REPORT OF THE HONG KONG MONETARY AUTHORITY ON ISSUES CONCERNING THE DISTRIBUTION OF STRUCTURED PRODUCTS CONNECTED TO LEHMAN GROUP COMPANIES

(Note: Certain parts of this report have been deleted to avoid prejudicing continuing investigations. The points in the text where this has been done are clearly marked. Apart from these deletions, the report is the same as that submitted to the Financial Secretary.)

Page

Overview 3-4

Chronology 5-6

1. Introduction 7-10

2. Lehman structured products 10-17

3. Policies and regulations governing the sale of Lehman structured products 17-25

4. Supervision of banks' securities business 25-41

5. Remedies available to investors 42-43

6. Investigations into complaints about Lehman products: some preliminary observations 43-47

7. Overseas practices 47-58

8. Recommendations 58-82

Conclusion 82-83

Annex 1

Overview

1. The objective of this report is to provide information and observations for the purpose of a review by Government of the existing regulatory regime and investor protection framework applicable to the sale to retail investors of Lehman Brothers Minibonds and other structured products akin to Minibonds. Some of the information upon which such observations are founded has been obtained in the course of the Hong Kong Monetary Authority's (HKMA) investigations of complaints referred to in this report. These investigations are continuing and may provide further information which may potentially affect some of the observations and recommendations made at this time.

2. Minibonds are credit-linked notes arranged by a Lehman entity. Other structured notes which have been sold to retail investors and which have been affected by the Lehman collapse have also been generically referred to as Minibonds. A brief description of the main features of Minibonds and of some of these other structured notes, sold by retail banks in Hong Kong, is set out in Chapter 2.

3. The policy objective of providing a reasonable level of investor protection is implemented through a disclosure-based approach (to enable investors to make informed investment decisions) complemented by a regulatory regime governing the conduct of regulated persons in the sales and distribution processes. Chapter 3 provides a brief overview of the current policy and regulatory landscape.

4. The supervisory framework for oversight of the sales and distribution process where the Securities and Futures Commission (SFC) is the lead regulator for the securities industry and the HKMA is the frontline supervisor of banks' securities business is described in Chapter 4. This Chapter sets out the division of

responsibilities between the SFC and the HKMA and explains how the HKMA carries out its supervisory responsibilities.

5. The regulators do not have the power to require banks to pay compensation to investors although there are some other channels through which investors can pursue their claims. Chapter 5 provides a brief overview of the remedies available to investors.

6. The process adopted by the HKMA for the handling and investigation of complaints relating to Lehman-related investment products is described in Chapter 6. Whilst it is premature to draw any conclusions at this stage, Chapter 6 also provides some general observations on matters arising from the complaints reviewed and investigated by the HKMA so far.

7. Other jurisdictions adopt similar regulatory regimes based upon disclosure, licensing of entities involved in the sale of investment products and suitability assessment requirements. Chapter 7 provides a broad overview of some relevant overseas practices.

8. The HKMA favours retention of a disclosure-based system but believes that the framework could be strengthened. Chapter 8 contains a number of recommendations for measures which might be taken to strengthen the protection of investors; simplify the supervisory framework for oversight of the sales and distribution process; and provide a cost-effective alternative dispute resolution mechanism.

Chronology

2008

2 June - S&P lowers its long-term credit rating of Lehman from A+ to A

9 June - Fitch Ratings lowers long-term and short-term Issuer Default Ratings of Lehman to A+ and F1 respectively

17 July - Moody's lowers its long-term senior rating of Lehman to A2

8-9 September - Lehman shares plunge by 52% amid worries that the investment bank is struggling to raise capital

10 September - Lehman announces a loss of $3.9 billion for the quarter ended 31 August 2008

10 - 11 September - Lehman shares drop further by 46%

15 September - Lehman Brothers Holdings Inc. files for bankruptcy protection under Chapter 11 of US Bankruptcy Code

16 September - SFC issues Restriction Notices on four Lehman Brothers subsidiaries in Hong Kong

17-29 September - Provisional liquidators are appointed for six Lehman entities in Hong Kong

2 October - The Hong Kong Association of Banks (HKAB) establishes a Task Force on Lehman related investment products

6 October - The Government proposes distributing banks buy-back Lehman Minibonds at current market prices

9 October - Provisional liquidators are appointed for two Lehman entities in Hong Kong

17 October - The Task Force of HKAB agrees to Government's proposal to buy-back Lehman Minibonds at market

prices

- Ernst & Young is appointed as an independent financial adviser to value Lehman Minibonds

- HKMA appoints PricewaterhouseCoopers as an independent adviser to review the process and strategy adopted by the distributing banks in implementing the buy-back proposal

31 October - HKMA announces a mediation and arbitration scheme for complainants in respect of Lehman related investment products distributed by banks

12 November - LegCo passes a motion to confer powers under the Legislative Council (Powers and Privileges) Ordinance to a sub-committee to study issues arising from the Lehman Minibonds and related structured financial products

19 November - Seven Lehman entities in Hong Kong are placed in liquidation

25 November - A US law firm representing the liquidator of Lehman sends a “cease and desist” letter to the trustee for the Minibonds, to the effect that, according to the US Bankruptcy Code, the trustee’s actions since 15 September might be invalid; and that the trustee might not lawfully realise the collateral and pay the money to Minibond investors, and should refrain from taking any further action

26 November - Another Lehman entity in Hong Kong (Lehman Brothers Commercial Corporation Asia Ltd) is put into liquidation

17 December - Distributing banks announce that they are prepared to provide finance to the trustee for the Minibonds of up to HK$100 million to assist it in the performance of its duties to protect the interests of Minibond investors

1. Introduction

1.1 Lehman Brothers Holdings Inc. (LBHI) filed for bankruptcy protection under Chapter 11 of the US Bankruptcy Code on 15 September 2008. Subsequently, eight Lehman companies have been put into liquidation in Hong Kong, including Lehman Brothers Asia Limited (LBAL).

1.2 The global financial crisis that led to the collapse of Lehman, the fourth largest investment bank on Wall Street, has been described as a "once-in-a-century" event. The severity of the crisis is unprecedented in modern times. Some of the most illustrious names in the financial industry have been overwhelmed, government intervention on a hitherto unimaginable scale has resulted, and the face of the financial markets has been radically changed.

1.3 Inevitably Hong Kong, as an open international financial centre, has not escaped entirely unscathed. However, at least in terms of the first-wave effects of the crisis on financial institutions, Hong Kong's banks have weathered the storm robustly, in comparison to their peers in the US and Europe. Measures have been taken to increase liquidity in the interbank markets and to reinforce confidence in the banking sector. Overall, the capital and liquidity positions of Hong Kong banks have remained sound.

1.4 The effects of the collapse of Lehman Brothers have not manifested themselves here in terms of banks' own direct exposures to the troubled Lehman companies (which amounted to approximately 0.05% of local banks' total assets and hence were insignificant) but rather through exposure to Lehman companies taken on by individual investors through the purchase of retail investment products distributed by banks and brokers.

1.5 As the majority of the affected investors bought the Lehman-related investment products through their banks, the immediate focus of enquiry in the aftermath of the Lehman collapse was on the possibility of these products' having been mis-sold by banks to retail customers. This in turn has prompted questions about the adequacy of the regime for the protection of retail investors in Hong Kong.

1.6 The Hong Kong Monetary Authority (HKMA) is responsible for promoting the safety and soundness of Hong Kong's banking system, along with its other responsibilities for maintaining the stability of the currency, managing Hong Kong's official reserves, and maintaining and developing Hong Kong's financial infrastructure.

1.7 The principal function of the Monetary Authority (MA) under the Banking Ordinance (Cap 155) (BO) is to promote the general stability and effective working of the banking system. Thus, in this regard, the HKMA is regarded as a prudential regulator, with a focus on the stability of the banking system on the one hand and on how effectively the system performs its functions (as a principal channel for financial intermediation) on the other. As such, the HKMA's banking supervisory framework is directed towards prudential issues such as the safety and soundness of the banks it regulates and the quality of their risk management and internal controls. Viewed from this prudential perspective, Hong Kong's banking system is currently recognised as one of the more robust in the world, with strong capital and liquidity positions and high asset quality, even against the extraordinarily stressful conditions now prevailing in the global financial system.

1.8 In addition to this focus on systemic issues, the HKMA does have a role in overseeing the general way in which banks conduct their business from the standpoint of prudence and integrity with a view to deterring improper conduct that might adversely affect their customers and risk loss of confidence in institutions or affect stability or inhibit the effective working of the banking system.[1] In this regard, the BO requires the MA, among other things, to promote and encourage proper standards of conduct and sound and prudent business practices among authorized institutions (AIs); to suppress illegal, dishonourable or improper practices in relation to AIs' business practices; to take all reasonable steps to ensure that AIs' business (including securities business) is carried on with integrity, prudence and the appropriate degree of professional competence; and to satisfy himself as to the fitness and properness of certain specified officers and staff of AIs.

1.9 This is the context in which the HKMA supervises the activities of AIs in the distribution of investment products to retail investors. The Securities and Futures Commission (SFC) registers AIs which undertake securities business (constituting "regulated activities" under the Securities and Futures Ordinance (Cap 571) (SFO)): AIs registered for this purpose are referred to as "registered institutions". The HKMA, as the frontline supervisor of the securities business of registered institutions, oversees their governance, systems and internal controls in accordance with

[1] The Joint Forum of the Basel Committee on Banking Supervision, the International Organization of Securities Commissions and the International Association of Insurance Supervisors noted in its April 2008 report on "Customer suitability in the retail sale of financial products and services" that "How financial firms approach the sale of financial products and services is at the core of consumer confidence in financial markets and subsequently, has implications for firms' financial soundness and financial system stability as well as investor protection" and "concerns about the impact of mis-selling are arguably an area where concerns about system stability and investor protection meet".

standards established by the SFC with a view to ensuring the proper conduct of their "regulated activities" under the SFO. The HKMA also investigates incidents of alleged misconduct of registered institutions and their relevant individuals[2], including those which come to light from consumer complaints. It is important to note, however, that the MA has no statutory power under the BO to intervene in, or adjudicate, disputes between AIs and their customers or to award compensation.

1.10 The HKMA has received 19,699 complaints[3] in respect of the sale by AIs of Lehman-related investment products. In the light of the considerable public concern about the distribution of these products in Hong Kong, this report aims to address the issue of whether the current regime affords adequate protection to retail investors who purchase such products from banks, and what can be done to improve that protection.

1.11 All monetary amounts in this report are in Hong Kong dollars, unless otherwise stated.

2. Lehman structured products

What are they?

2.1 As the public concern prompting this report has in large part been caused

[2] The staff who undertake "regulated activities" on behalf of the registered institutions.
[3] As at 24 December 2008.

by the nature and complexity of the Lehman-related structured products[4] that have been sold to retail investors, this Chapter aims to provide a brief description of these products and the manner of their distribution.

2.2 The Lehman structured products sold by retail banks (i.e. those with a branch network) to investors in Hong Kong can be broadly grouped into five categories as set out in Table 1. The total amount involved is around $20 billion and the number of investment accounts with retail banks holding such products exceeds 48,000.

Table 1

Category	**Issuer and Arranger**	**Issue dates** (Note 1)	**Amount involved ($mn)**	**Remarks**
Credit-linked notes where LBHI is not a reference entity **(Minibonds)**	Issuer : Pacific International Finance Ltd Arranger : LBAL	Between Jul 03 and May 08	11,205	For those series involving swap arrangements, the swap counterparties are wholly owned subsidiaries of LBHI and LBHI is the swap guarantor. The failure of LBHI is a termination event under the swap arrangements that could trigger early redemption. For some early series, LBHI is the guarantor of the collateral.
Equity-linked notes **(Pyxis Notes)**	Issuer : Pyxis Finance Ltd Arranger : LBAL	Between Aug 04 and May 07	72	LBHI is the swap guarantor and is the guarantor of the collateral for the notes. The swap counterparties are wholly owned subsidiaries of LBHI. The failure of LBHI is a termination event under the swap arrangements that could

[4] "Structured products" generally refer to products which, in addition to an exposure to the credit or default risk of the issuer (or guarantor where applicable), contain an exposure to an underlying asset, opportunity or risk that is usually unrelated to the issuer or the guarantor (Consultation Conclusions on the Consultation Paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance published by the SFC in September 2006). There are other Lehman investment products in the retail market, issued or guaranteed by Lehman group companies, which are subject to the credit risk of the issuer or guarantor and which have therefore been adversely affected by the Lehman collapse. However, these products are generally regarded as less complex for investors to comprehend than the structured products which have generated most of the concern in the aftermath of the Lehman collapse.

Category	**Issuer and Arranger**	**Issue dates** (Note 1)	**Amount involved ($mn)**	**Remarks**
				trigger early redemption. The collateral (except that for Series 10) consists of debt obligations of Lehman Brothers Treasury Co. B.V.
Fund-linked notes **(ProFund Notes)**	Issuer : Atlantic International Finance Ltd Arranger : LBAL	Aug 06 and Apr 07	80	LBHI is the swap guarantor and is the guarantor of the collateral for the notes. The swap counterparty is a wholly owned subsidiary of LBHI. The failure of LBHI is a termination event under the swap arrangements that could trigger early redemption. The collateral consists of debt obligations of Lehman Brothers Treasury Co. B.V.
Credit-linked notes where LBHI is a reference entity **(Constellation Structured Retail Notes)**	Issuer : Constellation Investment Ltd Arranger : DBS Bank Limited	Between Mar 06 and Jul 07	2,188	LBHI is one of the reference entities for some series of these notes. The failure of LBHI triggers a credit event and early redemption of the notes.
(Retail-Aimed Callable Investment Notes)	Issuer : SPARC Ltd Arranger : UBS Securities Asia Limited	May 07	64	
(Octave Notes)	Issuer : Victoria Peak International Finance Ltd Arranger : Morgan Stanley & Co International Limited	Between Sep 06 and Nov 06	374	
Private placements	Various		6,248	

Note 1: Matured issues not included

Credit-linked Notes where LBHI is not a reference entity

2.3 ***Minibonds*** are credit-linked notes, arranged by LBAL, with payment of interest and redemption payout at maturity linked to the credit of specified reference entities (which are generally well-known companies) for each series of Minibonds. Minibonds are subject to certain types of early redemption event. The interest coupon varied from series to series but was, generally, comfortably above the prevailing HIBOR/LIBOR at the time of issue. A table at **Annex 1** sets out the coupon rates (together with prevailing HIBOR/LIBOR rates as at the date of the relevant issue prospectuses) for the extant series of Minibonds.

