

立法會
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Panel on Financial Affairs

Minutes of special meeting
held on Monday, 23 May 2011 at 9:00 am
in Conference Room A of the Legislative Council Building

- Members present :** Hon CHAN Kam-lam, SBS, JP (Chairman)
Hon CHAN Kin-por, JP (Deputy Chairman)
Hon Albert HO Chun-yan
Ir Dr Hon Raymond HO Chung-tai, SBS, S.B.St.J., JP
Hon James TO Kun-sun
Hon Emily LAU Wai-hing, JP
Hon Vincent FANG kang, SBS, JP
Hon LEE Wing-tat
Hon Jeffrey LAM Kin-fung, SBS, JP
Hon WONG Ting-kwong, BBS, JP
Hon Ronny TONG Ka-wah, SC
Hon KAM Nai-wai, MH
Hon Starry LEE Wai-king, JP
Hon Paul CHAN Mo-po, MH, JP
Hon Mrs Regina IP LAU Suk-ye, GBS, JP
- Members attending:** Hon WONG Kwok-hing, MH
Hon LEUNG Kwok-hung
- Members absent :** Dr Hon David LI Kwok-po, GBM, GBS, JP
Dr Hon Philip WONG Yu-hong, GBS
Hon Abraham SHEK Lai-him, SBS, JP
Hon Andrew LEUNG Kwan-yuen, GBS, JP
Hon CHIM Pui-chung
Dr Hon LAM Tai-fai, BBS, JP

Public officers attending : Agenda item I

Mr Norman CHAN, SBS, JP
Chief Executive
Hong Kong Monetary Authority

Mr Peter PANG, JP
Deputy Chief Executive (Development)
Hong Kong Monetary Authority

Mr Eddie YUE, JP
Deputy Chief Executive (Monetary)
Hong Kong Monetary Authority

Mr Arthur YUEN, JP
Deputy Chief Executive (Banking)
Hong Kong Monetary Authority

Mr Howard LEE
Executive Director (Corporate Services)
Hong Kong Monetary Authority

Agenda item II

Mr Anthony LI
Principal Assistant Secretary for Financial Services
and the Treasury (Financial Services)

Attendance by invitation : Agenda item II

Mr Charles GRIEVE
Senior Director of Corporate Finance Division
Securities and Futures Commission

Mr Mark DICKENS
Head of Listing Division
Hong Kong Exchanges and Clearing Limited

Mr Wayne WONG
Vice President, Listing Division
Hong Kong Exchanges and Clearing Limited

Clerk in attendance : Ms Anita SIT
Chief Council Secretary (1)5

Staff in attendance : Mr Timothy TSO
Assistant Legal Adviser 2

Mr Noel SUNG
Senior Council Secretary (1)5

Ms Haley CHEUNG
Legislative Assistant (1)5

Action

I Briefing on the work of Hong Kong Monetary Authority

(LC Paper No. CB(1)2200/10-11(01) — Paper provided by the Hong Kong Monetary Authority)

Presentation

At the invitation of the Chairman, the Chief Executive, Hong Kong Monetary Authority (CE/HKMA), the Deputy Chief Executive (Development)/HKMA (DCE(D)/HKMA), the Deputy Chief Executive (Banking)/HKMA (DCE(B)/HKMA) and the Deputy Chief Executive (Monetary)/HKMA (DCE(M)/HKMA) gave a Powerpoint presentation on the work of the HKMA, covering assessment of risk to Hong Kong's financial stability, developments of Renminbi (RMB) business in Hong Kong, banking supervision and investment return of the Exchange Fund in the first quarter of 2011.

(Post-meeting note: The notes of the Powerpoint presentation LC Paper No. CB(1)2258/10-11(01) were issued to members via Lotus Notes e-mail on 23 May (Chinese version) and 3 June 2011 (English version).)

Discussion

Property market

2. Given the heated local property market, the measures taken by the Mainland authorities to suppress the Mainland property market and the appreciation of RMB, Mr WONG Kwok-hing expressed concern about the formation of a property market bubble in Hong Kong and the influx of capital from the Mainland to the local property market. Mr WONG enquired whether HKMA had undertaken any study on the impact of the influx of capital from the

Mainland on Hong Kong's property market. Mr WONG also enquired about HKMA's assessment of the trend of the interest rates for property mortgage loans in Hong Kong.

