advisers' services since 2003. For example we issued a press release to give investors general advice on structured notes by explaining the mechanism and operations of both ELNs and CLNs and reminding investors about credit risk and other risks involved at the end of 2003. The information was posted on our IE portal, InvestEd website. We also issued a circular to all intermediaries on the same day to remind them of the requirements of the Code of Conduct that intermediaries should assure that their clients understand the nature and risks of the products and have sufficient net worth to assume the risks and bear the potential losses of trading in the products.

9.9 In light of our findings in the 2006 Survey and Engagement of Investment Advisers Survey in 2006, we have prioritized our investor education work in these areas and stepped up our efforts in explaining product features and risks, clarifying misconceptions and reminding investors to ask the right questions when considering potential investments. On the same day as the SFC published these survey findings (28 November 2006), we took the following actions :

- the issuance of a press release highlighting the findings of the survey and warning that it is risky for investors to buy an investment product which they do not fully understand;
- the publication of a Dr Wise article titled "Retail Structured Notes - Buyer Beware", reminding prospective investors to understand the features and risks of any retail structured note before investing in it and highlighting the increasing sophistication of the products available; and
- the issuance of a circular titled "Enhance Prospective Investors' Understanding of Structured Products" to bring to the attention of all issuers of unlisted retail structured products the survey findings and also suggesting them to inform their distributors of the findings and of our requirement for them to ensure that all investors in the products have a good understanding of the underlying risks.

9.10 Altogether we conducted 107 investor education activities related to unlisted structured products and the duties of investment advisers in the period from April 2003 to September 2008 prior to the collapse of Lehman Brothers (see **Appendix 7**). These activities included articles in printed media, investor leaflets, electronic newsletters, on-line education resources, television and radio programmes and videos on public buses.



Q10. As stated in page 5 of the paper "Consultation Conclusions on the Consultation Paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance" published in September 2006 (S17), SFC proposed to amend the definition of "debenture" where it appears in the prospectus regime of CO and the SFO investment advertisement regime to the effect that all "structured products" will fall outside the definition, with the intention of subjecting public offers of structured products to regulation under the SFO investment advertisement regime. Please advise:

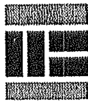
(a) Using the Minibonds and Constellation Notes (which appeared to have been structured as debentures) as examples, what would be the advantages and in what ways would investors be better protected, if the definition of "debenture" had been amended as proposed in 2006?

(b) What actions have been taken by SFC to follow up with the Administration the proposed amendment, and what is the current legislative timetable?

10.1 The prospectus law reform is an initiative formulated in support of the Administration's policy to streamline procedures for the issuance of investment products so as to foster the development of retail bonds and other investment products and this initiative was intended to take place in 3 stages. The third phase of the CO prospectus reform ("Phase 3") was a comprehensive review of the CO prospectus regime and was designed to bring Hong Kong's laws in this area up to date. This is in tandem with the CO rewrite exercise which also aims to modernize our company law to enhance Hong Kong's competitiveness and attractiveness as an international business and financial centre.

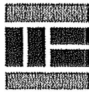
10.2 Phase 3 involves a package of law reform proposals to modernize the public offering regime for shares and debentures in Hong Kong, many of which have market-wide implications but were not designed to address the issues raised following the collapse of Lehman. The package of reform initiatives to be taken forward involve wide-ranging impact on the interests, practice and procedures of a cross-section of stakeholders involved in the public offering process (including IPOs) – these initiatives include: (i) moving from a document-based approach to a transaction-based approach; (ii) revamping the prescribed content requirements; and (iii) permitting incorporation by reference. After publication of the consultation conclusions in September 2006, the SFC undertook a substantial amount of work including soft-consulting various stakeholders on the detailed logistics and technical aspects of certain proposals to reduce any process risk associated with the implementation of these proposals. The SFC had completed an initial draft of the draft drafting instructions.

10.3 Another initiative to be taken forward is the proposal to transfer the regulation of public offers of structured notes to Part IV of the SFO. In view of the financial crisis and the current public sentiment, the SFC believes that there is merit to take forward the reform initiatives in relation to unlisted structured products separately and ahead of the other Phase 3 CO reform initiatives not designed to address the issues raised by the collapse of Lehman. Under the



existing legal framework, public offers of structured notes such as Minibonds and Constellation Notes which fall within the definition of "debentures" (as defined in section 2 of the CO) are regulated under the CO prospectus regime. The CO prospectus regime prescribes in some detail a series of requirements for public offers of shares and debentures including provisions regulating the information content of prospectuses, translation requirements and registration formalities. The SFC has power to exempt an issuer or a prospectus from compliance with prescribed disclosure requirements only if certain statutory criteria are satisfied. Under the SFO, the SFC can issue product codes which prescribe structural features, in addition to disclosure requirements, designed to enhance investor protection taking into account the nature of the product.

10.4 To mirror the eligibility requirements for issuers of listed structured products under the listing rules of The Stock Exchange of Hong Kong Limited, the SFC has taken administrative measures to impose certain eligibility requirements on issuers or swap counterparties / swap guarantors of unlisted structured notes – for example, the requirement for the issuer or a swap counterparty / swap guarantor to (i) have a net asset value (i.e. the aggregate of share capital and reserves) of not less than HK$2 billion as set out in its latest published audited financial statements and interim financial report; and (ii) a credit rating which is one of the top three investment grades awarded by Moody's, Standard & Poor's or Fitch Ratings. It is believed that after the amendment of the relevant provisions of the CO, the regulation of public offers of structured products under Part IV of the SFO through product codes will provide flexibility in light of market developments and the bases and principles of providing eligibility and other requirements in view of the nature of the products can be clearly articulated and understood by the market.