Equity-linked Notes

2.4 ***Pyxis Notes*** are equity-linked notes, arranged by LBAL, with payment of interest and redemption payout at maturity linked to the performance of equities underlying each series of Notes.

Fund-linked Notes

2.5 ***ProFund Notes*** are fund-linked notes, arranged by LBAL, with payment of interest and redemption payout at maturity linked to the performance of an underlying fund, namely the Templeton Asian Growth Fund or the Templeton China Fund.

Credit-linked notes where LBHI is a reference entity

2.6 ***Constellation Structured Retail Notes, Retail-Aimed Callable Investment Notes and Octave Notes*** are all credit-linked notes, arranged by DBS

Bank, UBS Securities Asia Limited and Morgan Stanley & Co International Limited respectively. The payment of interest and redemption payout at maturity is linked to the credit of specified reference entities. In some series of these notes, LBHI is one of these reference entities.

Private placements

2.7 In addition to the above products which were sold through "offers to the public", there are other Lehman structured products distributed by banks through private placement. Most of these products are equity-linked notes arranged by Lehman.

2.8 The complexity of these private placement products varies widely. Some of them, such as the Himalaya Notes, the return of which is linked to the performance of a basket of financial assets including currencies, shares, bond funds and commodity indexes, are complex, while others, such as the Index Bonus Fixed Coupon Principal Protected Notes, are relatively more straightforward. The risk level of these products also varies. Some of them offer principal protection whereas others do not.

2.9 It is worth noting that some of these products have been issued on a recurrent basis with apparently minimal changes between series and arguably appear to have been targeted at retail customers.[5] Another observation is that substantially the same product, although with slight variance in structure, was distributed by different banks. For example, at least three banks were involved in the distribution of the above-mentioned

[5] For example, over ten series of the Index Bonus Fixed Coupon Principal Protected Notes were issued between August and September 2008.

Himalaya Notes.

How were the products affected by the Lehman collapse?

Minibonds, Pyxis Notes and ProFund Notes

2.10 The issue proceeds from the sale of Minibonds, Pyxis Notes and ProFund Notes were used by the issuer, in each case, to purchase collateral upon which the Minibonds or Notes are "secured". The collateral is held by a trustee and is segregated for each series.

2.11 In the case of Minibonds, the form of collateral varies between each series, with some of the earlier extant series (Series 5 to 9) being collateralised by debt obligations of Lehman Brothers Treasury Co. B.V.[6] The latter series have tended to be collateralised by synthetic collateralised debt obligations, which are in turn backed by money market funds or by bonds of third party financial institutions and corporates.

2.12 The collateral for the Pyxis Notes (with the exception of Series 10) is securities issued by Lehman Brothers Treasury Co. B.V. and guaranteed by LBHI. The same is true for all series of the ProFund Notes.

2.13 In most series of these products, the issuer also entered into swap arrangements with a swap counterparty (being a Lehman entity), whose obligations were guaranteed by LBHI. Under these swap arrangements, amounts received in respect of the collateral are swapped for amounts payable by the issuer under the Minibonds/Notes. In the latter series of Minibonds, the issuer also entered into a credit default swap with the swap

[6] In bankruptcy proceedings in The Netherlands.

counterparty under which the swap counterparty paid a premium in return for the issuer's agreement to deliver the collateral to the swap counterparty upon the occurrence of a credit event.

2.14 For those series of Minibonds, Pyxis Notes and ProFund Notes involving swap arrangements, the Chapter 11 filing of the Lehman entities will generally constitute a termination event under the swap arrangements entitling the issuer to terminate the swaps and triggering early redemption of the Minibonds/Notes. In the event of an early redemption of the Minibonds/Notes, the recourse of the investors will be limited to the proceeds of realisation of the collateral (net of costs and expenses) plus or minus a swap termination amount.[7] Because of the current adverse market situation, the market values of the collateral are likely to have declined (this will certainly be the case for collateral consisting of securities issued and guaranteed by Lehman entities).

2.15 For those credit-linked notes with LBHI as a reference entity (i.e. the Constellation Structured Retail Notes, Retail-Aimed Callable Investment Notes and Octave Notes), the failure of LBHI means that a credit event has occurred. Taking the Constellation Notes as an example, the Notes will have to be redeemed at their credit-event redemption amount. This is calculated by reference to, among other factors, the price of a specified reference obligation of the reference entity that has suffered the credit event. Considering the results of the Lehman Credit-Swap Auction in October, which indicated a value in the region of eight to ten cents on the dollar for LBHI debt, the value of any such reference obligations will likely be substantially less than the principal amount of the Notes.

[7] Any termination of the swap arrangements and the application of the proceeds of realisation of the collateral may potentially be affected by US bankruptcy law.

2.16 In the case of those Lehman products sold through private placement, the amount of loss suffered by investors will vary according to the type of the product and the nature of the collateral. To the extent that the notes are credit linked to Lehman as a reference entity, or equity linked to Lehman's share price, or that the collateral consists solely of Lehman-related securities, the investors will likely suffer substantial loss.

3. Policies and regulations governing the sale of Lehman structured products

Policy

3.1 The policy objectives for the financial system set out in the Financial Secretary's statement of 27 June 2003[8] include the following:

> The Government should formulate specific policies to promote the efficient functioning of the financial system in the following manner…
>
> (c) Policies concerning the regulatory regime should aim to provide a regulatory framework that promotes the stability of the financial system, **provides an appropriate measure of protection to users of financial services** and facilitates competition, and **is consistent with the standards and practices of major international financial centres**.

(emphasis supplied)

[8] Issued following the exchange of letters between the MA and the Financial Secretary on their respective functions and responsibilities in monetary and financial affairs.

3.2 The provision of "an appropriate measure of protection to users of financial services" also appeared as a policy objective in the preparation and passage of the SFO. A consultation paper issued by the Government in April 2000 made reference to the following in connection with "offers of investments":

> (a) **providing a favourable environment for the development of the securities and futures industry and for the continued availability of as wide a range of investment options as the market can offer;**
>
> (b) ensuring a level playing field for market participants; and
>
> (c) promoting sound business standards and **ensuring a reasonable level of investor protection.**
>
> (emphasis supplied)

3.3 Thus the "offers of investments" regime seeks to balance market development (which includes giving consumers a wide range of investment options) with the provision of a reasonable or appropriate measure of protection to investors. In its approach to providing an appropriate or reasonable level of investor protection, the regime adopts a disclosure-based approach, in common with many other jurisdictions.[9] This essentially means that issuers are free to launch investment products so long as adequate disclosure is made to enable potential purchasers to take an informed investment decision. With the exception of collective investment schemes requiring authorisation from the SFC, Hong Kong does not adopt a system of product approval as a hurdle to issuance. "Dealing in securities" is a regulated activity under the SFO and, where

[9] For example the UK, other European Union countries, the US, Australia and Singapore.

products are sold through intermediaries[10], the disclosure-based approach is underpinned by requirements at the point of sale for such intermediaries to act with skill, care and diligence and in their clients' best interests. Where intermediaries make a recommendation or solicitation in respect of a product, they must assess the suitability of the product for individual purchasers.

Disclosure Regime

3.4 The prospectus requirements and the authorisation system in the Companies Ordinance (Cap 32) (CO) and the SFO seek to ensure that issuers disclose all relevant information in the offer documents so that the risks of investment can be assessed and an informed investment decision made.

3.5 Under the CO, at the risk of oversimplification, any document offering shares or debentures[11] to the public is a prospectus. It must be in English and Chinese, contain the information required by the CO (absent any exemptions from the SFC)[12], and bear a statement to the effect that if the recipient of the prospectus is in any doubt about any of its contents he should obtain independent professional advice. Before issue, a prospectus must be authorised for registration by the SFC and be registered with the Registrar of Companies. The authorisation does not mean that the SFC has endorsed the offer or the product. The directors

[10] "Intermediaries", where used in this report, means persons licensed by or registered with the SFC, as the case may be, unless the context requires otherwise.

[11] "Debenture" is defined (i) in the CO as including "debenture stock, bonds and any other securities of a company whether constituting a charge on the assets by the company or not"; and (ii) by case law as "a document which either creates a debt or acknowledges it". (Levy v Abercorris Slate and Slab Company [1888] 37 CH D 260 at 264).

[12] Extracts or abridgements of a prospectus, published by way of advertisement, must comply with requirements specified by the SFC including as to the form and manner of publication.

of the issuer take responsibility for the accuracy of the information contained in the prospectus and the CO requires the prospectus to state that "neither the Commission nor the Registrar takes any responsibility as to the contents of the prospectus." Where a series of debentures (such as Minibonds) are to be issued, they are usually issued under a programme, with information about the issuer and common information about the programme and the product contained in a programme prospectus and issue-specific information for each series of debentures in a separate issue prospectus, which requires separate SFC approval.

3.6 The Lehman structured products described in Chapter 2 constitute "debentures".[13] Accordingly, where the products have been "offered to the public", a prospectus has been issued. A prospectus is not, however, required for products distributed by way of private placement.

3.7 In addition to the prospectus provisions of the CO, under the SFO any advertisement or invitation to the public to enter into an agreement to acquire securities or to enter into a regulated investment agreement must also be authorised by the SFC before it can be issued. The Lehman structured products are "securities" for the purposes of section 103 of the SFO.[14]

[13] The SFC has proposed that the definition of "debenture" in the CO prospectus regime be amended to exclude all "structured products" (i.e. products which, in addition to exposure to the credit or default risk of the issuer (or guarantor where applicable) contain an exposure to an underlying asset, opportunity or risk that is usually unrelated to the issuer or guarantor) with the intention that public offers of such structured products be regulated under the SFO investment advertisement regime. Further, non-statutory product codes or guidelines could be tailored for products with similar characteristics to supplement the SFO investment advertisement regime (Consultation Conclusions on the Consultation Paper on Possible Reforms to the Prospectus Regime in the Companies Ordinances – September 2006).

[14] In the SFO "securities" are defined to mean, amongst other things, "…debentures…bonds or notes of, or issued by, a body, whether incorporated or unincorporated…"

3.8 The prospectuses and the associated marketing materials for those Lehman structured products "offered to the public" have been authorised by the SFC in accordance with the relevant provisions in the CO and the SFO. These documents contain information about the risks of the products to assist investors in making informed investment decisions. Taking the Minibond Series 36 issue prospectus of April 2008 as an example, risk factors are set out in a section headed "Investment Risks". Certain key risk factors are set out in bold type. For example:

> **Our Notes are not principal protected; you could lose part, and possibly all, of your investment**
>
> **Our Notes do not have a liquid trading market**
>
> **The only assets which back our Notes are the collateral and the swap arrangements; the swap counterparty's claims against the collateral will be paid ahead of Noteholders' claims if we have to redeem our Notes early**

Such statements are followed by more detailed explanation. The marketing leaflet for Minibond Series 36 also stated:

> **The Notes are not principal protected.**

3.9 Under the CO certain specified types of offer do not trigger the prospectus regime with its associated disclosure requirements. There are 12 categories of exempted offers (some of which are often loosely referred to in the banking industry as private placements to distinguish them from offers to the public), including offers to not more than 50 persons and offers where the minimum principal amount to be subscribed or purchased is not less than $500,000, provided in each of these cases that a "Warning

Statement" is included in the offer:

> WARNING
>
> 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. If you are in any doubt about any of the contents of this document, you should obtain independent professional advice.

3.10 The SFO, in turn, excludes these types of offer from the prohibition on the issue of invitations to the public to acquire securities which have not been authorised by the SFC. Thus, no SFC authorisation for registration or issue is required for private–placement documentation.

Conduct at Point of Sale

3.11 The disclosure regime under the CO and the SFO is complemented by the regulation of the conduct of intermediaries in the sales process. The SFC's Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission lays down the requirements to be observed by intermediaries in carrying out "regulated activities" under the SFO, including the promoting of investment products to customers. Generally, the Code requires intermediaries to act with due skill, care and diligence in the best interests of their clients (General Principle 2).

3.12 More specifically, section 5.1 of the Code requires intermediaries to establish their clients' financial situation, investment experience and investment objectives. Thereafter, section 5.2 of the Code, entitled "Know your client: reasonable advice", provides that

> Having regard to information about the client of which the licensed or registered person is or should be aware through the exercise of due diligence, the licensed or registered person should, when making a recommendation or solicitation, ensure the suitability of the recommendation or solicitation for that client is reasonable in all the circumstances.

Thus where an intermediary recommended that a customer purchase the Lehman structured products described above or solicited an order for such products, the intermediary should have assessed the suitability of the product for that individual customer.

3.13 Section 5.3 of the Code, entitled "Know your client: derivative products", further provides that

> 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.

3.14 In May 2007 the SFC issued a set of frequently asked questions and answers (FAQs) to provide practical guidance to intermediaries engaged in financial planning and wealth management business activities on how they may fulfill the suitability obligations required of them under the SFC's Code of Conduct. Question 1 asks "What are the suitability obligations expected of IAs [Investment Advisers]?" The response states that

> IAs should:
>
> a) know their clients;
> b) understand the investment products they recommend

to clients (*Product due diligence*);

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;

d) provide all relevant material information to clients and help them make informed investment decisions;

e) employ competent staff and provide appropriate training; and

f) document and retain the reasons for each product recommendation made to each client.