3. CE/HKMA responded that policies relating to the property market including the supply of land and public housing fell under the purview of the relevant Government bureaux. HKMA's work in relation to the local property market was premised on its statutory functions of, among others, maintaining the monetary and banking stability. Since October 2009, HKMA had introduced three rounds of prudential measures on banks' mortgage business, aiming at dampening the cyclical effects of the property market and upholding the stability of the banking sector. Hong Kong was a free and open economy allowing free flow of capital and HKMA therefore did not maintain data on the amount of capital from the Mainland invested in the local property market.

4. Ms Starry LEE remarked that while HKMA had the responsibility to maintain the stability of the banking and financial sectors, as part of the Administration, there were a number of measures HKMA could take to help counteract the overheated property market. Ms LEE enquired whether HKMA would consider issuing guidelines to banks setting limitations on the credit ratios for different types of economic activities, and/or for short, medium and long term loans.

5. CE/HKMA responded that the measures introduced by HKMA such as the imposition of maximum loan-to-value ratios for residential properties of different values and maximum debt-servicing ratio, and the requirement for banks to conduct stress tests for mortgage loan applicants focused on the risk management of banks. They were necessary to maintain the stability of the banking sector. HKMA would continue to ensure that credit growth would not be excessive, as it might result in higher risk of a property market bubble. HKMA was aware that any measures to lower the maximum loan-to-value ratios for mortgage loans might have an impact on genuine and/or first time home buyers, since the tightening up of banks' mortgage loan policy might reduce the amount of bank credit available to the mortgage loan applicants.

6. Mr LEE Wing-tat remarked that there had been indications of a property market bubble having been formed, e.g. property prices had risen by about 6 to 7% in the first quarter of 2011 and had already exceeded the 1997 level, and the affordability ratio of residential unit buyers had reached nearly 50% of their incomes. Mr LEE enquired whether HKMA had conducted any study on separation of the property market for local and overseas buyers. For instance, the Australian government had imposed restrictions on foreigners buying apartments in urban areas or re-sale of such flats to non-Australian residents. Mr LEE also enquired whether considerations would be given to introducing

different maximum loan-to-value ratios for mortgage loans granted to non-Hong Kong residents or mortgage loans granted to local residents who were not purchasing the residential unit for their own use.

7. CE/HKMA responded that whether there should be separate treatments for local and non-Hong Kong residents on purchase of property was a policy decision for the Government, and was outside the purview of the HKMA. The lowering of the maximum loan-to-value ratios for mortgage loans would help the banks manage their risks. In granting mortgage loans, banks had to comply with the maximum debt-servicing-ratio set by HKMA. HKMA regularly reminded banks on the importance of prudent risk management, especially in ascertaining the borrowers' income and repayment ability.

8. Mr Ronny TONG asked for information on the estimated amounts of RMB invested in the property market and securities in Hong Kong, and whether HKMA had taken any measure to prevent/combat money-laundering activities involving the use of RMB to purchase properties in Hong Kong, CE/HKMA agreed to find out whether the HKMA could provide the relevant information to the Panel.

9. Mr Paul CHAN requested that in order to assess the property market situation in respect of residential units of different sizes, HKMA should provide quantitative information (in tabular form) on residential mortgage lending for individuals and companies in respect of different flat sizes, with details on (a) the loan-to-value ratios and (b) the periods when mortgages were redeemed prematurely.

(Post-meeting note: The information provided by HKMA was circulated to members vide LC Paper No. CB(1)2488/10-11(01) on 16 June 2011.)

Interest rates for mortgage loans

10. Pointing out that the interest rates for mortgage loans made in 1997 were usually set at levels above the prime rates, whereas currently the interest rates for mortgage loans were usually fixed at levels lower than the prime rates, the Deputy Chairman enquired about the reasons for such a change, and whether HKMA had assessed the impact on the borrowers if the interest rates for mortgage loans reverted to levels above the prime rates.

11. CE/HKMA responded that the interest levels for mortgage loans were set by market forces. Before 1997 the property market was very active, leading to strong demand for mortgage lending and high interest rates for mortgage loans. After the burst of the property market bubble in 1997, and as a result of

other factors such as market competition for mortgage loan business and decrease in demand for residential properties, interest rates for mortgage loans trended downwards. As the demand for credit soared recently, the interest rates for new mortgage loans had risen again. The present low interest rate environment would not last forever, and the interest rate risk now was much higher than that in 1997.