Q11. Following the Minibonds incident, SFC issued a reminder to issuers of retail investment products on 3 October 2008 (paragraph 28.6 of SFC's Review Report (LC Paper No. CB(1)552/08-09(01)) urging them to step up and review their disclosure of information in the offering documents and marketing materials. What were the issuers' responses and did SFC take any follow-up action?

11.1 The purpose of our circular dated 3 October 2008 (the "3 October Circular") aims to remind product issuers of their duty to ensure their offering documents continue to be up-to-date and to contain sufficient information necessary for investors to make an informed decision to purchase investment products given the new circumstances that arose following the collapse of Lehman.

11.2 The 3 October Circular also reminded product issuers to ensure that their marketing materials must be clear, fair and present a balanced picture with adequate and prominent risk disclosure, including any new risks that may have emerged in the then prevailing market circumstances.

11.3 At the working level, our staff often communicate our standards and requirements to the issuers. Following the issue of the 3 October Circular, we continued to maintain a close dialogue with issuers to provide guidance and to clarify any questions they may have on the circular. We believe that the industry also considered it important and their duty to ensure that risks are disclosed upfront and when necessary, disclosure should be brought up-to-date in the offering documents of investment products publicly offered following the Lehman aftermath. Issuers that have reviewed and considered it necessary to update their offering documents in the aftermath of the collapse of Lehman have submitted the revised documents to the SFC for authorisation. The SFC has processed these cases accordingly.

Q12. In paragraph 27.1 of SFC's Review Report (LC Paper No. CB(1)552/08-09(01)), it was clearly stated that there are no statutory requirements for ongoing disclosure of information to investors for product offering documents authorized under CO and under section 105 of SFO. Please advise:

(a) Before the Minibonds incident, did SFC have any regulatory concerns about the absence of such requirements? Did SFC issue any advice to product issuers encouraging them to disclose information on an ongoing basis?

12.1 There are no statutory requirements for ongoing disclosure of information to investors for prospectuses authorised under the CO. As stated in paragraph 11.48 of the Report of the Securities Review Committee published in May 1988 (commonly known as the Hay Davison Report), a prospectus for an unlisted issue provides a one-off snapshot intended to form the basis of a contract between issuers and individual investors. This approach is consistent with that adopted by comparable jurisdictions.

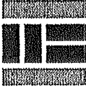
12.2 Unlike unlisted investment products (which are expected to be held until maturity) for which there is no assurance of a liquid secondary market, securities which are listed are intended to be traded on a continuous trading platform. Accordingly, issuers are subject to continuing disclosure obligations under the listing rules of the relevant stock exchange. As stated in paragraph 11.47 of the aforementioned Hay Davison Report, investors in listed securities are kept up to date by issuers making regular reports and publishing price sensitive information as and when required.

12.3 Despite the above, following the collapse of Lehman, investors' expectation of continuous disclosure for unlisted products has led the SFC to consider whether there needs to be a change in policy in this respect. Accordingly and as stated in paragraph 27.3 of SFC's Report to the Financial Secretary, the SFC has proposed, and will consult the public on, ongoing requirements for (a) issuers of investment products to provide information such as price information and changes in circumstances that may have significant effect on the value of the investment; and (b) distributors to take appropriate steps to ensure that the information is brought to the attention of investors.

(b) Before and after the failure of LB, did SFC discuss with HKMA the feasibility of encouraging distributing banks to disclose product information to investors on an ongoing basis?

12.4 Prior to the failure of Lehman, the SFC did not engage in any subject matter specific discussion with HKMA with an aim to encouraging distributing banks to disclose product information to investors on a continuous basis. After the collapse of Lehman, discussions were held with the HKMA on encouraging distributing banks to disclose product information to investors on a continuous basis.

12.5 In February 2009, the SFC informed HKMA that it had issued letters to certain LCs which were distributors of credit-linked notes reminding them to take appropriate steps to bring to clients' attention material information regarding



credit-linked notes sold to investors. The SFC has suggested to HKMA that they should consider doing the same by issuing similar letters to relevant banks.

(c) As bank clients have opened investment accounts holding the structured products purchased, do RIs owe a fiduciary or other duty to make ongoing disclosure of product information to them?

12.6 In the SFC's view, it is conceivable that RIs may owe fiduciary duties but that will depend on the facts of each case. There is no such requirement in the SFO or under the Code of Conduct though we are studying the practicability of imposing such an obligation upon intermediaries in future.

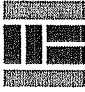
Q13. According to paragraph 28.5 of its Review Report (LC Paper No. CB(1)552/08-09(01)), SFC recognized that investors found it hard to understand disclosure documents of investment products running to many pages, even if written in plain language, and there was a tendency to give undue prominence to marketing materials of such products with punchy catch phrases and eye-catching graphics. Between April 2003 and mid-September 2008, what measures, if any, were taken by SFC to address these concerns? Did SFC raise these concerns to HKMA, which was the frontline supervisor of RIs whose staff were engaged in the sale of such products? If yes, please provide the details; if no, the reasons.

13.1 The SFC has been proactive in its investor education work. Between April 2003 and mid-September 2008 before the collapse of Lehman Brothers, there were 107 investor education activities about retail structured products and duties of investment advisers. Most of them explained key features and risks of unlisted structured products and reminded investors to ask the right questions when considering potential investments.

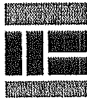
13.2 As mentioned above, the SFC conducts investor surveys from time to time to understand the product knowledge of investors in order to direct our educational efforts. In June 2006, we conducted the 2006 Survey and noted that banks were the most popular channel for investors to buy unlisted structured products (87.9%). In addition, only about half (48.9%) of those respondents who last purchased an equity-linked, credit-linked or index-linked product within the two years preceding the survey recalled having received offering documents from the selling intermediaries, and almost half of these respondents (45.5%) indicated that the sales representatives did not explain the product at the point of sale.

