

For information
on 2 February 2009

**Legislative Council
Panel on Financial Affairs**

**Action Plan on Recommendations in the Reports Prepared by
the Hong Kong Monetary Authority and
the Securities and Futures Commission
on the Lehman Brothers Minibonds Incident**

Purpose

This paper briefs Members on the Administration's Action Plan for taking forward the recommendations in the reports prepared by the Hong Kong Monetary Authority (HKMA) and the Securities and Futures Commission (SFC) on the Lehman Brothers Minibonds Incident to further improve our regulatory framework and enhance investor protection, particularly with regard to the securities business conducted by authorised institutions.

Background

2. Shortly after the collapse of Lehman Brothers in September 2008, the Financial Secretary requested HKMA and SFC to submit, by end of 2008, reports on their observations, lessons learned and issues identified during the process of investigating the received complaints regarding the Lehman Brothers Minibonds. On 31 December 2008, the Financial Secretary received the said reports from HKMA and SFC.

Action Plan

3. The Administration has formulated an Action Plan in consultation with HKMA and SFC for taking forward in phases the

various recommendations put forth in their reports. This is at the Annex. We shall coordinate efforts by the two regulators as necessary and review progress on a regular basis.

Initial Phase

4. Our immediate focus is on measures to improve the existing regulatory requirements and better protect investors. Specifically, we aim at early implementation of improvement measures in the following three areas –

- (a) the sale of investment products;
- (b) the business conduct of intermediaries; and
- (c) investor education.

5. Some of these improvement measures have already been implemented immediately. Before implementing other improvement measures, HKMA and SFC have to conduct market / public consultations (including consultation with this Panel) under the relevant (including statutory) requirements. Having regard to the outcome of the consultations, HKMA and SFC may exercise their existing powers to draw up codes of practice and regulations to implement these measures. This would not require amendments to the principal ordinances and hence would be completed within a relatively shorter time frame. Whatever shape the regulatory framework may take in future, these improvement measures should remain applicable to investment products and intermediaries for the protection of investors, and hence should be implemented ahead of any structural change to the regulatory framework.

Next Phase

6. In the next phase, we shall review the structure of the regulatory framework and other regulatory arrangements that would need to be implemented through primary legislation, including but not limited to the following –

- (a) whether the two public offering regimes under the Companies Ordinance and the Securities and Futures Ordinance should be retained;
- (b) whether a financial services ombudsman should be established by statute;
- (c) whether it is necessary to adjust the regulatory framework regulating the securities business of banks; and
- (d) whether a cross-sector Investor Education Council should be established by statute.

7. To expedite the improvement process, we will, in parallel to the initial phase, conduct research on the review work of the next phase in order to prepare for future market / public consultations.

8. In conducting the review, we will listen to the views of the markets and various sectors of the community. We will take into account the views of the Legislative Council Subcommittee to Study Issues Arising from Lehman Brothers-related Minibonds and Structured Financial Products. At the same time, we will also consider all relevant factors, such as the unique background and market needs of Hong Kong, the global trend of financial development, recommendations from international financial institutions (including G20 and the Financial Stability Forum). We will announce other details of the review and consult this Panel on relevant measures in due course.

Advice Sought

9. Members are requested to note the content of this paper.

Financial Services Branch
Financial Services and the Treasury Bureau
January 2009

**Action Plan on Recommendations in the
Reports prepared by HKMA and SFC on
the Lehman Brothers Minibonds Incident**

Initial Phase

Improvement Measures	Implementation Plan
I Sale of Investment Products	
1. To require attaching “ health warnings ” to retail derivatives products.	HKMA has issued a circular on 9 January 2009 to registered institutions (RIs) ¹ requiring them to implement this improvement measure immediately.
2. To make the SFC website become the repository of information about unlisted investment products authorized by the SFC.	SFC has already started implementation.
3. To require investment products to have concise and easily understood product and sales key facts statements .)) With input from HKMA on the proposal,) SFC to conduct market /
4. To establish more detailed principles that assist the market to develop materials that are correct, properly balanced and not misleading .) public consultation in Q3 of 2009.))

¹ Registered Institutions (RIs) refers to authorized institutions which are registered under the Securities and Futures Ordinance (SFO) to conduct securities intermediary activities. Under the existing regulatory framework authorized in the SFO and Banking Ordinance, the HKMA is the front-line supervisor of registered institutions.