3.15 Thus, intermediaries are required to conduct their own product due diligence, analysing a product's features and assessing its risk rating and the types of customer for whom it might be appropriate. Within registered institutions the assessment of a product's risk rating is made at the institution level, generally through a system administered with the involvement of a risk management function independent of the sales function. Intermediaries may then only recommend the product and solicit orders from those customers for whom it is considered suitable (i.e. for those customers whose personal circumstances match the product's risk return profile). In soliciting orders, intermediaries must ensure adequate disclosure of relevant material information (General Principle 5 of the Code), ensure any representations and information are accurate and not misleading (section 2.1 of the Code) and present a balanced view, drawing their clients' attention to the disadvantages and risks as well as to the favourable selling points of investment products (Q5, FAQs).

3.16 The Code of Conduct (section 4.1) and the FAQs require intermediaries to ensure that their staff are competent, fit and proper to undertake investment sales, and to provide appropriate training.

3.17 In addition to the Code of Conduct and the FAQs, the SFC and the HKMA have issued a range of other circulars and guidelines which are relevant to intermediaries' conduct at point of sale. Some of these are discussed in Chapter 4.

3.18 The SFC and the HKMA monitor intermediaries' systems and control processes for ensuring compliance with the Code of Conduct and the FAQs and other relevant circulars and guidelines. Failure to comply with these provisions could call into question fitness and properness to remain licensed or registered.

4. Supervision of banks' securities business

Overview

4.1 The existing regulatory framework for registered institutions is set out in the SFO and the BO. The framework was implemented in April 2003 (following the enactment of the SFO and the Banking (Amendment) Ordinance 2002) having regard to

> (a) the importance of putting in place a regulatory mechanism that provides **adequate protection to investors**, minimizes regulatory overlap, and thus, regulatory cost; and
>
> (b) the objective of levelling the playing field, as far as possible, between exempt authorized financial institutions [i.e. the entities that were to become "registered institutions"] and corporations licensed by the SFC.
>
> (emphasis supplied)

(Government Consultation Paper on the Securities and Futures Bill, April 2000)

4.2 Under the present framework, the SFC is the "lead regulator" for the securities industry. Any entity wishing to carry on a business in activities regulated by the SFO must be licensed (in the case of licensed corporations) or registered (in the case of AIs) by the SFC. The SFC sets the standards, through rules, codes and guidelines issued under the SFO, with which intermediaries should comply in carrying on their regulated activities.

4.3 The HKMA acts as the "frontline supervisor" of registered institutions. When an AI applies to become a registered institution, the HKMA will advise the SFC whether the AI is fit and proper to carry on the regulated activities for which it seeks registration. After registration, the registered institution is supervised by the HKMA and subject to the relevant regulatory requirements issued by the SFC and the HKMA.

4.4 Every registered institution must appoint at least two "executive officers" who are responsible for directly supervising each of its regulated activities. The MA consents to their appointment if he is satisfied that they are fit and proper and have sufficient authority within the institution to undertake the role of executive officers. The HKMA also maintains a public register of "relevant individuals", who are the persons (including the sales staff) through whom registered institutions conduct regulated activities. Management are required to ensure that the relevant individuals employed by their institutions meet the requisite levels of competence, qualifications and fitness and properness as stipulated in the SFC's Fit and Proper Guidelines and Guidelines on Competence (section 119 SFO). If the MA considers that an executive officer or a relevant individual is no longer fit and proper, he may, after consultation with the SFC, withdraw consent to the appointment of the executive officer or remove the particulars of the relevant individual from the public register, and the person should cease to undertake any regulated activities on behalf of the registered institution.[15]

4.5 In order to maintain a level playing field between licensed corporations and registered institutions, the HKMA supervises registered institutions following the standards set by the SFC. Any complaints relating to the regulated activities of registered institutions are handled by the HKMA in accordance with a set of procedures modelled on those of the SFC.

4.6 To facilitate co-operation, the HKMA and the SFC have a Memorandum of Understanding setting out their respective roles and responsibilities. Bilateral meetings to discuss issues of interest are held regularly. Table 2 contains a brief guide to the division of responsibilities between the HKMA and the SFC.

[15] Executive officers and relevant individuals are the counterparts of "responsible officers" and "licensed representatives" in licensed corporations.

Table 2

Division of regulatory responsibilities for AIs' securities business under the Memorandum of Understanding between the HKMA and the SFC		
	HKMA	**SFC**
Registration		
Institutional registration	• To consider applications for registration by AIs for the carrying on of regulated activities • To advise the SFC on whether the applicant is fit and proper to be registered	• To grant, or refuse to grant, registration to AIs as registered institutions for the carrying on of regulated activities • To maintain a register of registered institutions (including details of their executive officers) and to make the register available for public inspection
Executive officers	• To give, or refuse to give, consent to individuals to be executive officers of registered institutions	• The public register maintained by the SFC should include details of the executive officers of registered institutions
Relevant individuals	• To maintain a register of relevant individuals (including executive officers) and to make the register available for public inspection	
Regulatory and supervisory processes		
Developing rules, codes and guidelines	• To be responsible for making guidelines under the BO • To consult the SFC in so far as such guidelines apply to registered institutions	• To be responsible for making rules and publishing codes and guidelines under the SFO • To consult the HKMA in so far as such rules, codes and guidelines apply to AIs by reason of their being registered institutions
Exercising supervisory functions	• To be the frontline supervisor of registered institutions • To be responsible for the day-to-day supervision of registered institutions	• To consult the HKMA before exercising its powers of supervision under s.180 of the SFO in relation to an AI
Complaints		
Complaint referral	To refer complaints to the SFC whenever they are considered by the HKMA to be relevant to a matter that the SFC can investigate under s.182 of the SFO (e.g. an offence under the SFO or market misconduct) or to relate to the SFC's functions under the SFO	• To refer to the HKMA complaints concerning any registered institution, any executive officer of a registered institution, any member of the management of a registered institution, and any relevant individual

Division of regulatory responsibilities for AIs' securities business under the Memorandum of Understanding between the HKMA and the SFC		
	HKMA	**SFC**
Investigation		
Conducting investigations and sharing of results	For potential disciplinary cases identified: • to open a case for investigation • to notify the SFC • to keep the SFC informed of the progress • to forward to the SFC a copy of the investigation report, together with the HKMA's conclusions • to report any related matter to the SFC before completing the investigation where considered appropriate	• To consult the HKMA before exercising its power to initiate an investigation under s.182(1)(e) of the SFO • To share the investigation findings with the HKMA
Disciplinary action		
Consultation prior to disciplinary action	To consult the SFC before exercising its power to: • withdraw or suspend any consent given to a person to be an executive officer of a registered institution • remove or suspend the registration of a relevant individual	To consult the HKMA before exercising its power to: • suspend or revoke a registered institution's registration • reprimand, fine or issue a prohibition order against a registered institution, any of its executive officers, any member of its management involved in the carrying on of a regulated activity or any of its staff who is registered as a relevant individual
Appeals		
Conducting appeals	• To be responsible for conducting appeals against a decision of the HKMA • To consult the SFC during the course of any appeal where considered appropriate	• To be responsible for conducting appeals against a decision of the SFC • To consult the HKMA during the course of any appeal where considered appropriate

Regulation over the sale of retail investment products

4.7 The HKMA employs some 140 supervisory staff in its Banking Supervision Department (BSD). These staff are responsible for supervising all AIs in Hong Kong. In conducting their normal supervisory functions (including on-site examinations) they will, where appropriate, carry out checks on AIs' securities business to test regulatory compliance, assess effectiveness of control systems and identify possible control deficiencies and misconduct. Within the BSD, the Securities Supervision Team – a specialist team dedicated to supervising AIs' securities business – has a supervisory staff headcount of 11. In addition, within the Banking Development Department of the HKMA, there are two Securities Enforcement Teams, which have a combined staff headcount of nine and which are responsible for enforcement related matters.[16]

4.8 Out of the 201 AIs supervised by the HKMA, 103 are registered institutions and 23 of these are retail banks with branch networks in Hong Kong serving the retail investing public.

4.9 Charts A and B show that AIs' securities business has grown substantially in recent years. Registered institutions' aggregate income from securities business tripled from 2005 to 2007. Over the same period, the ratio of income from securities business to total income of registered institutions doubled to 18%. The benign investment environment during this period was an important factor contributing to this growth. It should be borne in mind that these figures reflect registered institutions' securities businesses as a whole, including stock trading, and are not confined to sales of investment products to investors.

[16] Some temporary redeployment of staff has been carried out to facilitate the handling of the large numbers of complaints about Lehman products.

Chart A: Growth in Registered Institutions' securities business

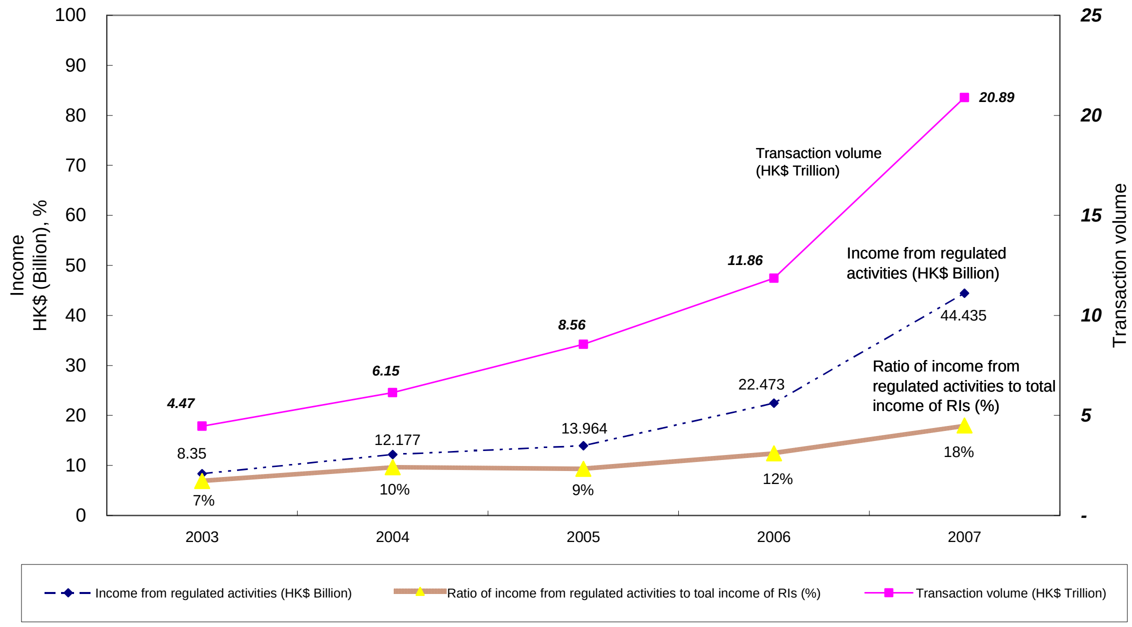
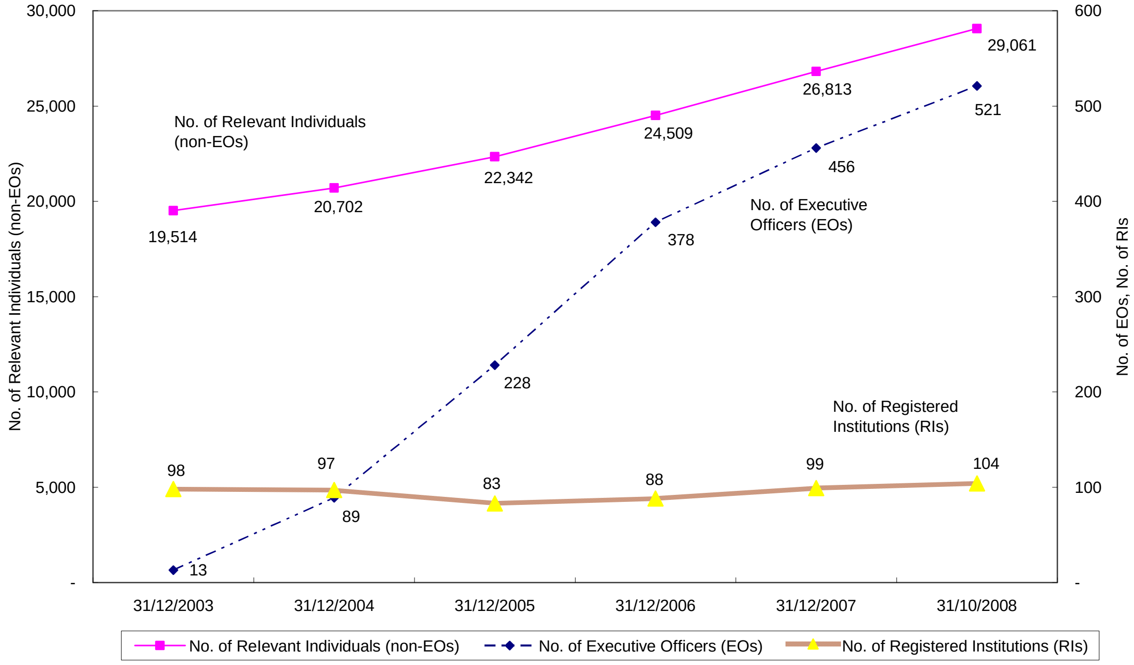


Chart B: Growth in number of institutions and individuals engaged in regulated activities



Supervisory Framework

4.10 The HKMA's approach to the supervision of registered institutions' securities business involves issuing guidelines and circulars, conducting regular on-site examinations (including thematic examinations), and undertaking off-site surveillance. To aid in off-site surveillance, certain registered institutions are required to commission an independent unit (such as their compliance department, which should be functionally independent from their business units) to conduct assessments of their compliance with rules and regulations relating to regulated activities.