13.3 In light of the findings in the 2006 Survey and Engagement of Investment Advisers Survey in 2006, we shared with the HKMA before they were published in November 2006 and we have prioritized our investor education work in these areas and stepped up our efforts in explaining product features and risks, clarifying misconceptions and reminding investors to ask the right questions when considering potential investments. On the same day as the SFC published these survey findings (28 November 2006), we took the following actions :

- the issuance of a press release highlighting the findings of the survey and warning that it is risky for investors to buy an investment product which they do not fully understand;
- the publication of a Dr Wise article titled "Retail Structured Notes - Buyer Beware", reminding prospective investors to understand the features and risks of any retail structured note before investing in it and highlighting the increasing sophistication of the products available; and
- the issuance of a circular titled "Enhance Prospective Investors' Understanding of Structured Products" to bring to the attention of all issuers of unlisted retail structured products the survey findings and also suggesting them to inform their distributors of the findings and of our requirement for them to ensure that all investors in the products have a good understanding of the underlying risks.



13.4 In fact, under the Code of Conduct, the intermediary should, when making a recommendation or solicitation, ensure the suitability of the recommendation or solicitation for that client is reasonable in all circumstances. To further clarify how intermediaries should ensure suitability when making a recommendation or solicitation as required under the Code of Conduct, the SFC issued the suitability requirement FAQs in May 2007 to all licensed corporations and banks.



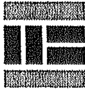
Conduct regulation

Q14. Paragraph 6.6.3 of SFC's Review Report (LC Paper No. CB(1)552/08-09(01)) stated that the Relevant Individuals (Rels) are not required to be approved by SFC or HKMA. Although HKMA enters their names in its Register of Relevant Individuals, it does not carry out any prior assessment of their fitness and properness. Instead it relies upon RIs to ensure that these staff members meet the requirements of the relevant guidelines set by SFC. HKMA may assess the on-going competence of Rels during its on-site examinations. From its experience in supervising licensed representatives, what difference would it make if Rels were immediately regulated by SFC instead of HKMA, and what impediments to the efficacy of regulation could be removed?

14.1 The sale process of all investment products offered by intermediaries, including RIs and LCs is governed by the Code of Conduct. The Code of Conduct applies equally to representatives of RIs and LCs and in particular, the Code of Conduct specifically states that a registered person includes a "Relevant Individual" as defined in s.20(10) of the BO. HKMA is responsible for the supervision of RIs and their staff including Relevant Individuals.

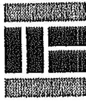
14.2 Under the Code of Conduct, the intermediary should, when making a recommendation or solicitation, ensure the suitability of the recommendation or solicitation for that client is reasonable in all the circumstances. To further clarify how intermediaries should ensure suitability when making a recommendation or solicitation as required under the Code of Conduct, the SFC issued the suitability requirement FAQs in May 2007 to all licensed corporations and banks.

14.3 We are not in a position to comment on the difference if Relevant Individuals were immediately regulated by SFC instead of HKMA, and what impediments to the efficacy of regulation could be removed.



Q15. According to HKMA, between April 2003 and mid-September 2008, only one Rel of a RI was sanctioned by SFC for mis-selling of investment products (paragraph 4.2 of M15). However, after the failure of LB and as at 15 May 2009, HKMA referred a total of 449 cases of alleged misconduct in respect of LB-related financial products, involving 16 banks, to SFC for consideration of disciplinary action. Please account for the great difference in number of cases before and after the Minibonds incident. Was the surge in cases indicative of any ineffectiveness of the existing regulatory arrangements?

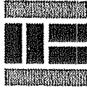
15.1 The surge in cases is result of the unexpected collapse of Lehman. The collapse of Lehman triggered counterparty default in products it had issued, products for which it acted as swap counterparty or swap guarantor, or products where it was a credit reference entity. The collapse triggered claims of mis-selling of those products.



Q16. Under the existing regulatory regime, if MA considers that an Executive Officer (EO) or a Rel is no longer fit and proper, he may, after consultation with SFC, withdraw consent to the appointment of the EO or remove the particulars of the Rel from the public register. Between April 2003 and mid-September 2008, were there any cases in which SFC advised MA to withdraw consent to the appointment of an EO or remove a Rel from the public register? In SFC's view, how would the conduct of mis-selling, if proven, impact upon the fitness and propriety of EOs and Rels?

16.1 Between April 2003 and 15 September 2008, there was one case in which the SFC advised the HKMA to remove a Rel from the register (this occurred in September 2005).

16.2 The conduct of mis-selling, if attributable to the conduct of EOs and Rels, would raise serious questions of fitness and properness. Whether enforcement action can be taken on the basis of a lack of fitness and properness depends on all the circumstances of the case, including the frequency and gravity of the conduct and any aggravating circumstances.



Q17. Before the Minibonds incidents, what were SFC's views on the regulatory tool of "mystery shopper" in testing the propriety of the sales practice adopted by intermediaries? What were SFC's reasons for not adopting this tool? Please provide the details, if any, of SFC's discussion with HKMA before the failure of LB on the feasibility or appropriateness of conducting "mystery shopper" surveys?