Positive mortgage data sharing

12. Given that the percentage of bank customers giving consent for sharing data of their pre-existing mortgages had been low, Mr KAM Nai-wai expressed concern about the effectiveness of the positive mortgage data sharing scheme.

13. DCE(B)/HKMA responded that Authorized Institutions (AIs) had been sending out letters to their existing mortgage customers to seek their prescribed consent for the uploading of their pre-existing mortgage data to the credit reference agency – so far about 5% of the customers had provided consent. DCE(B)/HKMA pointed out that all new applicants for mortgage loans were required to make declarations in relation to their pre-existing mortgages and to give consent for a comprehensive checking on their existing mortgage loan data to be conducted. As such, the relevant database would be built up over time.

Re-mortgage loans for Sandwich Class Housing Scheme

14. Mr Ronny TONG was concerned that banks were reluctant to provide re-mortgage loans to owners of residential units under the Sandwich Class Housing Scheme. Mr TONG requested that HKMA should provide information on the reasons for banks refusing to provide such re-mortgage loans, and the relevant guidelines issued by HKMA to banks, if any.

(Post-meeting note: The information provided by HKMA was issued to members vide LC Paper No. CB(1)2488/10-11(01) on 16 June 2011.)

Credit growth

15. Noting that US dollar and Hong Kong dollar bank loans had grown by 68.2% and 17.6% respectively, Mr Vincent FANG enquired about the reasons for the significant growth in US dollar loans.

16. CE/HKMA responded that the demand for US dollar credit loans from Mainland enterprises was high in the past year and the growth was expected to continue in this year, as the interest rates for US dollar loans in Hong Kong were lower than those in the Mainland. The HKMA would continue to remind the banks the importance of prudent risk management in granting loans.

17. Mr LEUNG Kwok-hung enquired whether HKMA had maintained any information in respect of Mainland enterprises investing in Hong Kong's property market.

18. CE/HKMA responded that the loans granted to Mainland enterprises mainly involved US dollars for investment in overseas projects rather than investment in the Hong Kong property market. DCE(B)/HKMA supplemented that since it would be difficult for the banks to verify the income proof of overseas buyers, the mortgage loans granted to overseas buyers were usually granted based on the value of the property. DCE(B)/HKMA pointed out that about 10% of mortgage loans approved last year were granted on the basis of the net worth of the borrowers.

19. Mr Ronny TONG expressed concern that many middle class and young people had been trapped in debts in using their credit cards, and banks charged relatively high interest on the outstanding balances of credit card accounts. Mr TONG enquired whether HKMA had issued any guidelines to banks to prevent indiscriminate issue of credit cards.

20. DCE(B)/HKMA responded that there had not been a marked increase in the rollover balances of credit cards recently. The credit growth in banks was mainly related to US dollar loans. HKMA had issued guidelines to Authorized Institutions (AIs) regarding prudent risk management on granting of loans. AIs would check the shared positive credit data of their clients in assessing applications for non-securitized loans. In response to Mr TONG's request, DCE(B)/HKMA undertook to provide information on the trend of rollover balances of credit cards and the extent to which the credit growth of the banking sector was attributed to the growth of rollover balances of credit cards.

(Post-meeting note: HKMA's response was issued to members vide LC Paper No. CB(1)2488/10-11(01) on 16 June 2011.)

Inflation

21. Noting that the food and energy components were excluded from the US Core Consumer Price Index (CPI) (slide No. 11 of HKMA's Powerpoint presentation), Mr Albert HO enquired whether the Headline CPI in Hong Kong would be extremely volatile if the food and energy components were also included. Mr HO further enquired whether the Government could, through monetary and credit measures, suppress the price increases of food and fuel in order to alleviate the inflation pressure on the community.

22. CE/HKMA responded that different jurisdictions used different criteria to define and assess CPI. The rises in food and fuel prices would gradually and eventually affect, through the transmission mechanism, the Core CPI. From a

currency policy angle, the US government did not consider that increases in interest rates would contain the increase in food and fuel prices effectively. CE/HKMA pointed out that the rental component constituted about 30% of the Core and Headline CPIs in Hong Kong. Since an increase in property prices would unavoidably lead to higher rentals, measures to slow down the cyclical effects on property prices would help relieve the inflationary pressure on the rental level. CE/HKMA remarked that HKMA was not in a position to implement measures to contain inflation in general.

23. Mr LEUNG Kwok-hung enquired whether HKMA had made an assessment on the impact of increased rentals on the operating costs of enterprises.