Guidelines and circulars

4.11 Immediately before the implementation of the current securities regulatory regime in 2003, the HKMA issued a supervisory policy manual (SPM) module entitled "Supervision of Regulated Activities of SFC-Registered Authorized Institutions".[17] The SPM module states that the "general approach adopted by the HKMA is to require RIs [registered institutions] to comply with standards equivalent to those applied by the SFC to licensed corporations in their regulated activities." The SFC's Code of Conduct for Persons Licensed by or Registered with the SFC and Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the SFC are specifically mentioned as examples of such standards.

4.12 One of the main concerns expressed during the Lehman episode has been the sale of complex structured products to those in the more vulnerable

[17] Issued as a statutory guideline under section 7(3) of the BO.

sectors of the community. Section 4.6.5 of the SPM module deals with the marketing of investment products to more vulnerable customers (for example the elderly), requiring registered institutions to adopt more stringent due diligence measures, and stating that

> …There should be proper procedures and training for front-line staff with regard to the marketing of investment products to such customers. The relevant procedures should give due weight to the following:
>
> - explaining to the customers the nature of the product, fees and charges (including penalty charges on early redemption, if applicable), and underlying risks (e.g. market risk, liquidity risk, and foreign exchange risk) before they enter into any transaction in the investment product; and
>
> - reminding the customers to avoid hasty investment decisions and, where necessary, seek independent advice on products and markets with which they are not familiar.

4.13 In addition to this SPM module, the HKMA issued six circulars to registered institutions on the selling of investment products between 2003 and 2007:

(a) 13 January 2003 – circular to provide specific guidance on the restrictions on unsolicited calls in relation to securities and futures contracts.

(b) 1 March 2005 – circular requiring registered institutions to ensure compliance with the recommendations in the SFC’s Report on Selling Practices of Licensed Investment Advisers.

(c) 3 March 2006 – circular to share with the industry examination findings on the sale of wealth management products to retail customers. This was accompanied by a set of industry best practices in relation to the conduct of wealth management business including: regular review of compliance with applicable codes and guidelines; customer profiling (which should include assigning a risk tolerance level for each customer); product suitability assessment (which should include giving due consideration to the product risk and the customer's risk appetite); proper risk disclosure; and effective management oversight. Again focusing on dealings with more vulnerable customers, the circular states (in relation to risk disclosure) that

> When selling RWM [retail wealth management] products to vulnerable customers such as the elderly, illiterate or visually impaired, additional precautionary measures (e.g. advise the customers to avoid hasty decisions, invite their relatives or friends to attend, and/or assign more than one staff to conduct, the suitability assessment interview and product presentation) should be implemented to safeguard the interests of these customers and to mitigate any legal and reputational risks the AIs might be exposed to. AIs should not sell complex RWM products to customers who may have difficulty in fully understanding the nature and risks of these products.

Following the issue of this circular, relevant registered institutions applied more systematic classifications for assessing and matching product risk and customers' risk appetite.

(d) 1 March 2007 – circular to inform the industry of major issues and good practices identified in a round of thematic on-site examinations of selected registered institutions active in investment advisory activities.[18] The good practices included specific criteria and special procedures (such as extra explanation of the products and third-party witnessing of transactions) for vulnerable customers, and mystery shopper inspections of sales practices conducted by some registered institutions.

(e) 7 May 2007 – circular to draw the attention of registered institutions to the SFC's FAQs on the suitability obligations of investment advisers, emphasising that the SFC and the HKMA would take into account compliance with the FAQs in determining whether a registered institution or its relevant individual is fit and proper to carry out financial planning and wealth management activities.

(f) 1 June 2007 – circular to draw registered institutions' attention to a report issued by the SFC, which sets out the common issues identified during the SFC's second round of thematic inspections of selected licensed investment advisers. Among the issues were insufficient knowledge of clients, insufficient product due diligence and lack of justification to illustrate suitability of advice.

4.14 In view of the prevailing market situation, in early 2008 the HKMA advised relevant registered institutions to adopt a "high" risk rating classification for credit-linked products without full principal protection, including those with CDOs as underlying collateral. The purpose was to restrict the future sale of such products to those customers who were willing to accept a high degree of risk.

[18] Conducted in parallel with the SFC's inspections of licensed investment advisers.

On-site examinations

4.15 The HKMA conducts regular on-site examinations of registered institutions. The objectives of these examinations are to enable the HKMA to understand the way in which regulated activities of registered institutions are being conducted and to determine whether registered institutions have established appropriate and effective policies, procedures and controls to ensure compliance with the relevant legislation, rules, codes and guidelines issued by the SFC and the HKMA.

4.16 On-site examinations comprise Tier 1 examinations covering the high level controls of registered institutions over their regulated activities; Tier 2 detailed examinations; and thematic examinations reviewing a particular activity or function across a selection of registered institutions. Tier 1 examinations are undertaken by the general supervisory staff in BSD, whereas Tier 2 and thematic examinations are normally undertaken by the Securities Supervision Team. When conducting examinations, the HKMA's examiners conduct checks (including reviewing a sample of transactions) to test regulatory compliance, assess the effectiveness of control systems and identify possible control deficiencies and misconduct.

4.17 Between the commencement of the SFO in April 2003 and October 2008, the HKMA conducted a total of 158 on-site examinations of registered institutions, which included in whole or in part a review of aspects of their securities business. Of these 158 examinations, 35 were Tier 1 examinations, 37 were Tier 2 examinations, and 86 were thematic examinations.

4.18 The themes covered in the thematic examinations included retail wealth management, investment advisory activities, registration controls over relevant individuals, and selling practices. Some thematic examinations were carried out in coordination with the SFC (for example the review of investment advisory activities undertaken in 2006).

4.19 Of the 158 on-site examinations, 100 were conducted on the 23 retail banks with branch networks in Hong Kong. On average, these retail banks undergo a Tier 2 or thematic examination every year, although the frequency of examination for each institution is determined under a risk-based approach.

4.20 Generally, the results of the on-site examinations have indicated that registered institutions have systems of control to ensure compliance with the regulatory requirements of the SFC and the HKMA. However, there were cases where systems required improvement. In these cases, the HKMA followed up with the management to ensure that appropriate remedial actions were taken to address the deficiencies identified in the examination.

4.21 The examinations also found instances of suspected non-compliance. Where cases involved a possible material breach of the SFC's or the HKMA's regulatory requirements, they were referred to the Securities Enforcement Teams within the Banking Development Department. Between April 2003 and August 2008, the BSD's supervisory staff made 111 referrals to the Securities Enforcement Teams, accounting for 34% of all the cases received by these teams. Of the 111 referrals, approximately 26% concerned suspected performance of regulated activities by unregistered staff; around 21% were related to suspected mis-selling of securities products; and about 18% concerned suspected capability problems, such as relevant individuals failing to meet competence requirements.

Off-site surveillance

4.22 The HKMA's on-site examination activities are supplemented by the off-site surveillance work of individual case teams. Each AI is assigned to the overall supervision of one case officer (or a team of officers for large institutions). These case officers and the Securities Supervision Team maintain a close dialogue. If a registered institution is assessed to be of higher risk in terms of non-compliance, the responsible case officer may approach the Securities Supervision Team for assistance (for example by requesting a Tier 2 on-site examination). Case officers are responsible for following up any deficiencies in the systems of the registered institutions under their supervision which are discovered in on-site examinations.

4.23 All registered institutions are required to submit semi-annually to the HKMA a "Return of Securities Related Activities". This return provides a general overview of the regulated activities being carried out by each registered institution as well as the trends in the industry to enable trend analysis to be conducted. The information collected is used for determining the scope and focus of on-site examinations.

4.24 Commencing from 2005 an increasing number (50 for 2008) of large, complex or active registered institutions (including all the active retail banks) have been required to commission annually an independent unit (for example, their compliance department) to review the institution's compliance with the regulatory requirements of the SFC and the HKMA concerning regulated activities. The units' reports are reviewed jointly by the institutions' case officers and the Securities Supervision Team. Common issues arising from the assessment of the reviews from 2005 to 2007 included inadequate controls for ensuring the accuracy of relevant individuals' registration details, and breaches of the Securities and Futures (Contract Notes, Statements of Account and Receipts) Rules. A few registered institutions reported control deficiencies in relation to the marketing of investment products. These issues were followed up by the HKMA to ensure remedial action. Material breaches of regulatory requirements identified in this process were reported to the Securities Enforcement Teams.

Enforcement

Enforcement framework

4.25 Under the existing regulatory regime, the MA is vested with statutory powers under the BO to impose certain disciplinary sanctions on executive officers and relevant individuals of registered institutions. These sanctions are withdrawal or suspension of consent to a person being an executive officer of a registered institution and removal or suspension of the registration of a relevant individual. The MA does not, however, have statutory powers to impose disciplinary sanctions on the registered institutions themselves in respect of their conduct of regulated activities under the SFO. This power is reserved to the SFC, which is vested with statutory powers under the SFO to discipline registered institutions, their executive officers, relevant individuals and any persons involved in the management of regulated activities (all referred to as "regulated persons").

The SFC is empowered under the SFO to revoke or suspend the registration of a registered institution and to issue a prohibition order on, to reprimand publicly or privately, and/or to fine, any regulated person.

4.26 Under the Memorandum of Understanding between the HKMA and the SFC, if the HKMA considers it appropriate to open a case for investigation, in respect of the conduct of regulated activities by any regulated person, the HKMA will so notify the SFC. Thereafter it will keep the SFC informed of the progress and result of the investigation and either recommend to the SFC (in cases where the power to impose a recommended sanction rests with the SFC), or consult the SFC (in cases where the sanction power rests with the MA) on, the appropriate disciplinary sanction. If the SFC initiates an investigation for the purpose of considering whether to impose disciplinary sanctions on a regulated person, the SFC will consult the HKMA with regard to both the investigation and any disciplinary sanctions it may propose to impose on the regulated person. The allocation of enforcement duties in respect of the regulated activities of registered institutions was further elaborated in a side-letter to the Memorandum of Understanding on 12 April 2007 to streamline communication and co-operation on enforcement matters. This close co-operation helps ensure consistency between the regulators in the approach to enforcement and a level playing field between registered institutions and licensed corporations.

Enforcement procedures

4.27 When a complaint is made to, or an event is identified by, the HKMA that may indicate potential grounds for discipline, the incident will be passed to the Securities Enforcement Teams. These teams will assess the information available and submit the matter to an internal standing committee (Event Review Committee), chaired by an Executive Director of the HKMA, to decide whether a case should be opened and the scope of any investigation.

4.28 If sufficient evidence is collected during the investigation, the case will be submitted to another internal standing committee (Disciplinary Committee), chaired by a Deputy Chief Executive of the HKMA, to consider whether, and if so which, disciplinary sanctions should be imposed. If the MA, on the advice of the Disciplinary Committee, considers that disciplinary sanctions should be imposed, he will consult or make a recommendation to the SFC accordingly.

4.29 If the HKMA or the SFC is minded to impose a disciplinary sanction, a notice will be issued to the party concerned setting out the findings of the investigation, the proposed sanction and a summary of the evidence relied on. The HKMA and the SFC will not exercise disciplinary powers against a regulated person without first giving that person an opportunity of being heard. The HKMA and the SFC will consult each other before deciding on the final sanction to be imposed. The person subject to disciplinary sanction has a right to appeal to the Securities and Futures Appeals Tribunal.

4.30 A regulated person may make a settlement proposal (via the HKMA or directly) to the SFC. The SFC has the power to settle disciplinary proceedings by agreement when the SFC considers it appropriate in the interest of the investing public or in the public interest.

5. Remedies available to investors

5.1 Investors may complain to the SFC or the HKMA if they believe that there has been mis-selling on the part of the registered institutions (for example that the institutions have failed to adequately disclose the risk of an investment product or ensure its suitability for sale to individual customers). If the regulators consider an investor's complaint to be substantiated, they may take disciplinary action against the relevant regulated persons. The regulators, however, do not have the power to order the institution to pay compensation to the investor. In cases where the investor and the institution cannot agree on a settlement, the investor will still have to take court action to seek compensation from the institution. If the regulators find mis-selling on the part of the institution, this may put the investor in a stronger position in seeking any remedies. It is also worth noting that willingness to compensate investors is a mitigating factor when regulators consider the appropriate sanctions for any misconduct found.

5.2 An aggrieved investor might take civil action through the courts (including, if the monetary claim involved is $50,000 or less, the Small Claims Tribunal) against the registered institution which sold the investment product, seeking to rescind the purchase contract or obtain damages from the institution, possibly on the grounds that the institution misrepresented the product during the selling process. Alternatively, investors might seek to engage the distributing registered institutions in settlement negotiations or mediation or arbitration proceedings with a view to reaching a settlement or adjudication of their claims.

5.3 Following an undertaking of the Government on 15 October 2008, the HKMA commissioned the Hong Kong International Arbitration Centre (HKIAC) to establish a mediation and arbitration scheme to help resolve questions of compensation between investors in Lehman products and distributing banks. A number of banks have also settled with some affected investors without the need for formal mediation or arbitration. Settlement negotiations, mediation and (unless previously contractually otherwise agreed) arbitration are voluntary processes.

6. Investigations into complaints about Lehman products: some preliminary observations

[TEXT DELETED]

Approach adopted by the HKMA to investigating complaints about the sale of Lehman-related products

6.1 Since LBHI filed for bankruptcy protection on 15 September 2008, the HKMA has received, up to 24 December 2008, 19,699 complaints concerning Lehman-related investment products. To process these complaints as quickly as possible while ensuring due process, the HKMA has deployed 203 staff to handle the complaints, including 98 existing staff members and 105 secondees from two external auditing firms. The HKMA is in the process of engaging 125 temporary staff to assist in the investigation of the complaints and enable the majority of the redeployed permanent staff to return to their normal duties.