17.1 As part of SFC's supervisory approach, we conducted the following in respect of the selling practices of intermediaries:

Investor surveys

17.2 The SFC conducts investor surveys from time to time to understand the product knowledge of investors in order to direct our educational efforts. In June 2006, we conducted the 2006 Survey and noted that banks were the most popular channel for investors to buy unlisted structured products (87.9%). In addition, only about half of those respondents who last purchased an equity-linked, credit-linked or index-linked product within the two years preceding the survey recalled having received offering documents from the selling intermediaries, and almost half of the respondents (45.5%) indicated that the sales representatives did not explain the product at the point of sale.

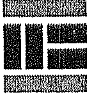
17.3 In light of the findings, we shared them with the HKMA before they were published in November 2006. On the same day of release of the survey findings, we took the following actions :

- the issuance of a press release highlighting the findings of the survey and warning that it is risky for investors to buy an investment product which they do not fully understand;
- the publication of a Dr Wise article titled "Retail Structured Notes - Buyer Beware", reminding prospective investors to understand the features and risks of any retail structured note before investing in it and highlighting the increasing sophistication of the products available; and
- the issuance of a circular titled "Enhance Prospective Investors' Understanding of Structured Products" to bring to the attention of all issuers of unlisted retail structured products the survey findings and also suggesting them to inform their distributors of the findings and of our requirement for them to ensure that all investors in the products have a good understanding of the underlying risks.

17.4 Separately, in 2005 we discussed with the Consumer Council their conducting a mystery shopper survey on financial advisers and the results of the survey were published in the Council's Choice magazine in May 2006.

Thematic inspection of selling practices of licensed investment advisers (conducted in 2004 and 2006)

17.5 In about 2004, noting a rising trend for Hong Kong investors to invest in investment products other than the more traditional listed securities, SFC conducted the first thematic inspection on 15 selected licensed investment advisers to gauge the range of prevailing market practices. A final draft of the report was sent to HKMA on 24 January 2005. We published our report on



23 February 2005 identifying areas of unsatisfactory practice noted during the review.

17.6 A second round of thematic review was conducted in 2006 with a view to assessing the prevailing selling practices adopted by 10 sampled licensed investment advisers and reviewing whether any improvement had been made since the issuance of the last report. This time, the inspection was done in parallel with the HKMA's inspection of the selling practices of selected RIs We sent to HKMA the final draft of the second thematic review report on 21 May 2007. We finally published it on 31 May 2007.

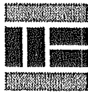
17.7 Our thematic inspections would always involve a sample review of actual sale transactions and client files, focussing on high mis-selling risk scenarios, such as high commission rebate, long lock-in periods and complex structures. We would, for example, review the basis of recommendations to investors, the contents of product disclosure documents and marketing materials and the product due diligence carried out by the distributors.

17.8 The effectiveness of the inspections in identifying deficiencies and malpractices can be demonstrated by the second thematic inspection, which resulted in the SFC taking enforcement action in relation to 5 of the 10 investment advisers covered in that inspection.

17.9 We take the view that 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.

17.10 Nevertheless, as anticipated in our report to the Financial Secretary, we will examine whether this tool can add value in keeping licensed corporations up to the required standards.

17.11 In fact, we understand that when the UK and Australian regulators conducted "mystery shopping" survey they engaged third parties to carry out the work.



Q18. Under the current regulatory regime, HKMA supervises RIs and their staff in the conduct of securities-related business following SFC's regulatory guidelines, including the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (Code of Conduct) (S1-Appendix 11), the Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the Securities and Futures Commission (S1-Appendix 12), the Fit and Proper Guidelines (M7-Appendix 6), the Guidelines on Competence (M7-Appendix 7), and the Guidelines on Continuous Professional Training (M7-Appendix 8). Please advise:

(a) the process of preparing the above guidelines and the divisions/staff responsible for the preparation;

18.1 The Intermediaries Supervision Department of the SFC was primarily responsible for the preparation of the Code of Conduct and the Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the Securities and Futures Commission (Internal Control Guidelines), whilst its Licensing Department was primarily responsible for the preparation of the Fit and Proper Guidelines, the Guidelines on Competence and the Guidelines on Continuous Professional Training.

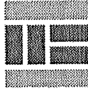
18.2 All these Codes and Guidelines were made under section 399 of the SFO and replaced the earlier versions which were published before the commencement of the SFO in 2003.

18.3 During the drafting process of the Codes and Guidelines, the SFC had consulted the relevant stakeholders, including market practitioners, the HKMA and the HKEx, where appropriate. The SFC took into account the comments made by other parties and made revisions to the drafts where necessary. The final versions of the Codes and Guidelines were then submitted to the Board of the SFC for approval before they were published.

(b) whether HKMA had any involvement in the drafting of any of the guidelines; if yes, what comments/advice did HKMA provide to SFC, and what was SFC's response, if any?

18.4 Pursuant to section 399(9) of the SFO, SFC has consulted HKMA prior to the publication of the amendments to the Code of Conduct and Internal Control Guidelines. The SFC also consulted the HKMA on the Fit and Proper Guidelines, the Guidelines on Competence, and the Guidelines on Continuous Professional Training before they were published. The HKMA's comments and the SFC's responses respectively on Fit and Proper Guidelines, the Guidelines on Competence, and the Guidelines on Continuous Professional Training are attached at **Appendix 9.**

18.5 Section 399(9) of the SFO requires that SFC consult HKMA regarding codes or guidelines it proposes to publish under any provision of the SFO, or amendments it proposes to make to codes or guidelines published under the SFO, in so far as such codes or guidelines or such amendments (as the case may be) apply to authorised financial institutions by reason of their being registered institutions, or associated entities of intermediaries.

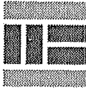


(c) since April 2003, whether HKMA has made any suggestions to SFC to revise any of the guidelines (particularly in relation to RIs' sale of structured financial products); if yes, what were SFC's responses, if any, and to what extent HKMA's suggestions were adopted?