Improvement Measures	Implementation Plan
5. To consider imposing restrictions on the use of gifts as a marketing tool to promote investment products to investors.)))
6. To consider the feasibility of a “ cooling-off ” period to investors for certain investment products.)) With input from HKMA on the proposals,) SFC to conduct market /
7. To consult the market on the definition of Professional Investors .) public consultation in Q3 of 2009.)
8. To explore requiring client agreements to allow clients to have their grievances resolved by a dispute resolution procedure .))))
II Business Conduct of Intermediaries	
1. For the assessment of a customer’s risk profile – (a) it should be conducted by qualified staff independent of staff making the sale; (b) the customer should be provided with a copy of the risk profile and asked to confirm his agreement that it is accurate; and (c) mandatory requirements to audio tape the assessment process should be introduced.) HKMA has issued a circular on 9 January) 2009 requiring RIs to implement this) improvement measure as soon as possible) but no later than end of March 2009.)) SFC to conduct market / public consultation) on 1(a) –(c) and 2 in Q3 of 2009.)
2. To introduce a requirement to audio-record the sales process .))

Improvement Measures	Implementation Plan
<p>3. If there is a risk mismatch between the risk rating applied to the investment products and the customer's risk profile, full and complete documentation should be retained of the reasons. Endorsement of supervisory staff within the institution should also be sought. The above sales process should be audio-recorded.</p>	<p>HKMA has issued a circular on 9 January 2009 requiring RIs to implement this improvement measure immediately, except audio-recording which should be implemented as soon as possible but no later than end of March 2009.</p> <p>SFC to conduct market / public consultation in Q3 of 2009.</p>
<p>4. A mystery shopper programme to be instituted periodically by the regulatory authorities (as well as by RIs themselves) to test sales processes, and a pilot programme of customer surveys be commissioned to gauge whether such surveys can provide information useful for the examination of specific issues in the context of the longer-term customer relationship.</p>	<p>HKMA has issued a circular on 9 January 2009 requiring RIs to implement internal mystery shopper programme as soon as possible but no later than end of March 2009.</p> <p>HKMA and SFC will jointly develop an external mystery shopper programme in H2 of 2009.</p> <p>Time frame for pilot programme of customer surveys to be worked out by HKMA and SFC.</p>

Improvement Measures	Implementation Plan
<p>5. To place greater focus on remuneration structures for staff engaged in RIs' securities business in the HKMA's on-site examinations and off-site surveillance of RIs' securities business.</p>	<p>HKMA has issued a circular on 9 January 2009 requiring RIs to implement this improvement measure immediately.</p>
<p>6. To examine a pre-sale disclosure requirement for commissions and fees that the intermediary would receive for products being offered or sold.</p>	<p>With input from HKMA on the proposal, SFC to conduct market / public consultation in Q3 of 2009.</p>
<p>7. To determine what changes are appropriate to existing inspection regime in light of findings from the investigations currently underway.</p>	<p>HKMA and SFC have jointly started identifying appropriate changes to existing inspection regime.</p>
<p>8. Intermediaries to conduct a formal self examination of their controls and procedures to ensure that –</p> <ul style="list-style-type: none"> (a) sales staff are trained; (b) products are sold by staff who have a sufficient understanding of the product; (c) they document and provide a copy to each client of the rationale underlying the recommendations or solicitation made to the client; and (d) product due diligence is carried out on a continuous basis. 	<p>Immediate implementation upon SFC's issuance of circular by February 2009.</p>

Improvement Measures	Implementation Plan
9. To explore requiring intermediaries to adopt suitable criteria for characterizing investors to help ensure that investment advice and products offered are suitable for investors.	With input from HKMA on the proposal, SFC to conduct joint market / public consultation in Q3 of 2009.
III Investor Education	
1. To clarify through investor education what is meant by “ SFC authorization of a product ”.	Ongoing.
2. To emphasize the principles underlying the disclosure-based regime, focusing particularly on the responsibilities of investors, intermediaries and regulators in public education campaigns to be launched during 2009.	SFC preparing for immediate implementation. A total of HK\$20m has been earmarked in the SFC budget in 2009-10 for investor education.

Major Improvement Measures	Target Time Frame
3 To (a) revisit whether Hong Kong should retain two public offering regimes for investment products and (b) consider whether the existing exemptions from the requirement for SFC authorisation of offering documents (i.e. the scope of private placement) are too broad.)))))
II Others	
1. To consider the need for a financial ombudsman with statutory powers to order compensation.) Parallel to the Initial Phase, the) Administration, HKMA and SFC have) started conducting research on the review
2. To consider establishing an Investor Education Council .) work to prepare for future market / public) consultations. The review work will take) into account (a) views of various sectors of) the community and LegCo Lehman) Subcommittee; and (b) other relevant) factors. Changes to primary legislation may) be involved.

Financial Services Branch
 Financial Services and the Treasury Bureau
 January 2009