24. CE/HKMA responded that property prices and rentals were closely related. When property prices soared, rentals would rise. Enterprises had to find ways to address the challenge of rising rentals.

Development of Renminbi business in Hong Kong

25. Noting that the amount of RMB deposits in Hong Kong had reached RMB451.4 billion by the end of March 2011, Mr Vincent FANG enquired whether the amount would continue to rise to RMB800 billion by the end of 2011.

26. DCE(D)/HKMA responded that the increase of RMB deposits was mainly a result of the net inflow of RMB from trade settlements and currency conversion to RMB by individual depositors. While it was difficult to estimate the total amount of RMB deposits as at end of 2011, the growth of RMB deposits was expected to continue steadily.

Warning system for financial crisis

27. Given that the international regulatory bodies had discussed at different forums about ways to enhance global financial stability after the outbreak of the global financial crisis in 2008, Ir Dr Raymond HO enquired whether a fore-warning system had been devised by the international community against the emergence of future global financial crises.

28. CE/HKMA responded that after the recent global financial crisis, international financial organizations such as the Financial Stability Board, the International Monetary Fund, the Basel Committee on Banking Supervision, and the regulatory bodies of different jurisdictions including Hong Kong had implemented measures to reform the financial regulatory regimes, including putting in place a warning system against serious financial crises. So far the focus had been placed on the financial regulatory regimes in major developed

financial markets, such as those in the US and Europe.

Economic situation in Japan

29. Ir Dr Raymond HO enquired about the economic impact of the recent natural disaster and nuclear incident in Japan on Hong Kong, such as imports and exports, the property market, the retail sector and the tourism industry.

30. CE/HKMA responded that the recent natural disaster and nuclear incident in Japan would inevitably have short-term effect on the business activities between Hong Kong and Japan. Given the resilience of the Japanese economy, the business activities between Hong Kong and Japan would probably be restored to the previous level by the end of this year or early next year.

Lehman Brothers Minibonds Incident

31. Mr KAM Nai-wai expressed concern that, despite the settlements reached between the banks and investors of Lehman Brothers related structured products, the outcome of the investigations into some 2 000 complaints relating to the Lehman Brothers Minibonds Incident had yet to be concluded. Mr KAM enquired how HKMA would monitor the repurchase arrangements for Lehman Brothers related structured products.

32. DCE(B)/HKMA responded that HKMA had completed the investigation into the great majority of the complaint cases related to the Lehman Brothers Minibonds Incident by March 2010, and proceeded to pursue disciplinary actions in the substantiated cases. The parties involved were entitled to have sufficient time to respond to HKMA's proposed disciplinary actions according to the established rules and statutory procedures. Announcements of the outcome of the investigations would only be made when all the necessary procedures had been completed. DCE(B)/HKMA added that the receivers of certain series of the Lehman Brothers Minibonds had been requested to expedite the recovery of the collaterals and payments to the holders of the relevant Minibonds.

Linked Exchange Rate System

33. Given the increase in the circulation of and deposits in RMB in Hong Kong, the Deputy Chairman enquired whether the Administration had assessed the risk of the Hong Kong dollar being marginalized or even replaced by RMB in Hong Kong, and whether the Administration would consider ways to prevent such a change. The Deputy Chairman further enquired whether the

Administration had considered pegging the Hong Kong dollar with RMB under the Linked Exchange Rate system.

34. CE/HKMA pointed out that two-thirds of the RMB450 billion deposits in Hong Kong came from trade activities between local or overseas enterprises and their Mainland counterparts. Hong Kong residents could also have converted some of their foreign currency deposits to RMB. It would be inaccurate and exaggerating to suggest that the Hong Kong dollar would be substituted by RMB. A local currency could only be considered being substituted by a foreign currency if local residents had lost confidence in their own currency and used a foreign currency for daily transactions. There was no sign whatsoever in Hong Kong that Hong Kong residents had lost confidence in the Hong Kong dollar. The increase in RMB deposits was a sign of Hong Kong being successful in developing itself into a major off-shore RMB centre.