18.6 HKMA has not made any suggestions to SFC to revise any of the guidelines (particularly in relation to RIs' sale of structured financial products) since Apr 2003.

(d) whether a mechanism has been in place since April 2003 for SFC to evaluate the implementation and effectiveness of any of the guidelines in relation to RI's sale of investment products; if yes, please provide the details (particularly whether any deficiencies have been identified from RIs' implementation of any of the guidelines); if no, the reasons.

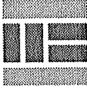
18.7 HKMA is the frontline regulator of RIs and their staff. It is primarily responsible for the day-to-day supervision of the carrying on of regulated activities by RIs. Section 5(3) of the SFO provides that the SFC, in performing any of its functions in relation to an RI or an associated entity of an RI, may rely on the supervision of such RI and its associated entity by HKMA.



Q19. SFC's Code of Conduct includes general principles GP1 (Honesty and fairness) and GP6 (Conflicts of interest) and a section on Best interests of clients (paragraph 3.10 of S1-Appendix 11), which serve as reference for RIs, EOs and Rels to properly address any actual or potential conflicts of interests in the sale of individual products. In SFC's view, what are the safeguards or concrete measures that should be put in place by RIs so that their EOs and Rels are able to comply with the aforesaid principles in practice?

19.1 As mentioned above, HKMA is the frontline regulator of RIs, Relevant Individuals and persons involved in the management of any regulated activity. RIs are subject to the comparable legal and regulatory requirements that apply to SFC licensed corporations as far as regulated activities are concerned.

19.2 It is the responsibility of licensed corporations and RIs to put in place effective internal systems and controls to ensure compliance with the Code of Conduct and all regulatory requirements applicable to the conduct of its business activities. What practical safeguards and measures are needed depends on the nature of a firm's business and the size of its business.



Co-ordination with the Administration and HKMA

Q20. Paragraph 8.19 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) (M16) stated that the Minibonds incident has demonstrated the complexities of the existing dual regulatory arrangement between HKMA and SFC when it comes to enforcement mechanics. In the light of its operational experience, has SFC identified any of such complexities under the dual regulatory arrangement since April 2003?

20.1 Customers may be confused as to which regulator is responsible for the sale of financial products to the retail market as evidenced by a very large number of complaints received by the SFC. There appears to be misunderstanding in the eyes of the general public regarding whether the SFC or the HKMA has the lead role in enforcing standards and conduct on RIs and their staff. If these are the "complexities" the HKMA are referring to we agree with them.

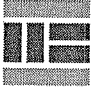
20.2 Between April 2003 and 15 September 2008, the HKMA referred 9 cases of suspected misconduct to the SFC.

20.3 We also note that the HKMA has the power to remove or suspend the particulars of any Relevant Individuals from the registers that HKMA maintains and to withdraw or suspend the consent given to an executive officer, which we do not have, and so they are able to take remedial action where individuals have been found to have fallen short of requirements.

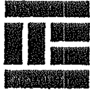
20.4 If the HKMA becomes aware of a material breach by an RI or its staff of any applicable provision of the SFO or any rules, codes or guidelines made or published by the SFC under the SFO, the MOU provides that HKMA should refer the matter to the SFC. The SFC may (after consultation with the HKMA) commence an investigation under s.182 of the SFO. Where the SFC finds that the RI or its staff was guilty of misconduct, or if it is of the opinion that the person is not fit and proper, the SFC may (after consultation with the HKMA) impose various sanctions under s.196(2) of the SFO. The sanctions range from a public reprimand to a fine not exceeding the greater of (i) $10,000,000; or (ii) 3 times the amount of the profit gained or loss avoided by the regulated person as a result of his misconduct or the conduct which leads the SFC to form the opinion that he is not fit and proper. Between April 2003 and 15 September 2008, the HKMA referred 9 cases of suspected misconduct to the SFC.

20.5 The dual regulation of securities and futures activities has the potential to cause operational complexities which is why the MOU was put in place to ensure that responsibilities were clearly defined. Each regulator is allowed and in practice required, to rely on the other for the supervision of their areas of responsibilities. If issues are observed which relate to the areas of responsibilities supervised by the other regulator then this matter should be raised with the other regulator either at an MOU meeting or otherwise, in order that they may deal with it. The MOU assists in minimising regulatory overlaps.

20.6 On a more general level, complexities arise in many jurisdictions due to the



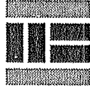
proliferation of financial products. Products can be structured as funds, insurance products, "deposits", notes, structured products or other forms. The underlying product may be the same, but could be subject to different regulatory standard. This is further mentioned in our review report submitted to the Financial Secretary on 31 December 2008, that in general, jurisdictions adopting the institutional approach suffer from a potential inconsistency in the application of requirements by different regulators.



Q21. It is noted that HKMA has supervised RI's regulated activities through, among others, on-site examinations. Did SFC provide any suggestion or advice to HKMA on how such examinations (including the one on credit-linked investment products in 2008) should be conducted? If yes, please provide the details; if no, the reasons.

21.1 Pursuant to 7.2.1 (a) of the MOU, the HKMA is the frontline ~~regulator~~ supervisor of registered institutions. It is responsible for the day-to-day supervision of the carrying on of regulated activities by registered institutions. This includes performing on-site inspections of registered institutions and, where appropriate, their associated entities and related corporations to ascertain their compliance with applicable legal and regulatory requirements. Therefore, HKMA would decide how many examinations should be conducted.