6.2 In light of the public concern that complaints about the sale of Lehman-related products be investigated expeditiously, the HKMA has agreed with the SFC a set of specifically designed procedures to deal with the large numbers of complaints. Under these procedures, the HKMA, in accordance with its powers under the BO and the SFO, reviews each complaint to ascertain whether there is prima facie evidence to open an investigation. If an investigation is opened and during the course of it the HKMA finds sufficient justification, it will refer the case to the SFC (which is the authority ultimately responsible for deciding whether a registered institution has been guilty of misconduct) for the SFC to decide whether further action, including the imposition of sanctions, is warranted. The HKMA will continue its review of individual cases, whether or not referred to the SFC, to investigate whether there has been misconduct on the part of the individual staff members concerned.

Progress in the handling of the complaints

6.3 The progress, up to 24 December 2008, in the handling of complaints about Lehman products is summarised in Table 3.

Table 3

Complaints statistics concerning Lehman-related investment products *(Up to 24 Dec 2008)*

	No. of complaints received	**Stage 1 & 2** **Registration and establishment of allegations completed** [1]	**Stage 3** **Preliminary assessment completed** [2]	**Stage 4** **Actions following preliminary assessment**				
				Insufficient prima facie evidence	*Seeking further information*[3]	*Investigation opened*[4]		
						Investigation in progress	*Further work required*[5]	*Referred to Securities and Futures Commission*[6]
Products arranged / issued by Lehman Brothers		**15,310**	**14,614**	**54**	**10,734**	**2,497**	**1,108**	**221**
- Minibonds		12,881	12,288	40	9,145	2,187	779	137
- Others		2,429	2,326	14	1,589	310	329	84
Products referenced to Lehman Brothers		**3,688**	**3,482**	**14**	**2,710**	**464**	**277**	**17**
Product type to be confirmed		**280**	**186**	**16**	**170**	**-**	**-**	**-**
Total:	**19,699**	**19,278**	**18,282**	**84**	**13,614**	**2,961**	**1,385**	**238**

Note

[1] The HKMA formally registers each complaint and writes to each complainant to confirm receipt of his/her complaint, assigns a complaint number to facilitate subsequent communication and makes follow-up contact with each complainant (mainly by phone) to obtain or clarify details of allegations.

[2] The HKMA reviews and decides for each case (a) whether there is a lack of prima facie evidence for investigation, (b) whether further information should be sought or (c) whether there is prima facie evidence to open a case for investigation.

[3] These are cases where additional information is being obtained from the complainant and the registered institution to facilitate the HKMA's consideration of whether to open a case for investigation

[4] These are cases considered to have sufficient grounds for opening cases for investigation. The relevant registered institution will be required to provide, where necessary, additional information to facilitate investigation.

[5] These are cases which have gone through preliminary investigation but further information from the complainant and the registered institution is considered necessary to enable the HKMA to take the matter further.

[6] These are cases where the HKMA has decided, after a preliminary investigation, that there is prima facie evidence to support a referral to the SFC for consideration of whether there has been a failure at the bank level. The HKMA will continue its investigation into these cases to establish if there has been a failure by the relevant individuals concerned.

6.4 Table 3 shows that the HKMA has completed preliminary reviews of 18,282 complaints. It has opened investigations into 25% of these complaints (or 4,584 cases). Out of these 4,584 cases, the HKMA has so far conducted detailed assessments of 1,623 cases by examining all relevant available documents and evidence provided by the complainant and the registered institution concerned. Sufficient grounds for referral to the SFC for further action have been found in 15% of these cases (238 cases). For the remaining 85% (or 1,385 cases), further work is required to confirm whether there is sufficient evidence to substantiate claims of mis-selling. [TEXT DELETED]

6.5 In respect of 69% of the complaints (13,614 cases), a decision on whether to open an investigation cannot yet be made on the basis of the initial information provided by the complainant. For these cases, the complainant and the registered institution concerned have been, or will be, requested to provide further information to facilitate the HKMA's investigation. The remaining 0.5% (or 84 cases) were found to lack sufficient prima facie evidence to justify opening an investigation.

6.6 [TEXT DELETED]

[TEXT DELETED]

6.7 [TEXT DELETED]

[TEXT DELETED]

6.8 [TEXT DELETED]

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6.9 [TEXT DELETED]

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6.10 [TEXT DELETED]

[TEXT DELETED]

6.11 [TEXT DELETED]

6.12 [TEXT DELETED]

6.13 [TEXT DELETED]

[TEXT DELETED]

6.14 [TEXT DELETED]

6.15 [TEXT DELETED].

7. Overseas practices

7.1 Structured products may take different forms and involve a variety of underlying assets, which will in turn affect how they are treated under different legal systems. The general observations on overseas practice that follow, and those that appear elsewhere in this report, should therefore be regarded as a broad overview rather than as legal analysis.

7.2 There do not appear to be absolute restrictions on the sale of structured products to the retail public in any of the jurisdictions the HKMA reviewed. Generally, it appears that jurisdictions such as the UK, the US, Australia, Singapore, the Netherlands and Germany adopt a broadly similar approach based upon (a) disclosure by product issuers in public offers; (b) licensing of financial intermediaries; and (c) requirements on financial intermediaries to treat customers fairly, assess their suitability for products recommended to them, and disclose adequate information about these products to enable the customers to make informed investment decisions. Some jurisdictions require the issuers of products to identify the target market and the types of customer for whom the product is likely to be unsuitable.

Suitability assessment

7.3 Under the Markets in Financial Instruments Directive (MiFID) framework applied in the European Union, if a retail client receives investment advice, the firm involved must conduct a suitability test covering the client's investment objectives, financial situation and knowledge and experience in the relevant investment field as well as his level of education and profession.

7.4 In the US, guidance issued by the National Association of Securities Dealers (NASD)[19] in September 2005 states, among other things, that

- A member has an obligation to perform a reasonable-basis suitability determination to ensure that the product is suitable for some investors. For individual customers, a member must perform a customer-specific suitability determination to ensure that a recommendation is suitable by examining the customer's financial status, tax status, investment objectives and other relevant information.

- The derivative component of structured products and the potential loss of principal for many such products may make them unsuitable for investors seeking alternatives to debt securities.

- The profit-and-loss potential of many structured products is more akin to an option contract, particularly where principal invested is at risk from market movements in the reference security. For such products, it may be useful for registered representatives to consider whether the customer meets the more stringent suitability requirements for options trading.

7.5 Some jurisdictions extend the suitability requirement to the issuer of financial products. In the UK, the FSA recommends the manufacturers

[19] The predecessor of the Financial Industry Regulatory Authority (FINRA) currently the largest self-regulatory organisation in the US operating under Securities and Exchange Commission oversight and responsible for regulating all securities firms that do business with the public, including with respect to professional training, testing and licensing of registered persons, arbitration and mediation. Broker-dealers in the US cannot conduct business until they are members of a self-regulatory organisation.

of financial products among other things to identify the types of customer that the product is likely to be suitable or unsuitable for; periodically to review products whose performance may vary materially to check if they continue to meet the general needs of the target customers; and to consider how to ensure the information provided to investors is clear, fair and not misleading, and apply due skill, care and diligence when preparing information for the use of distributors.

7.6 The FSA also encourages manufacturers to conduct regular mystery shopping exercises and post-launch reviews of products to ensure that the right customers are being targeted and to analyse distributors' customer lists to help ensure that the product is offered to appropriate investors.

7.7 In the US, the NASD has issued similar guidance requiring manufacturers and distributors of third-party products to, among other things, consider whether the products are intended for limited or general retail distribution and to whom the products should not be offered.

Disclosure

7.8 Some jurisdictions appear to prescribe extensive disclosure obligations on intermediaries (in addition to, or operating in tandem with, the disclosure obligations imposed on product issuers through prospectus regimes and the like). For example, intermediaries in Australia are required to provide customers with a Financial Services Guide (FSG), which provides information about the firm, and a Statement of Advice (SOA) whenever personal advice is given to retail customers. The FSG must, among other things, include information about whom the intermediary acts for when providing the financial service; the remuneration and commission it (and its related companies, directors, employees & associates) will receive for the services; the relationships between the intermediary and the product issuers capable of influencing the intermediary in the provision of the services; and the dispute-resolution system covering complaints. The SOA must include among other things a statement setting out the advice; information about the basis on which the advice is given; if any warning is required to be given to the client in relation to the advice (due to incomplete or inaccurate information in relation to the client's personal circumstances), a statement setting out the warning; and information about the remuneration and commission the intermediary will receive and the relationships between the intermediary and the product issuers (similar to that required under the FSG). Further, at point of sale retail clients must be given a Product Disclosure Statement (PDS) (which is the responsibility of the product issuer) when purchasing certain financial products. The PDS sets out significant product features including risks, benefits and costs with the objective of helping consumers compare and make informed choices. All information contained in a PDS must be worded, and presented, in a clear, concise and effective manner.

7.9 In the European Union, MiFID also contains extensive disclosure requirements applicable to firms when providing investment services. The information required includes details about the firm and its services, the financial products (including warnings of risks), execution venues and costs and associated charges. Information should also be disclosed about certain conflicts of interest and any fees and commissions the firm pays to, or receives from, a third party in relation to an investment service.

7.10 In the Netherlands, it appears that investment undertakings providing complex financial products (which would appear to include structured products) must make available a Financial Information Leaflet (FIL) which includes a graphic quantitative risk indicator in addition to the qualitative risk indication to enable customers to quickly gain insight into the inherent risks of these products. The graphic indicator has five risk categories, ranging from "very low" to "very high" risk. The methodology for quantifying the risk takes into account (i) an estimate of the "average payout in the case of unfavourable contingencies" based on a method derived from an expected loss above value-at-risk model; and (ii) whether the payment of principal is guaranteed.

7.11 In the US, the NASD's guidance states that sales materials and oral presentations that omit a description of the derivative component of the structured products and instead present such products as ordinary debt securities are considered to be in violation of its rules.

Supervisory approach

7.12 A number of jurisdictions undertake on-site inspections of banks' securities business and, to varying degrees, adopt a risk-based approach in devising their on-site examination schedules. In Singapore, Australia, the UK, and the Netherlands, inspections are carried out by the regulators. In the US, self-regulatory organisations (such as FINRA) have responsibility for routine on-site inspections. The Securities and Exchange Commission (SEC) conducts oversight examinations to evaluate the quality of the inspections of the self-regulatory organisations (SROs). The SEC also directly inspects the largest broker-dealers. In Switzerland and Germany routine inspections are conducted by external auditors appointed by the intermediaries and agreed by the regulator.

7.13 Germany seems to have a regular review cycle with a pre-determined frequency for examinations (yearly) in the absence of any exemption, although "special audits" may be performed by the Bundesanstalt fűr Finanzdienstleistungsaufsicht (BaFin) (or an external auditor appointed by BaFin) at any time. Switzerland also has an annual review cycle. In other jurisdictions, the frequency is usually determined having regard to the risk profile of the intermediary institutions, and the need to use resources in the most efficient and economic way. For the US and the UK the inspection frequency ranges between one and four years.

7.14 In the US the SEC has indicated that unannounced on-site inspections are carried out when appropriate. Broker-dealers posing a higher level of risk may also receive less advance notice of inspections. In Germany special audits or inspections are generally unannounced. In the UK it appears that the FSA does not conduct unannounced on-site inspections (apart from mystery shopping).

Supervisory focus and measures

7.15 It appears from the information available that the Australian Securities and Investment Commission's (ASIC) reviews usually consider both the internal controls and compliance arrangements of an institution as well as the compliance by sales and product staff with the required standards of conduct. ASIC does from time to time undertake transaction testing. ASIC occasionally uses a "mystery shopping" technique in which it enlists consumers to acquire products or seek advice and subsequently report back on their experience.

7.16 The UK FSA conducts transaction testing in its thematic work surveying industry practices such as reviewing financial promotions and the quality of advice processes in financial advisors and firms. The FSA also uses "mystery shopping" techniques as part of its thematic sampling work.

7.17 Mystery shopping is used in Singapore not just by the Monetary Authority of Singapore (MAS), but by financial institutions, some of which also use client callback exercises to obtain feedback on the sales process and quality of advice provided as well as to assess the effectiveness of controls they have implemented.

Cooling-off periods

7.18 In Australia there is a right to return certain financial products within a period of 14 days.[20] However, it seems that a structured product of the type discussed in Chapter 2 would not be included within the definition of financial products for this purpose.

7.19 In the UK according to the FSA's Conduct of Business Sourcebook, a consumer has the right to cancel certain contracts within periods ranging from 14 to 30 days, depending upon the type of contract. However, again it appears that a structured product of the type described in Chapter 2 would not be included within the contracts covered by these provisions.

7.20 In Singapore there appears to be a right to cancel an agreement to purchase units in a unit trust within seven days of the signing of the purchase agreement.

[20] When a product is returned, the amount refunded may be less than the customer originally paid due to fluctuations of the market price of the product or an amount being deducted to cover taxes and administrative costs.

Dispute resolution

7.21 A number of jurisdictions have some form of dispute resolution process between distributing intermediaries and retail investors. In the US, SROs require that all broker-dealers must accept arbitration of disputes if the customer so chooses. Singapore has established the Financial Industry Disputes Resolution Centre (FIDReC) for mediation or adjudication. In Australia the law requires financial firms to belong to one or more of the established dispute resolution schemes (for example, the Financial Ombudsman Services). Similar financial dispute resolution or Ombudsman schemes also exist in the UK, the Netherlands and Germany.

Recent developments

7.22 The MAS has recently indicated that it will undertake a review of the marketing and sale of structured products. The review will consider the need for stronger suitability requirements for certain types of products, clearer product labelling and risk rating, and simpler descriptions of the features and risks of products so that they can be more easily understood. The MAS has observed that it needs to be careful not to take retrograde steps by developing overly-prescriptive rules.

