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**Legislative Council**

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**Panel on Financial Affairs**

**Meeting on 2 November 2009**

**Background Brief on**

**Progress of the Administration's 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 sets out the background of the Administration's action plan on 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. It also summarizes Members' major views and concerns on the action plan expressed at meetings of the Panel on Financial Affairs (FA Panel).

**Background**

2. Shortly after the collapse of Lehman Brothers in September 2008, the Financial Secretary (FS) 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 complaints regarding the Lehman Brothers Minibonds. On 31 December 2008, HKMA and SFC submitted their reports to FS. The Administration then formulated an action plan in consultation with HKMA and SFC for taking forward in phases the various recommendations put forth in the two reports. A table setting out the improvement measures and implementation plan proposed by the Administration in its action plan is in **Appendix**.

3. In the initial phase of the action plan, the Administration has proposed to focus on measures to improve the existing regulatory requirements and better protect investors. Specifically, the Administration aims at early implementation of improvement measures in the sale of investment products; the business conduct of intermediaries; and investor education. As part of the implementation plan for the initial phase of improvement, SFC has undertaken to conduct market/public consultation in the third quarter of 2009 on various measures to improve the sale of investment products and business conduct of intermediaries. In the next phase, the Administration would 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 (Cap. 32) and the Securities and Futures Ordinance (Cap. 571) 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.
4. The Administration has undertaken to conduct research on the review work of the next phase, in parallel to the initial phase, in order to expedite the improvement process.

### **Members' major views and concerns on the Administration's action plan**

5. At the Panel meetings on 2 and 23 February 2009, the Administration, HKMA and SFC briefed the FA Panel the recommendations in the two reports and measures to improve the regulatory requirements in the Administration's action plan. The major views and concerns expressed by Members are summarized in the ensuing paragraphs.

#### Disclosure of product features and risks

6. Given the complexity of the investment products, notably structured financial products with underlying collaterals, some Members expressed concern that ordinary retail investors could hardly understand the product features and risks. The disclosure-based regulatory regime could not provide sufficient protection to investors in this regard, as there was inadequate risk disclosure in the marketing materials. Some Members considered that SFC should perform a gate-keeping role in the authorization of the offer documentation and marketing materials of the investment products to ensure full risk disclosure and that the documentation/marketing materials would not contain misleading information. Disclosure on issuer risk was also inadequate under the current regime. The regulators should be empowered to prohibit the offering of investment products with returns disproportionate to the high risks involved to the investing public, as well as imposing restrictions on the use of gifts as a marketing tool to promote investment products to investors.

7. On the other hand, some Members were of the view that a proper balance should be struck between protection of the investing public and development of the financial market, so that a diversity of investment products would be available for investors to choose and the status of Hong Kong as an international financial centre would not be adversely affected by excessive compliance burden and complicated procedures at the point of sale.

### Business conduct of intermediaries

8. Some Members doubted whether the sales staff possessed sufficient understanding of the investment products and had ensured that the investment advice and products offered were suitable for the investors. The regulators should ensure that the issuers and distributors had given adequate information and explanation to facilitate investors' understanding of the features, risks and returns of the investment products. Distributors should comply with on-going disclosure requirements for making available latest information on the investment products to the investors who have bought the products.

9. Some Members expressed concern about measures to protect the investors when there was a risk mismatch between the risk rating applied to the investment products and the customer's risk appetite. These Members questioned why the requirements for retaining full and complete documentation on the reasons for the risk mismatch and audio-recording of the sale process had not been introduced earlier. Some Members considered that customers should have the right to obtain the audio recording of the sale process and that of the assessment of their risk profile.

10. As the securities business of banks and brokerage firms were regulated by HKMA and SFC respectively, some Members queried about the consistency in the standard of regulation between the two regulators.

### Dispute resolution procedure for complaints against regulated entities and enforcement actions

11. Some Members questioned whether the dereliction of the regulators in the supervision of intermediaries had resulted in the large number of complaints relating to Lehman Brothers Minibonds. These Members expressed much concern about the extensive impact of the Lehman Brothers Minibonds Incident on retail investors in Hong Kong compared with overseas jurisdictions. Noting the slow progress of investigation of complaints and the top-down approach adopted in the investigation, some Member asked whether the involvement of two regulators, i.e. HKMA and SFC, in the investigation process was the cause of the slow progress. Members called on the regulators to allocate more manpower resources for early completion of the investigation and to work out measures to assist the victims of mis-selling to get back their money.

12. Some Members doubted the deterrent effect of the existing enforcement regime in terms of penalties on offences or serious infraction. They opined that the investigation report and findings by SFC on the Sun Hung Kai case should be disclosed to enhance transparency. This could provide illustration of the standard required of the intermediaries and shed light on whether the existing requirements need to be tightened. The Administration should also review the need to empower the regulators to take necessary enforcement actions to effect compensation for the victims, such as through obtaining compensation orders.

## Review of the regulatory framework and measures to enhance investor protection

13. Some Members were of the view that the review of the regulatory framework and measures to enhance investor protection should be undertaken by an independent third party, other than HKMA and SFC which were overseeing the regulation of investment products and the conduct of intermediaries in the sale of these products.

14. Noting that HKMA had issued a circular on 9 January 2009 requiring registered institutions (RIs)<sup>1</sup> to take steps to ensure clearer differentiation between traditional deposit-taking activities and retail securities business, some Members were concerned about the access to information on retail customers' deposit accounts by staff involved in selling of investment products. They considered that clear segregation of RIs' retail securities business and ordinary banking business was necessary for protection of retail investors.