21.2 Noting a rising trend in investing in investment products other than the more traditional listed securities by Hong Kong investors, the SFC conducted thematic inspection of selling practices of licensed investment advisers and invited HKMA in an MOU meeting on 17 September 2004 to perform, in parallel, inspection of the selling practice of RIs. HKMA agreed and conducted thematic inspection of selling practices of banks in parallel with SFC's thematic inspection of selling practices of licensed investment advisers. SFC commented on HKMA's draft inspection programme and provided its inspection programme to HKMA for HKMA's reference. The comments of SFC were given to HKMA for its consideration in tailoring an approach applicable to RIs that it would adopt. SFC also wrote to HKMA on 31 August 2006 suggesting that HKMA covered retail banks in its thematic inspection. Furthermore, SFC staff gave a presentation on inspections on investment advisers to HKMA in early August 2006. During the thematic inspections of selling practices, there was also exchange of one staff between SFC and HKMA for about 3 weeks in October 2006 to strengthen cooperation.



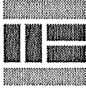
Q22. In view of the significant growth in the retail sale of structured financial products, did SFC find it necessary, before the failure of LB, to suitably revise the Memorandum of Understanding between the Securities and Futures Commission and the Hong Kong Monetary Authority (MOU) (S1-Appendix 10) to strengthen its co-operation with HKMA in regulating the sale of such products and strengthening investor protection? If yes, please provide the details of the required revisions.

22.1 In the responsibility for regulating selling practices of licensed corporations and banks, the responsibility is divided between SFC and HKMA respectively according to the nature of the institution. Section 5(3) of the SFO provides that SFC, in performing any of its functions in relation to a bank or an associated entity of a bank, may rely on the supervision of such bank or its associated entity by HKMA.

22.2 HKMA is the frontline banking regulator. HKMA supervises all aspects of banks operations and refers possible breaches to SFC for investigation and disciplinary action. The MOU seeks to set out the roles and responsibilities of SFC and HKMA, respectively, under each major functional aspect of the existing regulatory regime as well as the arrangements between the parties in relation to the exchange of relevant information and notification or referral of relevant matters.

22.3 Noting a rising trend in investing in investment products other than the more traditional listed securities by Hong Kong investors, SFC conducted thematic inspection of selling practices of licensed investment advisers and invited HKMA in an MOU meeting on 17 September 2004 to perform, in parallel, inspection of the selling practice of RIs.

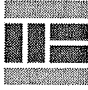
22.4 There has been no indication of a need to revise the MOU throughout the meetings, communications and discussions between SFC and HKMA.



Q23. Under the existing dual regulatory arrangement, HKMA is the frontline supervisor of RIs' regulated activities following the standards set by SFC. In its Review Report (pp.77-78 of LC Paper No. CB(1)552/08-09(01)), SFC took the view that such an arrangement suffers from a potential inconsistency in the application of requirements by different regulators and other challenges associated with interagency co-ordination. In this connection, please provide information from SFC's regulatory experience since April 2003 to substantiate the above view?

23.1 We would like to clarify the question raised. We made reference to the G30 report in the SFC review report submitted to the Financial Secretary on 31 December 2008, that in general the institutional approach suffers from a potential inconsistency in the application of requirements by different regulators (such as different applications of customer protection rules) as well as other challenges associated with inter-agency coordination. However, the SFC review report has not specifically mentioned any such inconsistency in the present dual regulatory arrangement between the SFC and HKMA.

23.2 Between April 2003 and 15 September 2008 the SFC completed 527 disciplinary inquiries for suspected breaches of the Code of Conduct by brokers or their representatives. Following these inquiries 430 persons/companies were disciplined (some persons/companies had more than one sanction imposed on them). Of these, 23 had their licence revoked, 164 had their licence suspended and 54 were prohibited from applying for a licence (e.g. if their licence had lapsed during the inquiry). In total, 102 were fined and 188 were publicly reprimanded. The largest fine imposed was HK$38 million. 168 cases involved a settlement agreement. The largest settlement negotiated was an ex gratia payment of HK$255 million to clients in the Towry Law case.



Q24. According to "Responsibilities of the Financial Secretary and the Secretary for Financial Services and the Treasury" issued by the Chief Executive on 27 June 2003 (A22), SFST is responsible for overseeing regulators' implementation of the Government's financial policies. It is also stated that the regulatory authorities shall exercise their powers and discharge their functions independently in accordance with the respective statutes. Please explain how SFC has been subject to the "oversight" by SFST, while maintaining its independence in exercising its functions. Please also provide examples to illustrate your explanation.

<u>Independence</u>

24.1 As an independent statutory body the SFC is bound to operate within the functions under the SFO. All the members of the Board are appointed by the Administration for a fixed term. The SFO requires that the majority of the board members must be independent Non-Executive Directors (NEDs).

24.2 The post of CEO was created in 2006 following the passage of the Securities and Futures (Amendment) Ordinance 2006 to separate the posts of the Chairman and CEO.

24.3 Since its inception in 1989, the SFC has been subject to various checks and balances designed to ensure fairness and observance of due process. These include statutory rights of appeal, judicial review, and scrutiny by independent bodies such as the Process Review Panel (PRP), the ICAC and the Ombudsman.

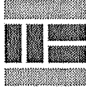
24.4 The PRP, which is an external, independent, non-statutory panel, reviews and advises the SFC on the adequacy of its internal procedures and operational guidelines. To carry out its work, the PRP receives and considers periodic reports from the SFC in respect of the manner in which complaints against the SFC or its staff have been considered and dealt with. In addition, the PRP may call for, and review, the SFC's files to verify that the actions taken and decisions made in relation to any specific case or complaint are consistent with the relevant internal procedures and operational guidelines.

24.5 The PRP is required to submit its reports to the Financial Secretary annually. The PRP has published its annual reports to the public.

