

**Bills Committee on Securities and Futures and Companies Legislation  
(Structured Products Amendment) Bill 2010**

**Regulatory Actions taken by the Hong Kong Monetary Authority on the  
Sale of Unlisted Investment Products by Authorized Institutions**

**Purpose**

At the 16 December 2010 Bills Committee meeting, Members requested the Hong Kong Monetary Authority (“HKMA”) to provide a comparison between the regulatory actions taken by the HKMA on the sale of unlisted investment products by authorized institutions (“AIs”) before and after the Lehman Brothers Minibonds Incident, including details of the number and frequency of on-site examinations, off-site reviews and mystery shopper checking, and the number and rank of officers deployed in the work. This paper responds to Members’ request.

**On-site Examinations and Independent Reviews**

2. Before the Lehman Brothers Minibonds Incident, from 2003 to 2008, on average the HKMA conducted around 28 on-site examinations on AIs’ regulated activities and/or sale of investment products each year.

3. After the Lehman Brothers Minibonds Incident, under the respective settlement agreement between 17 AIs and the HKMA and the Securities and Futures Commission (“SFC”) <sup>1</sup> following the SFC’s investigations of Lehman-related complaint cases, the AIs concerned were required to engage an independent reviewer approved by the regulators to conduct an independent review of their internal controls on the sale of unlisted structured products, and commit to the implementation of all recommendations by the independent reviewer. As the regulators would take into account, among other relevant factors, the results of these independent reviews and the AIs’ implementation of the reviewers’ recommendations in determining whether any disciplinary actions are to be taken in relation to these AIs’ sale of unlisted structured products (other

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<sup>1</sup> These settlement agreements were entered into by the SFC under section 201 of the Securities and Futures Ordinance.

than those products under repurchase offer or payment arrangement to affected customers in accordance with the respective settlement agreement), the HKMA has accorded a high priority to handling these independent reviews. In order to ensure the effectiveness of such reviews, the HKMA performed the following work in close co-ordination with the SFC-

- (a) considered proposals from the AIs concerned on the appointment of independent reviewers and negotiated the terms of reference for such independent reviews in order to ensure that the scope of the reviews adequately covered the relevant systems, controls, policies and procedures;
- (b) maintained regular communications with the independent reviewers to ensure that their review approach (including on-site fieldwork) and procedures were in line with the regulators' expectations;
- (c) monitored the progress of the independent reviews, and discussed the review results and recommendations with the independent reviewers;
- (d) reviewed the independent review reports; and
- (e) followed up with the independent reviewers and the AIs concerned regarding the implementation of the recommendations made in such reports.

4. In addition to the work related to the above independent reviews, the HKMA also performed 14 on-site examinations on AIs' conduct of regulated activities and/or sale of investment products in 2010.

5. The objectives of the on-site examinations are to understand how AIs perform their regulated activities and/or sale of investment products and to ensure AIs' compliance with the relevant regulatory requirements.

## Off-site Work

6. Before the Lehman Brothers Minibonds Incident, the off-site work on AIs' sale of investment products mainly included -

- (a) issuing circulars to enhance the regulatory requirements and/or provide guidance to AIs on the regulatory standards and expected practices;
- (b) analysing the information submitted by all registered institutions ("RI")<sup>2</sup> in the semi-annual "Return of Securities Related Activities" (which provides a general overview of the regulated activities carried out by each RI as well as the trends in the business to enable trend analysis to be conducted);
- (c) reviewing the results of self-assessments performed by large, complex or active RIs (including all the active retail banks) on their compliance with relevant regulatory requirements; and
- (d) following up any deficiencies in the internal controls of AIs that are discovered in on-site examinations or other sources, e.g. AIs' internal reviews.

7. The HKMA has enhanced the off-site surveillance work on AIs' sale of investment products after the Lehman Brothers Minibonds Incident. Particularly, in addition to the above-mentioned off-site work, the HKMA has -

- (a) issued more circulars to enhance the regulatory requirements and/or provide guidance to AIs on the regulatory standards and expected practices. The circulars issued after the Lehman Brothers Minibonds Incident in relation to the sale of unlisted investment products (including currency-linked, interest rate-linked as well as currency and interest rate-linked instruments ("ILCL instruments")) are set out in Table 1 below

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<sup>2</sup> A "registered institution" is an AI which is registered under the Securities and Futures Ordinance to conduct securities or futures intermediary activities.