### **Latest developments**

15. As part of the improvement measures under the initial phase of the Administration's action plan, SFC has launched a three-month consultation on proposals to enhance protection for the investing public by releasing a consultation paper on the subject on 25 September 2009. In the information note on its policy initiatives for 2009-2010, the Financial Services and the Treasury Bureau (FSTB) sets out its plans for improving regulatory framework and investor protection. Among the various initiatives, the plans to improve the offering regime for structured products and the proposed establishment of an investor education council and a financial dispute resolution scheme are relevant to the proposals in the action plan. Public consultations on the proposals will be launched by SFC and FSTB later in 2009.

16. At the Council meeting on 21 October 2009, Hon Frederick FUNG asked a question on measures to improve regulation of financial institutions and financial products while Hon Jeffrey LAM asked about the proposed cooling-off period for sale of investment products.

17. The Administration proposes to brief the Panel on the progress of the action plan, including SFC's consultation paper, at the regular meeting of the FA Panel in November 2009.

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<sup>1</sup> Registered Institutions refers to authorized institutions which are registered under the Securities and Futures Ordinance (Cap. 571) to conduct securities intermediaries activities. Under the existing regulatory framework authorized in SFO and Banking Ordinance (Cap. 155), HKMA is the frontline supervisor of registered institutions.

## Relevant papers

18. Relevant papers are available at the following links:

SFC's report entitled "Issues raised by the Lehman Brothers crisis – Report to the Financial Secretary"

[http://www.sfc.hk/sfc/html/EN/whatsnew/review\\_lehman.html](http://www.sfc.hk/sfc/html/EN/whatsnew/review_lehman.html)

HKMA's report entitled "Report of the HKMA on Issues concerning the Distribution of Structured Products Connected to Lehman Group Companies"

<http://www.legco.gov.hk/yr08-09/english/panels/fa/papers/fa0202cb1-552-2-e.pdf>

The Administration's action plan on recommendations in the reports prepared by HKMA and SFC on the Lehman Brothers Minibonds Incident

<http://www.legco.gov.hk/yr08-09/english/panels/fa/papers/fa0202cb1-678-3-e.pdf>

Information note on regulation of the sale of retail structured financial products in selected places prepared by the Research and Library Services Division of the Legislative Council Secretariat

<http://www.legco.gov.hk/yr08-09/english/sec/library/0809in06-e.pdf>

Minutes of FA Panel meeting on 2 February 2009 (verbatim record in Appendix to the minutes)

<http://www.legco.gov.hk/yr08-09/english/panels/fa/minutes/fa20090202.pdf>

SFC's response to members' request at the meeting on 2 February 2009

<http://www.legco.gov.hk/yr08-09/english/panels/fa/papers/fa0223cb1-837-2-e.pdf>

Report on "The Structure of Financial Supervision: Approaches and Challenges in a Global Marketplace" published by the Group of Thirty in October 2008

<http://www.legco.gov.hk/yr08-09/english/panels/fa/papers/fa0223cb1-837-3-e.pdf>

Minutes of FA Panel meeting on 23 February 2009 (verbatim record in Appendix to the minutes)

<http://www.legco.gov.hk/yr08-09/english/panels/fa/minutes/fa20090223.pdf>

SFC's "Consultation paper on proposals to enhance protection for the investing public"

<http://www.sfc.hk/sfc/html/EN/speeches/consult/InvestingPublic.html>

Administration's paper on policy initiatives of the Financial Services and the Treasury Bureau"

<http://www.legco.gov.hk/yr09-10/english/panels/fa/papers/fa1022cb1-31-1-e.pdf>

Hon Frederick FUNG's question on measures to improve regulation of financial institutions and financial products

<http://www.info.gov.hk/gia/general/200910/21/P200910210163.htm>

Hon Jeffrey LAM's question on the proposed cooling-off period for sale of investment products

<http://www.info.gov.hk/gia/general/200910/21/P200910210173.htm>

Council Business Division 1  
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**Action Plan on Recommendations in the  
Reports prepared by HKMA and SFC on  
the Lehman Brothers Minibonds Incident**

**Initial Phase**

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

<sup>1</sup> 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 <b>restrictions on the use of gifts</b> as a marketing tool to promote investment products to investors.	) ) )
6. To consider the feasibility of a “ <b>cooling-off</b> ” 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 <b>Professional Investors</b> .	) public consultation in Q3 of 2009. )
8. To explore requiring client agreements to allow clients to have their grievances resolved by a <b>dispute resolution procedure</b> .	) ) ) )
<b>II Business Conduct of Intermediaries</b>	
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 <b>risk profile</b> and asked to confirm his agreement that it is accurate; and (c) mandatory requirements to <b>audio tape</b> 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 <b>requirement to audio-record the sales process</b> .	) )

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, <b>full and complete documentation</b> should be retained of the reasons. Endorsement of supervisory staff within the institution should also be sought. The above sales process should be <b>audio-recorded</b>.</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 <b>mystery shopper programme</b> 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"> <li>(a) sales staff are trained;</li> <li>(b) products are sold by staff who have a sufficient understanding of the product;</li> <li>(c) they document and provide a copy to each client of the rationale underlying the recommendations or solicitation made to the client; and</li> <li>(d) product due diligence is carried out on a continuous basis.</li> </ul>	<p>Immediate implementation upon SFC's issuance of circular by February 2009.</p>

<b>Improvement Measures</b>	<b>Implementation Plan</b>
9. To explore requiring intermediaries to <b>adopt suitable criteria</b> 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.
<b>III Investor Education</b>	
1. To clarify through investor education what is meant by “ <b>SFC authorization of a product</b> ”.	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 <b>retain two public offering regimes</b> 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.	) ) ) ) )
<b>II Others</b>	
1. To consider the need for a <b>financial ombudsman</b> 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 <b>Investor Education Council</b> .	) 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  
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