<u>The Government and the SFC</u>

24.6 The Government is responsible for formulating the policies in relation to the financial system and Hong Kong's status as an international financial centre. Specifically, SFST is responsible for formulating specific policies to achieve the policy objectives as determined by the FS. SFST is also responsible for overseeing the implementation of the policies through the regulatory authorities which include the SFC, the HKMA and other organizations.

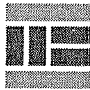
24.7 The Financial Market Development Taskforce which was set up in November 2001 under FS' direction endorsed and recommended the facilitation of debt issuance by enhancing awareness of forthcoming offers prior to and



subsequent to the registration of a prospectus. The SFC was asked to put in place measures to facilitate the development of the debt market in three phases:

- In phase I, the SFC issued three sets of guidelines to facilitate offers of shares and debentures in 2003 and the Companies Ordinance (Exemption of Companies and Prospectuses from Compliance with Provisions) (Amendment) Notice came into effect in 2003 to exempt the issuer of debentures from providing certain information in the prospectus.
- In phase II, the Companies (Amendment) Ordinance came into effect on 3 December 2004 which entrenched the regulatory approach set out in the SFC Guidelines regarding the offer awareness materials and the use of a dual prospectus structure for programme offerings. 12 safe harbours from the prospectus regime were also introduced, i.e. the prospectus requirements in the CO do not apply to documents containing offers described in those safe harbours and SFC authorisation of the relevant offer document is not required.
- Phase III involves, amongst other proposals, (i) moving the regulation of public offers of structured notes out of the CO and into Part IV of the SFO; (ii) moving from a document-based approach to a transaction-based approach; (iii) revamping the prescribed content requirements; and (iv) permitting incorporation by reference.

24.8 The SFC is subject to regular reporting and furnishing of information to the FS and FSTB regarding our operations and important areas. Each year, the revised and proposed budgets of the SFC are submitted to the FS for approval and laid before the Legislative Council after consideration by the Commission.



Q25. In its Review Report (LC Paper No. CB(1)552/08-09(01)), SFC made a list of recommendations to improve the regulation of the retail sale of financial products. They include a review of the current regulatory structure, the definition of "professional investor" and the structure of banking organization where banks used their general bank deposit channels to help sell investment products, and disclosure at point of sale of the commissions, fees and other benefits that the intermediary receives from the sale of products. Before the failure of LB, did SFC discuss similar suggestions with the Administration or HKMA? If yes, what were the details and the responses?

Definition of “professional investor”

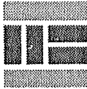
25.1 In 2002, the SFC sought the views of the FSTB and the HKMA on the draft Securities and Futures (Professional Investor) Rules (“PI Rules”) as part of the revamp of the securities law. Comments of FSTB and HKMA included the amendments to the proposed definition of “custodian” and the means of ascertaining the asset value of entrusted assets of trustee companies etc. Taking into account all the comments received during the consultation stage, the proposed PI Rules were revised and tabled for consideration by the Subcommittee on Draft Subsidiary Legislation of the Legislative Council (“Subcommittee”). The FSTB, HKMA and SFC further discussed the PI Rules and attended the Subcommittee meetings on 6 June and 24 October 2002. The PI Rules were eventually gazetted on 29 November 2002 and came into effect on 1 April 2003. There have been no material changes to the PI Rules since then. On 7 July 2008, the SFC undertook to review the definition of a “professional investor” in a meeting with the Legco Financial Affairs Panel. The SFC are considering the proposals to be made and HKMA’s views have been sought from time to time.

Structure of banking organization where banks used their general bank deposit channels to help sell investment products

25.2 Regarding the structure of banking organization where banks used their general bank deposit channels to help sell investment products, SFC reviewed the matter because of the failure of Lehman.

Disclosure at point of sale of the commissions, fees and other benefits that the intermediary receives from the sale of products

25.3 Regarding the disclosure at point of sale of the commissions, fees and other benefits that the intermediary receives from the sale of products, SFC has mentioned in the report on selling practices of licensed investment advisers published in 2005 that it would engage investment advisers to study the disclosure to potential clients on how investment advisers earn their remuneration and disclosure of the quantum of commission / rebates received from the product providers. SFC has also mentioned to HKMA that that it was studying the overseas’ practices on this area in a MOU meeting held on 16 March 2005. Furthermore, SFC has been engaging in discussion with the industry, including some banks through the arrangement of HKMA.



Issues relating to private placement

Q26. According to the information provided by the Administration, SFC and HKMA to the House Committee in October 2008, some HK$6.19 billion of Lehman Brothers-related structured notes were sold by banks through private placement. Paragraphs 2.7 to 2.9 of HKMA's Review Report (M16) gave a brief description. As the prospectuses and marketing materials for investment products sold by way of private placement, as opposed to public offer, are not required to be authorized by SFC, please advise:

(a) Under what conditions/arrangement(s) is the sale of investment products from RIs to their clients considered by SFC as private placement?

26.1 There is no statutory definition of the term "private placement". The following is a brief explanation of the regulatory framework on offers made through "private placement" assuming that such term is used in the loose sense to cover offers of financial products in respect of which the offer documents do not require prior authorisation from the SFC.

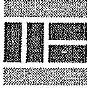
Companies Ordinance – prospectus regime:

26.2 The safe harbours to the prospectus regime in the CO were introduced in response to: (a) the Budget Speech in 2003 that in order to foster the development of retail bonds and other financial products, we would introduce a bill to amend the CO to simplify the procedures for the registration and issue of prospectuses; and (b) the market view that there should be more clarity as to the types of offers that can be made without triggering the prospectus regime.