7.23 In Australia, ASIC formed a Retail Investors Taskforce in 2007 to identify ways to assist retail investors and ensure retail investors become better informed and better equipped to manage their investments and protect their wealth. The taskforce has focused on the quality of advice and information investors receive, better disclosure, advertising and the early detection and elimination of illegal schemes. The taskforce also completed a marketplace review which, together with an external consultant's report commissioned by ASIC on retail customers' profiles released in April 2008, is expected to form the blueprint for ASIC's work with consumers and retail investors for the next three to five years.

7.24 In the UK, the FSA introduced a principle-based "Treating Customers Fairly" (TCF) initiative in recent years. It defines six consumer outcomes which firms are expected to deliver. They are:

(a) consumers can be confident that they are dealing with firms where the fair treatment of customers is central to the corporate culture;

(b) products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly;

(c) consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale;

(d) where consumers receive advice, the advice is suitable and takes account of their circumstances;

(e) consumers are provided with products that perform as firms have led them to expect, and the associated service is of an acceptable standard and as they have been led to expect; and

(f) consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint.

7.25 Starting from January 2009, delivery of TCF will be assessed as part of the FSA's usual supervision of firms. These assessments will involve a review of TCF outcomes with reference to a firm's own management information established for the purpose; direct testing of the consumer experience (for example through call listening, mystery shopping, file reviews, and reviews of consumer communications); and examination of any other relevant evidence (such as the results of recent thematic work).

7.26 The FSA is in the process of conducting a Retail Distribution Review (RDR) in response to recurrent problems in the market for the distribution of retail investment products. The RDR aims to address the problems by providing greater clarity for consumers about the advisory services being offered, distinguishing between independent advice (ensuring this is unbiased, unrestricted and extends to all types of investments) and sales advice; raising professional standards for advisers by setting minimum qualifications for different types of advice and establishing a Professional Standards Board; and requiring independent advisers to agree the cost of financial advice with customers upfront, removing commission bias and ensuring the cost of advice is clear to consumers. The FSA intends to publish a consultation paper in June 2009 containing detailed rule proposals. The issue of consumer responsibility has been raised in the context of the RDR and in December 2008 the FSA issued a discussion paper on "Consumer responsibility". The paper examines the legal and regulatory landscape, the capability of consumers in the financial services market, and how the FSA considers consumer responsibility in its decision and policy making. The paper presents a list of sensible actions which consumers might take to protect their own best interests. These include reading all documents with a "keyfacts logo", asking questions if they do not understand, helping diagnosis of their capacity for risk, and reading the suitability report.

8. Recommendations

Policy

8.1 The first question to be addressed is whether there should be a change in the current disclosure-based approach to investor protection. The policy objectives of providing a reasonable level of investor protection are effected through: requiring disclosure of the nature and risks of the product and an assessment by regulated intermediaries of the suitability of the product for the investor, so as to enable the investor to make an informed decision and take responsibility for it. There is no mandate in Hong Kong for the SFC or the HKMA to prohibit outright the sale of specific investment products.[21]

8.2 The question now is whether market innovations over recent years have produced certain products which should be regarded as so intrinsically unsuitable for the general public that an absolute prohibition should be imposed on their sale. For example, should there be a ban on the sale of structured products which, in return for higher interest income compared with bank deposits, contain embedded derivatives such that, when certain events occur, there is a risk of losing all, or a substantial portion, of the principal? Even if individual derivative products are not in themselves regarded as unsuitable, should complex "composite products" combining various components which are capable of interacting to increase risk be

[21] Although the SFC does have power under section 104 of the SFO to authorise collective investment schemes.

prohibited from retail sale?

8.3 Such a prohibitive approach would be unusual, in that it appears many of the jurisdictions to which Hong Kong would naturally look in considering international standards, for example the US, the UK and other European Union countries, Australia and Singapore, retain disclosure-based regimes. The argument for prohibition would have to be that it is unreasonable to expect retail investors ever to be capable of understanding (or ever to take the steps necessary to understand) the specified types of products. In the absence of such an understanding, they cannot judge the risks inherent in the products and so are not able to make informed investment decisions. The complexities of some of the structured products described in Chapter 2, considered in the light of some of the issues arising from the investigations mentioned in Chapter 6, might support this view.

8.4 This is a difficult issue, however, as such a prohibitive approach would effectively deprive a broad category of investors of otherwise legitimate investment opportunities. There may well be retail investors who could, and would, take the steps necessary to understand the products, and such an approach would operate to prevent them from taking greater risks to earn a higher rate of return. In any case, it is not strictly necessary for the investor to be fully conversant with all of the technical financial engineering of the product: what matters is that he should be aware of the underlying sources of risk, particularly where there is exposure to entities unrelated to the issuer. To the extent that financial innovation and financial engineering can, if properly used, hedge risk or increase yield, the investors concerned would be debarred from their benefit. The prohibition would substitute the regulatory authorities' judgement for that of investors. In such a regime, if a given product is not prohibited, a degree of moral hazard may even be induced by this fact, encouraging investors to buy without carefully considering the risks on the basis that it must be "safe" because it has not been banned. On a practical level, there would also be difficulties in defining what should be prohibited.

8.5 The introduction of a product screening body, either an existing regulator or a new Financial Product Safety Commission, with powers to screen products and authorise their issuance, raises similar concerns. Situations can be envisaged where moral hazard would arise around products authorised by the body and where liability or reputational concerns might curtail product innovation that might be beneficial. If a separate body were to be considered, there would also be issues of finding expertise to enable appropriate judgements to be made and providing indemnities or statutory protections to members for potential liabilities arising from authorised products.

8.6 On balance, therefore, the HKMA favours retention of the present disclosure-based system rather than a removal of freedom of choice of investment to such a degree as to ban certain products. This would be in line with international standards and would continue to make available a wide range of investment options to the investing public. However, the HKMA recognises that the landscape is changing both in terms of the growth in volume and complexity of investment products being sold to retail investors by AIs and in terms of investors' expectations about the level of protection that they should be afforded. The HKMA therefore believes that to ensure delivery of the policy objectives, the regulatory framework should be reinforced. Some recommendations are set out below.

8.7 Investor education is crucial to any disclosure-based regime, since all investment products, no matter how simple or complex, involve a degree of risk. The regulators may need to assume a greater role here in periodically undertaking public education programmes to focus on the principles underlying the disclosure-based system. Such programmes should explain the purpose of the disclosure-based system in enabling investors to make informed investment decisions and to take responsibility for those decisions. It is essential that investors understand that whether to buy or not to buy is ultimately their decision, based upon whether, from the information provided to them, they can understand the nature and risks of the product and, consequently, whether they can take an investment decision on an informed basis.

8.8 However, investor education has its limits. It must be recognised that investors will not read and understand copious documentation, which is often designed more for the protection of the issuer than for the enlightenment of the customer. Investor education alone cannot deal with the issues identified from the Lehman episode, but if it were combined with some of the measures recommended below to strengthen the regulatory framework, it would yield greater benefits. It is therefore considered and recommended that:

- ***the policy objectives on which the disclosure-based system for investor protection rests are appropriate for Hong Kong and should be retained. [Recommendation 1]***

- ***the Government should reaffirm these policy objectives. [Recommendation 2]***

- ***public education campaigns regarding these objectives should be periodically undertaken, focusing particularly on the responsibilities of investors, intermediaries and regulators. [Recommendation 3]***

- ***the regulatory framework should be strengthened to take into account the growth in the volume and complexity of investment products sold to the retail public by AIs and the change in public expectations and risk tolerance by investors particularly in the light of the Lehman episode. [Recommendation 4]***

Disclosure

8.9 For disclosure to be successful in making risks clear to investors and assisting them to make informed investment decisions, it should be clear, concise and comprehensible.

8.10 Few investors are likely to read a full prospectus. Therefore, consideration should be given to introducing short-form uniform disclosure formats for retail structured products (and the concept could be extended to other retail investment products). These should be designed to provide balanced disclosure by systematically setting out the nature and risks of a product and giving equal prominence to benefits and risks. Something along the lines of two simple "Key Facts Statements" (of, say, three pages each maximum) in reasonable-sized print might be appropriate. First, the issuer could produce a product Key Facts Statement covering, for example, whether the product is principal protected; the major risks by which the investor could suffer loss (including scenarios of the potential maximum loss which the investor could suffer); limitations on any secondary market for the product; and the total costs attached to the product. Secondly, the distributing institution could produce a sales Key Facts Statement covering such matters as the capacity in which it is acting (principal or agent) and any fees and commissions it receives; the fact that the products are not deposits (and thus not covered by the Deposit Protection Scheme); and, if a dispute resolution scheme is put into place (as recommended below), reference to the complaints procedure and that scheme. Key Facts Statements should be provided in Chinese or English (according to the customer's preference) before any sale is made.

8.11 An issue that may arise in relation to Key Facts Statements would be a tendency for them to become legalistic and overly long, and used to protect product issuers rather than enlighten customers. Steps might have to be taken to ensure that the Key Facts Statements are tailored to specific products and target audiences; are focused on the decision to buy or not to buy; stand out clearly among other sales documentation; use concise plain language, supported by good presentation; and are developed with the capability and needs of the customer in mind.

8.12 Another approach which could complement Key Facts Statements would be to adopt a "health-warning" system for retail structured products with embedded derivatives (and again the concept could be extended to other retail derivative products) to reduce any confusion with plain vanilla debt securities. The idea would be to have a very simple, large-print, warning in both Chinese and English on product documentation that alerts investors to the inherent risk. So, for instance, the presence of embedded derivatives in the structured product would warrant the "health warning":

> **This is a structured product which involves derivatives. Do not invest in it unless you fully understand and are willing to assume the risks associated with it.**

8.13 The references to “retail” structured products or other “retail” products in the context of disclosure above would include products distributed by way of private placement, if these continue to be as widespread as at present.

8.14 More disclosure is not necessarily better disclosure. What is needed is customer-friendly prominent disclosure which cannot be overlooked and from which a warning of the riskiness of the product can be swiftly gleaned. It is therefore recommended that:

- ***“Health-warnings” should be attached to retail structured products with embedded derivatives or to retail derivative products generally. [Recommendation 5]***

- ***Uniform disclosure formats such as simple “product key facts statements” and “sales key facts statements” should be required to be produced in respect of such products (and indeed other retail investment products). [Recommendation 6]***

8.15 In the marketing of some Lehman retail investment products, “gifts” such as supermarket vouchers, audio-visual equipment and the like were offered for certain levels of subscription. These appear to be specifically designed to attract retail investors and to encourage them to subscribe more than they perhaps otherwise would in order to reach the next level of subscription and attain the gift. Arguably, these offers serve as a distraction from the key facts and from the seriousness of the investment decision being made. Accordingly, it is recommended that:

- ***Consideration be given to whether there should be restrictions on the use of gifts as a marketing tool to promote financial products to investors. [Recommendation 7]***

8.16 The HKMA's investigation into the complaints regarding Lehman-related investment products revealed that around 11% of the complaints involved products sold through private placement rather than public offer. Sales by private placements avoid the need for a prospectus and for the SFC's approval of offering documentation, which would otherwise be required for an offer to the public. Yet, with some of the Lehman products, there were several series of notes with substantially similar terms, although each individual series was kept within the bounds of a private placement. The question arises of whether the Lehman episode indicates a degree of abuse and, if so, whether the private placement regime should be tightened up. Accordingly, it is recommended that:

- ***A review of the private placement regime should be undertaken to ensure that the regime is appropriate in the light of market developments. [Recommendation 8]***

Supervisory Architecture

8.17 Complaints from retail investors alleging mis-selling of Lehman investment products have arisen in Singapore and Taiwan, where there are unified regulators, and in the Netherlands, where there is an objectives-based, “conduct-of-business” regulator. The choice of supervisory architecture does not therefore appear to have been a factor in preventing allegations of mis-selling. The supervisory architecture for each jurisdiction has been developed to best suit the local market situation.

8.18 In Hong Kong the present architecture, in which the HKMA acts as the front-line supervisor of AIs’ securities businesses while the SFC retains responsibilities for licensing, standard-setting, investigation and enforcement[22], was introduced following the enactment of the SFO in 2003. The objectives of this approach are to:

- enable the HKMA to have direct supervisory oversight of all AIs’ business and thereby assist it in its responsibilities for maintaining financial stability by allowing it to obtain an overall picture of AIs’ strengths and weaknesses;

- avoid the need for AIs to deal with multiple regulators;

- avoid duplication of regulatory effort; and

- achieve economies in the use of supervisory resources by enabling the SFC to rely on the HKMA’s supervision of AIs.

8.19 On the supervisory front, the dual arrangement has helped ensure the application of standards to AIs’ securities business that are in line with those applied by the SFC to licensed corporations. The Lehman episode has, however, demonstrated the complexities of the dual arrangement

[22] For registered institutions and in respect of certain sanctions for relevant individuals.

when it comes to enforcement mechanics. Also, investors were initially confused about whom they should complain to.

8.20 Alternatives to the “dual” arrangement between the HKMA and the SFC would be:

(a) to bring all of the AIs’ securities business within the HKMA’s supervision and regulation, providing the MA with the powers to licence registered institutions, to set standards for the conduct of their securities business, and to investigate and sanction as necessary in line with the powers currently vested in the SFC (including public censure and fining powers);

(b) to pass all aspects of regulation and supervision in respect of AIs’ securities business to the SFC (either directly or indirectly through the imposition of a requirement on AIs to conduct securities business through subsidiaries licensed by the SFC).

8.21 There are pros and cons to each alternative. If the HKMA is mandated to take over all aspects of the regulation of AIs’ securities business:

- It would, most importantly, allow the HKMA to retain a fuller overall picture of the AIs’ activities. The exercise by the HKMA of as much direct supervisory oversight of AIs’ businesses and operations as possible is important from the point of view of maintaining banking stability and the stability of Hong Kong’s monetary and financial systems generally. The ability of the HKMA to detect at an early stage potential threats to the safety and soundness of AIs and, through the possibility of contagion, to the banking and financial systems as a whole, is crucial in enabling the HKMA to fulfil its systemic stability role.