**Table 1**

<b>Circulars</b>	<b>Date issued</b>
“Selling of Accumulators”	22 December 2010
“Selling of Renminbi Deposit, Investment and Insurance Products”	16 September 2010
“Implementation of Pre-Investment Cooling-off Period for Retail Customers”	20 May 2010
“Selling of Investment Products”	13 July 2009
“Implementation of recommendations in the HKMA’s Report on Issues Concerning the Distribution of Structured Products Connected to Lehman Brothers (“the HKMA’s Report”)”	25 March 2009
“Report of the HKMA on Issues Concerning the Distribution of Structured Products Connected to Lehman Group Companies”	9 January 2009
“Selling of investment products to retail customers”	This circular was initially sent to selected retail banks on 23 October 2008 and then re-issued as a circular on 11 December 2008

- (b) starting 2010, required all retail banks to submit to the HKMA a quarterly survey on sale of investment products. The purpose of this survey is to collect relevant information on the

sale of investment products (including ILCL instruments) to retail banking customers to facilitate the HKMA in conducting off-site monitoring, prioritising supervisory resources, and determining the scope and focus of on-site examinations.

### **Mystery Shopper Programme**

8. In 2010, the HKMA instituted a mystery shopper programme. The HKMA and the SFC have jointly engaged a service provider to undertake the mystery shopping exercise. The objective of the programme is to assist the regulators in understanding the selling practices of intermediaries in respect of unlisted investment products. The exercise assesses the extent to which the regulatory requirements in relation to the practices of intermediaries in selling unlisted investment products to Hong Kong investors are implemented. For the banking sector, the HKMA has included ILCL instruments in the scope as well. The results of the exercise will be used to complement the regulators' policies and regulatory work.

### **Manpower**

9. Immediately before the Lehman Brothers Minibonds Incident in mid-September 2008, the number of staff involved in the HKMA's regulation of AIs' regulated activities<sup>3</sup> was 110, comprising 11 staff in a specialist team dedicated to supervising AIs' regulated activities (the securities supervision team) and 99 general banking supervision staff responsible for the overall supervision of AIs' businesses and prudential matters.

10. To increase regulatory focus on conduct issues and step up the regulation of selling of investment products by AIs, the securities supervision team has been transferred to a specialised division in the Banking Conduct Department ("BCD") since 1 April 2010 as a result of an organisational restructuring within the HKMA. The securities supervision team's headcount has expanded to 28 for supervising AIs' conduct of regulated activities, the sale of investment products not regulated under the Securities and Futures Ordinance ("SFO"), and insurance and Mandatory Provident Funds ("MPF") intermediary activities. With the addition of dedicated resources, the expanded team has stepped up its monitoring

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<sup>3</sup> The number of staff does not include those staff involved in the enforcement function.

of industry development in the sale of investment products (e.g. through analysing the results of the new quarterly survey on sale of investment products among retail banks and the mystery shopper programme) and made more proactive regulatory responses to the industry development (e.g. the HKMA issued circulars of “Implementation of Pre-Investment Cooling-off Period for Retail Customers”, “Selling of Renminbi Deposit, Investment and Insurance Products”, and “Selling of Accumulators” in 2010, and is working with the banking industry on a proposal to distribute Product Key Fact Statements<sup>4</sup> of certain unlisted investment products which are not subject to the SFC’s authorisation regime (including ILCL instruments) to retail customers during the selling process).

11. The division head of the specialised division in BCD supervises both the on-site and off-site supervisory work of the securities supervision team. A breakdown of the remaining 27 staff in the team in terms of internal ranks and their supervisory role is set out in Table 2 below<sup>5</sup> -

**Table 2**

Rank	Number of staff	
	On-site examination sub-team	Off-site surveillance sub-team (which also oversees the mystery shopper programme)
Senior Manager	2	1
Manager	5	4
Assistant Manager	10	5
<b>Total</b>	<b>17</b>	<b>10</b>

<sup>4</sup> Product Key Fact Statements provide concise product summaries written in plain language to help investors understand the key features and risks of investment products.

<sup>5</sup> Within the on-site examination sub-team, one senior manager and one manager are also engaged in off-site surveillance work.

12. In addition, 10 headcount will be added to the specialised division in BCD in 2011 to further enhance its manpower for on-site work and off-site surveillance.

**Hong Kong Monetary Authority**  
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