26.3 After a period of public consultation and scrutiny by the Bills Committee, the Companies (Amendment) Bill 2003 was enacted on 22 July 2004 and came into effect on 3 December 2004. The amendments expressly excluded from the definition of "prospectus" documents containing or relating to offers and invitations that fall within 12 categories of offer listed in the 17th Schedule to the CO – "the safe harbours" and hence, the prospectus requirements in the CO do not apply to documents containing these types of offers and SFC authorisation of the relevant offer document is not required.

Background

26.4 On 10 March 2003, the FSTB and the SFC jointly issued a consultation paper to seek the views of the public on legislative proposals to rationalise the prospectus regime in the CO to facilitate offers of shares and debentures. Extracts from the draft Companies (Amendment) Bill 2003 were annexed to the consultation paper. The consultation conclusions were published in November 2003. Most of the comments received were incorporated into the Bill introduced to LegCo on 25 June 2003. The Bill was scrutinized by the Bills Committee during the period between 18 July 2003 and 10 June 2004. The Companies (Amendment) Bill 2003 was enacted on 22 July 2004 and



came into effect on 3 December 2004.

26.5 The safe harbours now commonly relied upon by issuers include:

(a) An offer to professional investors within the meaning of section 1 of Part 1 of Schedule 1 to the SFO (para. 1 of Sch. 17). The rationale for this safe harbour was that the requirement for a prospectus is designed to protect a retail investor. A more sophisticated market professional does not need the same level of protection;

(b) An offer to not more than 50 persons (para. 2 of Sch. 17). The rationale for this safe harbour was that in practice, many local market practitioners have been using the numerical limit of 50 persons as a benchmark for private placings in part possibly because section 29 of the CO limits the membership of "private companies" to this number;

(c) An offer in respect of which the minimum denomination of, or the minimum consideration payable by any person for, the shares or debentures is not less than HK$500,000 (para. 4 of Sch 17). The rationale was that an investor who can afford to take up such offers should be sufficiently knowledgeable to understand the risks involved or should be able to secure professional advice if necessary. Accordingly, such an investor does not need the protection afforded to a retail investor by a prospectus.

26.6 Please see the joint consultation paper on the rationale for other safe harbours in the 17th Schedule to the CO.

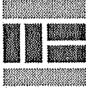
26.7 For documents containing or relating to offers to not more than 50 persons and offers with a minimum consideration of HK$500,000, such documents must contain the warning statement specified in the 18th Schedule to the CO to the effect that "the contents of this document have not been reviewed by any regulatory authority in Hong Kong. You are advised to exercise caution in relation to the offer". Part 4 of the 17th Schedule to the CO also contains an aggregation provision for the purposes of the "50 offerees" safe harbour and the small scale offer (i.e. total consideration payable for the shares or debentures offered not exceeding HK$5,000,000) safe harbour in respect of offers made within a period of 12 months.

<u>SFO – Offers of Investments</u>

26.8 Where the financial product being offered is NOT legally structured as a share or debenture, the prospectus regime in the CO does not apply but public offers of such financial products may be regulated under Part IV of the SFO. Part IV of the SFO also contains various exemptions from the requirement for prior SFC authorisation – these include:

(a) The issue of an advertisement, invitation or document by or on behalf of an intermediary licensed or registered for Type 1, Type 4 or Type 6 regulated activity in respect of securities;

(b) The issue of any advertisement, invitation or document made in respect of securities, or interests in any collective investment scheme



or regulated investment agreement which are or are intended to be disposed of only to professional investors."

(b) Did SFC keep track of the development of the market of private placement since April 2003? If yes, please provide the details, including any deficiencies identified;

26.9 Under the current regulatory structure, documents relating to offerings and marketing of structured products through private placement do not require prior authorisation from the SFC. This is in line with the policy and international practice. We do not have a systematic means to collect information about private placing.

(c) Did SFC and HKMA discuss the implications and the likelihood of any regulatory issues arising from the sale through private placement of complex financial products that had not been subject to any oversight by SFC? If yes, please provide the details; if no, the reasons; and

26.10 The SFC and HKMA did not discuss the implications and the likelihood of any regulatory issues arising from the sale through private placement of complex financial products that had not been subject to any oversight by the SFC.

(d) Was SFC aware of LB-related structured financial products designed for sale through private placement being sold to retail investors (i.e. offered to the public) by RIs? If yes, did SFC work with HKMA to follow up the matter?

26.11 Please see paragraphs (b) and (c) above.

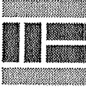
(e) In SFC's view, should the sale of structured financial products through private placement be subject to the same or comparable regulatory standards (e.g. the intermediary should conduct product due diligence and a suitability test of the customer vis-à-vis the risk of the product)?

26.12 Whether the structured financial products are sold to investors through an offer to the public or through a private placement, the relevant intermediaries in both situations are required to comply with the Code of Conduct and other applicable guidelines as long as the activities are regulated activities under the SFO.

(f) How can SFC monitor the sale of investment products through private placement and detect mis-selling in the absence of complaints?

26.13 The SFC detects mis-selling through complaints, thematic inspections and investigations which may or may not have been initiated to address various breaches of the SFO.

26.14 As part of carrying out its regulatory functions and duties, SFC performs on-site inspections of licensed corporations to assess the general compliance by licensed intermediaries with applicable regulatory requirements on a risk-based approach. In an inspection of selling practices, the SFC adopts a top-down approach by reviewing supervision over selling practices by the



management and policies and procedures etc which govern the way the intermediaries sell investment products. SFC also reviews samples of actual sales transactions and client files. In the samples of transactions chosen for testing, the samples cover both products offered by way of offers to the public or those sold through private placements, as the case may be.