- From the AIs' point of view, having the HKMA as sole regulator will avoid their having to deal with multiple-regulators (with the attendant regulatory overlap, inefficiencies and costs).

- The brokerage community may complain about the lack of a "level playing field", as they believe the HKMA will treat AIs more leniently as compared to the SFC's treatment of brokers. In fact, one of the HKMA's principal aims in its supervision of AIs' securities business has been to ensure, through co-operation with the SFC, the frequency and depth of its supervisory activities, and the issue of additional guidance to AIs, that its standards of supervision are at least as stringent as those of the SFC. In any case, if the recommendations set out under "Regulation at Point of Sale" below in this Chapter are applied to AIs' securities business, AIs would be subject to more stringent requirements than brokers.

8.22 If all aspects of regulation and supervision of AIs' securities business is passed to the SFC, AIs will have to deal with multiple regulators (with the attendant regulatory overlap and increase in regulatory burden) and the HKMA will not obtain as full a picture of a substantial part of AIs' operations, which may have serious implications for the HKMA's overall supervisory responsibility for the soundness of AIs and the banking system as a whole. If so, there would appear to be no alternative but to require subsidiarisation, with all of the implications that would follow (see paragraph 8.26 below).

8.23 Whilst the above comments relate to securities business, it is worth noting that certain investment products offered by AIs to their customers may fall outside the ambit of the SFO (for example foreign exchange structured products including foreign exchange structured deposits and accumulators which may fall within leveraged foreign exchange contracts or leveraged foreign exchange trading for which AIs are exempted from authorisation and registration requirements under the SFO). Currently the HKMA supervises, and imposes consistent standards across, all of the different types of retail wealth management products sold by AIs. If there were to be any proposal for the SFC to supervise AIs' activities in respect of securities products, the question of dual regulation of AIs' retail wealth management (and private banking) activities, controls and staff would still need to be resolved. Resolution by an expansion of the SFC's powers to cover foreign exchange structured deposits and the like could conflict with the HKMA's general supervision of deposit-taking business.

8.24 In view of the comments above, it is further recommended that:

- ***All aspects of AIs' securities business (including registration, standard-setting, supervision, investigation and sanction) should be placed under the HKMA. At the same time, the HKMA recommends that coordination between the HKMA and the SFC, with the aim of setting broadly consistent standards of conduct, be strengthened. [Recommendation 9]***

Regulation at Point of Sale

8.25 Generally speaking, a significant proportion of AIs' retail customer base might be regarded as a different category of potential investor from clients of brokers and other more specialised investment houses, with the latter being likely to have more investment experience and to be more ready to take risks. AIs' customers may not fully understand the distinction between a deposit, which is protected by the Deposit Protection Scheme, and an investment product which is not. There is potential for confusion in customers' minds if they are sold structured products at their bank when their initial intention was to place, or roll-over, a time deposit. The carrying out of both retail securities business and ordinary banking business by the same sales staff and at the same counter, and the degree of convenience with which a depositor can become an investor, tends to reinforce the perception that there is little difference between the two activities and undermines the policy objective of ensuring that the investor understands the nature and risk of an investment product. To help differentiate investment products from traditional deposits in customers' minds, consideration should be given to some form of segregation of retail securities business from traditional retail banking business.

8.26 The extreme approach would be to prohibit AIs from selling securities altogether. This is not recommended since it would severely reduce the opportunities and access available to the investing public through AIs' branch networks and could result in branch closures. Another option would be to require AIs to conduct their securities business through subsidiaries. However, there would be costs to this institutional segregation which would be passed on to customers. One important issue that would arise would be the extent to which subsidiaries should be restricted in their ability to carry out their business in the existing branch network. Subsidiarisation would not necessarily remove contagion risk for AIs because customers would tend to identify the relevant subsidiaries with the relevant AIs (and the AIs would have to stand behind their subsidiaries) so the reputation risk would remain. If, as discussed above, the HKMA assumes responsibility for all aspects of regulation and supervision of AIs' securities businesses, then there would be no need to subsidiarise. Instead, an adequate degree of segregation of retail securities business could be achieved by other less disruptive and costly means, such as physical segregation of retail securities business from ordinary banking business within branches.

8.27 Physical segregation of retail securities business could encompass the creation of separate counters or "investor centres" within bank branches, with separate staff whose duties are solely confined to securities business (i.e. they do not also act as tellers dealing with ordinary banking transactions). There could be investor education to promote understanding of the different functions of the investment centre from those of the branch in general, with warning signs suitably prominently displayed. Further, to reduce the risk of "hard selling" prompted by a salesperson's knowledge of a retail customer's bank balances, the physical segregation concept could encompass information segregation in the sense of the imposition of restrictions within AIs' computer systems to prevent investment sales staff from accessing data on customers' deposit accounts. This would serve to remove any temptation to target customers for investment products by review of total net worth held with the AI.

8.28 If the concept of physical segregation for retail securities business is accepted, consideration will need to be given to whether retail investment products which are not "securities" should be handled through the investment centres and the extent to which private banks should be covered by the segregation requirements. Logically, the sale of insurance products (many of which have elements of investment) should be accorded similar treatment to remove any confusion in customers' minds.

8.29 It is therefore recommended that:

- ***AIs, which are registered institutions, continue to be permitted to undertake securities business (including selling investment products to retail customers), but steps should be taken to ensure clearer differentiation between traditional deposit-taking activities and retail securities business, including:***

    - ***physical segregation of AIs' retail securities business from their ordinary banking business***

    - ***a requirement that staff involved in selling investment products to retail customers should not be involved in ordinary banking business***

    - ***a requirement that AIs make clear, through physical signs and warnings, the distinction between deposits and investments and particularly the risks attached to the latter***

    - ***a requirement that there be complete information separation between a retail customer's deposit accounts and his investment accounts and a prohibition on an AI's making use of deposit-related information to target and channel retail customers into investment activities. [Recommendation 10]***

It is also recommended that:

- ***the above forms of segregation should apply to AIs' insurance activities and other investment activities. [Recommendation 11]***

8.30 In conducting sales of investment products, a registered institution conducts an assessment of the investment product it proposes to sell in order to gauge its level of risk and recommends the product to a customer after an assessment of the customer's risk profile. The assessment of its customer should involve a proper analysis of the customer's circumstances (net worth, employment status, etc.), background (education level, investment experience) and investment objectives. The product assessment should be conducted through a system administered with the involvement of a risk-management function independent of the sales function. The customer assessment is however usually conducted by the frontline sales staff through interviewing customers and completing a profiling questionnaire. Most retail banks adopt a scoring system, through which customers are classified into particular risk-tolerance categories on the basis of their answers to the questionnaire. It may be argued that these systems are highly structured making it difficult for a salesperson to influence the customer's risk profile. However, to remove any perception of potential conflict and to help underscore in the customer's mind the importance of the risk profiling procedure and the implications that flow from it, it would be desirable to require the customer assessment to be conducted by staff who have no role in the sales process. Further, audio-recording the assessment process would remove or lessen areas for subsequent dispute. This may present some practical difficulties, but if the physical segregation recommendation is adopted then the "investor centres" so created could be designed to accommodate audio-recording facilities. Accordingly, it is recommended that:

- ***To provide further protection for investors, the assessment of a customer's risk profile be separated from the sales process and be carried out by non-sales staff and that the customer be provided with a copy of the risk profile and asked to confirm his agreement that the risk profile is accurate. Mandatory requirements to audio record the assessment process should be introduced. [Recommendation 12]***

8.31 In addition to audio-recording of the assessment process, the sales process should also be audio-recorded, which would serve as a useful source of reference and provide important evidence in any subsequent dispute about whether sales staff mis-sold the product. Accordingly, it is recommended that:

- ***The regulatory requirements at point of sale should be reviewed with a view to introducing mandatory requirements for the audio-recording of the sales process and ancillary arrangements. [Recommendation 13]***

8.32 Once a product has been assessed and assigned a risk rating, the SFC's FAQs require product due diligence to be conducted on a continuous basis at appropriate intervals having regard to the nature, features and risk of investment products. Where, as a result of such ongoing due diligence, a distributing institution decides to change the risk-rating of a product, the institution should be required to notify customers to whom it recommended and sold the product. There may be no easily accessible secondary market for the product. Nevertheless, the notification would at least allow the customer to take steps to offset any increased risk. Accordingly, it is recommended that:

- ***Where the continuous review by a registered institution of the risk ratings of the investment products it sells results in a higher risk rating being attributed to a product, the institution should disclose this to customers to whom it recommended and sold the product. [Recommendation 14]***

8.33 Complainants have claimed that they were sold products carrying a higher risk rating than warranted by their risk profile. It is important to ensure that the customer's acceptance of risk mismatch is properly obtained and recorded.

8.34 The SFC's FAQs require intermediaries to "document and retain the reasons for each product recommendation made to each client". To properly demonstrate the customer's awareness of the ramifications of his actions in cases of risk mismatch, the institution should keep an enhanced "audit trail", including a full written justification of the reasons why the investor decided to buy the product (not simply a tick box acknowledgement of risk mismatch), an audio-recording of the sales process, and the endorsement of a supervisor of the sales staff. Accordingly, it is recommended that:

- ***In cases of sales of investment products where there is a risk mismatch between the risk rating applied to the product and the customer's risk profile, full and complete documentation should be retained of the reasons why the customers made the investment decision, the sales process should be audio-recorded, and***

endorsement should be sought from supervisory staff within the institution. [Recommendation 15]

8.35 Another suggestion which has been put forward to mitigate any high-pressure sales tactics and to give customers time to reflect on the risks and wisdom of their investment is a "cooling-off" period. This already exists for certain insurance products in Hong Kong. Cooling-off periods are also found in Singapore and Australia in relation to certain financial products such as collective investment schemes although it appears not to cover structured products taking the form of debentures in either jurisdiction.

8.36 Providing time, even a short period of time, for reflection would go some way to mitigate concerns about investors not having time to read and understand disclosure documentation. At its simplest, provision could be made in regulations governing point of sale that either certain products (for example structured products the components of which take some time to consider and understand) could not be sold "same day" (i.e. the date of receipt of the documentation relating to the offer), or certain categories of investor (for example vulnerable investors) could not purchase certain products "same day", but would have to return on another day to complete the purchase. This will no doubt inconvenience investors but that inconvenience has to be weighed against the mischief of hard-sell tactics and impulse purchases.

8.37 The complexity of certain structured products may argue for a longer cooling-off period. It may also be the case that some forms of products are not readily amenable to cooling-off periods. Before coming to any conclusions, it would be useful to discuss these concepts with the industry to understand if there are any impediments to cooling-off periods which are not immediately obvious.

8.38 There may be products where a price or strike price is to be agreed at the time of sale. In these cases, that price might vary substantially between the time at which the customer receives details of the product and the end of the cooling-off period. Thus, a cooling-off period could work to the detriment of certain customers if they are unable to obtain the original price quoted and the subsequent price at end of the cooling-off period is less favourable. To accommodate this type of case, the customer should be entitled to waive the cooling-off period, but if he does so, similar safeguards to those recommended for cases of risk mismatch above should be implemented, namely audio-recording, full documentation of the reasons for the waiver of the cooling-off period and endorsement by supervisory staff within the institution.

8.39 Accordingly, to reduce the scope for dispute and avoid any aggressive sales tactics leading to hasty, unconsidered decisions, it is recommended that:

- ***The regulatory requirements at point of sale should be reviewed with a view to introducing mandatory requirements for the imposition of a cooling-off period between the provision of disclosure documents and the closing of the sale. Consideration should be given to allowing waivers of the cooling-off period subject to certain safeguards. [Recommendation 16]***

8.40 To test sales staff's understanding of the products and the manner in which they are actually sold, there has been a suggestion that a programme of "mystery shoppers" might be considered. The mystery shopper could, for example, take the initiative of seeking information on an investment product the first time he walks into a bank branch and check what type of information is provided, as well as the quality of advice offered, by the relevant individual in the AI conducting the potential sale. There may, however, be some limitations in the operation of a mystery shopper programme for AIs' securities business in that the usual customer-institution relationship in this area is of a more long-term nature and it is difficult for a mystery shopper programme to cover all aspects of a selling process which might involve several face-to-face meetings.

8.41 Another option would be to conduct customer interviews and surveys with a view to observing how the sales process is working in practice in the context of the longer-term relationship. Customers might be reluctant to participate, particularly in times when the investment climate is good and they have no complaints, but again it may nevertheless be worth instituting a pilot programme, possibly combined with a public education programme on responsibility for taking informed investment decisions, to gauge effectiveness and cost-efficiency.

8.42 Accordingly, it is recommended that:

- ***A mystery shopper programme be instituted periodically by the HKMA (as well as by registered institutions themselves) to test sales processes, and a pilot programme of customer surveys be commissioned by the HKMA to gauge whether such surveys can provide information useful for the examination of specific issues in the context of the longer-term customer relationship. [Recommendation 17]***

8.43 The financial turmoil has generally highlighted issues relating to distortions in risk-taking incentives caused by remuneration structures. Supervisors are increasingly focusing on remuneration policies in their reviews of financial institutions' risk management processes. Incentive structures for frontline sales staff may have an impact on their approach to recommending products to their customers. While the HKMA already reviews the remuneration package of relevant sales staff of registered institutions in Tier 2 examinations, there is a case for enhancing the HKMA's review of AIs' controls and procedures to ensure that frontline sales staff are not remunerated with bonuses calculated solely on the basis of financial performance but that other factors (including adherence to best practice guidelines) are in fact taken into account. Accordingly it is recommended that:

- ***Remuneration structures for staff engaged in AIs' securities business be subject to greater focus in the HKMA's on-site examinations and off-site surveillance of AIs' securities business. [Recommendation 18]***

Dispute Resolution

8.44 Although the HKMA and the SFC receive complaints in relation to the securities-related services of registered institutions and licensed corporations, their roles in handling these complaints are confined to ascertaining whether the institution and the staff concerned have breached any applicable requirements under the securities regulatory framework. Neither regulator has any power to adjudicate disputes between customers and financial institutions, or to order them to pay compensation to aggrieved customers. Consequently, even if the HKMA or the SFC finds fault in the conduct of the institution or its staff, the complainant will still have to seek compensation through the court system if the complainant and the institution cannot reach a settlement.

8.45 Within the court services offered in Hong Kong, the Small Claims Tribunal handles monetary claims not exceeding HK$50,000. However, many complaints received following the Lehman episode related to investments exceeding this amount. Therefore, investors may be left with no alternative but to use the regular courts with the attendant costs and time involved.

8.46 In other financial centres comparable to Hong Kong, some form of dispute resolution mechanism is available at low cost to both customers and market participants in the financial sector. For example, the UK has established the Financial Ombudsman Service, which handles disputes across the whole financial sector and provides free and independent dispute resolution services to consumers. The service is funded by levies and case fees, which the financial institutions covered by the service are required to pay by law. Consumers do not have to accept any decisions which the Ombudsman makes and still retain their rights to go to Court. But if a consumer accepts an Ombudsman's decision, it is binding on both the consumer and the financial institution. The Ombudsman does not punish or fine financial institutions if the rules are broken: that remains the task of the regulator.

8.47 In Singapore, the Financial Industry Disputes Resolution Centre Ltd (FIDReC) established in August 2005, provides a low-cost avenue for consumers and financial institutions to resolve their disputes. Like the

Financial Ombudsman Service in the UK, consumers are free to choose whether to accept FIDReC's decisions. If a customer accepts FIDReC's decision, the financial institution concerned is bound by the decision and the parties enter into a written settlement agreement. On the other hand, if the customer does not accept FIDReC's decision, both parties are free to take any further action to pursue their rights. The FIDReC is primarily funded by the financial industry, although a small fee is levied on the customers who use the scheme's adjudication service.

8.48 In the period from 1 April 2007 to 31 March 2008, the Financial Ombudsman Service in UK resolved 99,699 cases. 92% of them (91,739 cases) were resolved by mediation, recommended settlements and adjudications, and the remaining 8% (7,960 cases) required formal ombudsman decisions. In Singapore, the FIDReC resolved 417 cases between 1 July 2007 and 30 June 2008. 83% (348 cases) were resolved by mediation and the remaining 17% (69 cases) involved adjudication by the FIDReC.

8.49 A similar independent body in Hong Kong could provide an efficient means to adjudicate or settle disputes. It would also reduce the pressures on already limited resources within the regulators, especially where incidents arise that generate a large number of complaints, such as has occurred with the Lehman episode. Following the UK and Singapore precedents, an ombudsman scheme could be largely financed by levies on, and case fees from, the financial institutions covered by the scheme. Participation by financial institutions should be mandated to ensure its effectiveness. It is therefore recommended that:

- ***Taking into account international practice and the desirability of***

having a focused, specialised organisation with powers to adjudicate or settle disputes between investors and intermediaries, consideration should be given to establishing a dispute resolution mechanism for the financial industry (along the lines of a financial services ombudsman) in Hong Kong. [Recommendation 19]

8.50 Protocols would have to be developed to cover interaction between the ombudsman and the regulators where complaints or the ombudsman's investigations reveal systemic issues within regulated entities.

Conclusion

1. The upheaval in the financial markets over the past eighteen months is unprecedented in modern times and the demise of Lehman a truly exceptional event that few would have foretold a year (and arguably even six months) ago.

2. The Lehman episode has sparked concern and controversy about the sale of structured products to retail investors. Investors have lost money and have voiced their criticism of a regulatory system which allowed them to purchase these products.

3. Investment losses do not of themselves connote failure of regulation. No amount of regulation or oversight can prevent all loss without imposing inappropriate and unjustified restrictions on investors' choice and inhibiting market growth and development.

4. A review of the investor protection regime is timely. However, care should be taken not to impose overly prescriptive rules which may severely curtail

investment options and, in so doing, ultimately work to the detriment of investors. Specific refinements targeted at enabling investors to take better informed decisions and reinforcing the suitability assessment process should be considered. Intermediaries have their role to play in ensuring fair dealing and the fair treatment of their customers. Investors too must play their part by reading, and making efforts to understand, advertisements and other product disclosure information provided to them; asking questions if they do not understand the information provided; and seeking independent, qualified advice where appropriate.

Hong Kong Monetary Authority
31 December 2008

Interbank interest rate and Minibond coupon rate

Annex 1

					Coupon rate (p.a.)			
Series		**Date of Prospectus**	3-month HIBOR (HKD) % p.a.	3-month LIBOR (USD) % p.a.	**HKD (Tranche 1)**	**HKD (Tranche 2)**	**USD (Tranche 1)**	**USD (Tranche 2)**
Minibond	Series 5	16/06/2003	1	0.97	N/A	N/A	3.80% (2-year term, extendable to 7-year term)	N/A
Minibond	Series 6	01/09/2003	1.0625	1.1	N/A	N/A	5.00% for the first two years; 8.00% for the remaining 3.5 years if Maturity Extension is exercised	N/A
Minibond	Series 7	15/11/2003	0.125	1.14	4.20% (5-year term)	N/A	4.20% (5-year term)	N/A
Minibond	Series 8	16/02/2004	0.07	1.06	7.00% in the first year; interest will be paid in the second to the fifth year, the amount of which will depend on the closing price from time to time of the units in the Tracker Fund of Hong Kong; such interest cannot be more than 7.00% and could be as low as zero	N/A	N/A	N/A
Minibond	Series 9	05/03/2004	0.0938	1.08	3.50% for Years 1 to 3; 4.10% for Years 4 to 5.5	N/A	3.70% for Years 1 to 3; 4.30% for Years 4 to 5.5	N/A
Minibond	Series 10	03/05/2004	0.3125	1.1	4.00% for Years 1 to 3; 4.50% from Years 4 to 5.5	N/A	4.25% for Years 1 to 3; 4.75% from Years 4 to 5.5	N/A
Minibond	Series 11	07/06/2004	0.4063	1.34	7.60% for Year 1; 7.60% minus 6-month LIBOR with a minimum of zero from Year 2 to 5.5	4.00% for Year 1 to 3; 4.30% from Year 4 to 5.5	8.00% for Year 1; 8.00% minus 6-month LIBOR with a minimum of zero from Year 2 to 5.5	4.20% for Year 1 to 3; 4.50% from Year 4 to 5.5
Minibond	Series 12	06/08/2004	0.75	1.615	4.10% for Years 1 to 3; 5.10% from Years 4 to 5.5	N/A	4.65% for Years 1 to 3; 5.40% from Years 4 to 5.5	N/A
Minibond	Series 15	25/11/2004	0.3125	2.36	3.30% for Years 1 to 4; 4.00% from Years 5 to 5.5	N/A	4.30% for Years 1 to 4; 5.00% from Years 5 to 5.5	N/A
Minibond	Series 16	31/12/2004	0.2813	2.555	3.20% for Years 1 to 4; 3.75% for Years 5 to 5.5	N/A	4.20% for Years 1 to 4; 4.75% for Years 5 to 5.5	N/A
Minibond	Series 17	01/02/2005	1.1563	2.735	3.60% for Years 1 to 4; 4.20% for Years 5 to 5.5	N/A	4.35% for Years 1 to 4; 5.00% for Years 5 to 5.5	N/A
Minibond	Series 18	07/03/2005	1.9375	2.845	3.70% for Years 1 to 4; 4.70% for Years 5 to 5.5	N/A	4.50% for Years 1 to 4; 5.50% for Years 5 to 5.5	N/A
Minibond	Series 19	25/04/2005	2	3.14	4.15% for Years 1 to 4; 5.15% for Year 5 to 5.5	N/A	4.75% for Years 1 to 4; 5.75% for Year 5 to 5.5	N/A
Minibond	Series 20	20/06/2005	3.1875	3.42	4.20% for Year 1 to 4; 5.40% for Year 5 to 5.5	3-month HIBOR + 0.45% for Year 1 to 4; 3-month HIBOR + 1.65% for Year 5 to 5.5	4.80% for Year 1 to 4; 6:00% for Year 5 to 5.5	3-month USD LIBOR + 0.55% for Year 1 to 4; 3-month USD LIBOR + 1.75% for Year 5 to 5.5
Minibond	Series 21	17/08/2005	3.75	3.79	4.80% for Years 1 to 4; 5.60% for Year 5 to 5.5	4.45% (with bonus interest of 20% x percentage rise in value of HSBC Holdings plc shares during the lifetime (5.5 years) of the Notes)	5.20% for Years 1 to 4; 6:10% for Year 5 to 5.5	N/A

Interbank interest rate and Minibond coupon rate

					Coupon rate (p.a.)			
Series		Date of Prospectus	3-month HIBOR (HKD) % p.a.	3-month LIBOR (USD) % p.a.	HKD (Tranche 1)	HKD (Tranche 2)	USD (Tranche 1)	USD (Tranche 2)
Minibond	Series 22	20/10/2005	4.1563	4.16	4.40% for Years 1 to 4; 5.40% for Year 5 to 5.5	4.25% (with bonus interest of 20% x percentage increase in the share price of HSBC Holdings plc during the lifetime (5.5 years) of the Notes)	4.65% for Years 1 to 4; 5.65% for Year 5 to 5.5	N/A
Minibond	Series 23	03/01/2006	4.1875	4.54	5.10% for Years 1 to 4; 5.75% for Year 5 to 5.5	8.60% for Year 1; 8.60% minus 3-month HIBOR for Year 2 to 5.5	5.35% for Years 1 to 4; 6.00% for Year 5 to 5.5	8.88% for Year 1; 8.88% minus 3-month USD LIBOR for Year 2 to 5.5
Minibond	Series 25	20/03/2006	4.3438	4.905	5.30% for Years 1 to 4; 6.00% for Year 5 to 5.5	8.30% for Year 1; 8.30% minus 3-month HIBOR for Year 2 to 5.5	5.50% for Years 1 to 4; 6.50% for Year 5 to 5.5	8.88% for Year 1; 8.88% minus 3-month USD LIBOR for Year 2 to 5.5
Minibond	Series 26	17/05/2006	4.4375	5.14	5.30% for Years 1 to 4; 6.00% for Year 5 to 5.5	4.90% (with bonus interest of 20% x percentage increase in the share price of HSBC Holdings plc during the lifetime (5.5 years) of the Notes)	5.50% for Years 1 to 4; 6.50% for Year 5 to 5.5	N/A
Minibond	Series 27	07/08/2006	4.1188	5.41	6.30% for Years 1 to 3; 7.50% for Years 4 to 7 (if the issuer exercises its extension option)	5.40% for Years 1 to 4; 6.40% for Year 5 to 5.5	7.00% for Years 1 to 3; 8.30% for Years 4 to 7 (if the issuer exercises its extension option)	6.10% for Years 1 to 4; 7.20% for Year 5 to 5.5
Minibond	Series 28	18/09/2006	4.0881	5.36	5.50% for Years 1 to 3; 7.00% for Years 4 to 7 (if the issuer exercises its extension option)	4.60% for Years 1 to 4; 6.00% for Year 5 to 5.5	6.50% for Years 1 to 3; 8.00% for Years 4 to 7 (if the issuer exercises its extension option)	5.70% for Years 1 to 4; 7.00% for Year 5 to 5.5
Minibond	Series 29	13/11/2006	3.89	5.35	5.00% for first 3 years; 6.50% for last 4 years (if the issuer exercises its extension option)	4.30% for first 4 years; 5.60% for last 1.5 years	6.00% for first 3 years; 7.50% for last 4 years (if the issuer exercises its extension option)	5.30% for first 4 years; 6.60% for last 1.5 years
Minibond	Series 30	02/01/2007	3.8688	5.36	5.00% for first 3 years; 6.50% for last 4 years (if the issuer exercises its extension option)	4.30% for first 4 years; 5.60% for last 1.5 years	6.00% for first 3 years; 7.50% for last 4 years (if the issuer exercises its extension option)	5.30% for first 4 years; 6.60% for last 1.5 years
Minibond	Series 31	12/03/2007	4.105	5.31	5.50% for first 3 years; 7.10% for last 4 years (if the issuer exercises its extension option)	5.00% for first 4 years; 5.80% for last 1.5 years	6.00% for first 3 years; 7.60% for last 4 years (if the issuer exercises its extension option)	5.40% for first 4 years; 6.60% for last 1.5 years
Minibond	Series 32	04/06/2007	4.565	5.34	5.50% for first 3 years; 7.10% for last 4 years (if the issuer exercises its extension option)	5.40% for first 4 years; 6.40% for last 1.5 years	6.10% for first 3 years; 7.80% for last 4 years (if the issuer exercises its extension option)	6.00% for first 4 years; 7.00% for last 1.5 years
Minibond	Series 33	23/07/2007	4.3381	5.325	6.30% for first 3 years; 8.10% for last 4 years (if the issuer exercises its extension option)	6.00% for first 4 years; 7.75% for last 1.5 years	7.00% for first 3 years; 9.10% for last 4 years (if the issuer exercises its extension option)	6.50% for first 4 years; 8.25% for last 1.5 years
Minibond	Series 34	19/11/2007	3.3688	4.9	5.60% (3-year term)	N/A	6.00% (3-year term)	N/A
Minibond	Series 35	16/01/2008	2.9688	3.87	5.60% (3-year term)	N/A	6.00% (3-year term)	N/A
Minibond	Series 36	14/04/2008	1.815	2.82	5.00% (3-year term)	N/A	5.50% (3-year term)	N/A