II Policy issues relating to suspension of trading and subsequent buyback of four derivative warrants linked to the Nikkei 225 Index issued by Goldman Sachs Structured Products (Asia) Limited

(LC Paper No. CB(1)2104/10-11(01) — Letter dated 5 May 2011 from Hon James TO Kun-sun (Chinese version only)

LC Paper No. CB(1)2248/10-11(01) — Paper provided by the Administration

LC Paper No. CB(1)2234/10-11 — Background brief on regulation of derivative warrants market prepared by the Legislative Council Secretariat)

Meeting procedures

35. Mr James TO said that the Chairman had twice turned down the requests from 高盛烏輪關注組 (hereafter referred to as the "Concern Group") to attend the Panel meeting to present their case in the incident. Given that the Concern Group wished to present information relating to the incident which was not covered in the Administration paper, Mr TO requested the Chairman to allow the Concern Group to brief members on their situation in the incident so as to facilitate the Panel's discussion of the relevant issues.

36. The Chairman said that he considered it not appropriate to accede to the Concern Group's request for attending this Panel meeting. He understood that

the Concern Group had already lodged a complaint about the incident with the Complaints Division of the Legislative Council Secretariat, and arrangement was being made for representatives of the Concern Group to meet with Legislative Council Members, and adequate time would be given to the Concern Group to present their case to the Legislative Council Members.

37. Mr James TO asked whether the Chairman would consider arranging the Deputy Chairman to take over the chairmanship for this item in order to avoid a conflict of interest, as the Chairman was a non-executive director of the Securities and Futures Commission (SFC), and the subject under discussion involved accusations against the SFC. Moreover, the Chairman had not allowed the Group to present their case at the meeting.

38. The Chairman said that he did not accept that a conflict of interest situation existed, and reiterated that the Complaints Division had been dealing with the complaint lodged by the Concern Group. The Chairman said he would conduct the meeting according to the Rules of Procedure.

39. Mr James TO said that he wished to move a motion requesting the Deputy Chairman to take over the chairmanship for this item. Mr KAM Nai-wai said he would second the motion. Mr KAM said that based on the Rules of Procedure and House Rules, a motion moved by a member of the Panel should be dealt with by the Panel. The Chairman responded that a motion which was unrelated to the item under discussion would not be dealt with by the Panel.

40. Mr James TO and Mr KAM Nai-wai requested the Assistant Legal Adviser 2 (ALA2) to advise on the relevant rules/procedure. At the invitation of the Chairman, ALA2 advised that according to Rule 83A of the Rules of Procedure, a Member should not move any motion or amendment relating to a matter in which he had a pecuniary interest, whether direct or indirect, or speak on any such matter, except where he disclosed the nature of that interest. Rule 84 of the Rules of Procedure covered voting or withdrawal by a Member upon any question in which the Member had a direct pecuniary interest. In the past, there were cases where the chairman of a Panel/committee had on his/her own volition chosen not to chair a meeting in view of possible perceived conflict of interest. As far as the Rules of Procedure were concerned, there was not any rule prohibiting the chairman of a committee from chairing a meeting on grounds of conflict of interest.

41. Mr LEUNG Kwok-hung asked whether the Chairman considered that, as a non-executive director of SFC, there was a conflict of interest for him to chair the meeting for discussion of the incident.

42. The Chairman remarked that there was no conflict of interest for him to chair the meeting for discussion of issues relating to the incident, and he had declared that he was a non-executive director of SFC.

43. The Principal Assistant Secretary for Financial Services and the Treasury (Financial Services) (PAS(FS)) and the Head of Listing Division, Hong Kong Exchanges and Clearing Limited (H(L)/HKEx) briefed members on the listing and regulation of listed structured products under the Listing Rules, the suspension of trading of four derivative warrants linked to the Nikkei 225 Index issued by Goldman Sachs Structured Products (Asia) Limited (GS) on 31 March 2011 and subsequent buyback thereof, by highlighting the salient points in the paper.

Discussion

44. Mr James TO said that he had to reprimand the Chairman for being in a conflict of interest position and disallowing the victims concerned to provide supplementary information on the incident to facilitate members' discussion of the item. Mr TO demanded to put on record that he had made a reprimand on the Chairman.

45. The Chairman remarked that Mr James TO, in repeating similar remarks, was distracting the Panel from the discussion of the agenda item, and there should be sufficient justifications if Mr TO wanted to reprimand him as the Chairman. The Chairman said that he would not accept such a reprimand. The Chairman reiterated that he was not in a conflict of interest position in chairing the meeting. The Chairman said that in keeping on arguing the conflict of interest issue, Mr James TO was doing injustice to the Chairman and other members.

46. Mr James TO remarked that members were discussing the responsibilities of the SFC, including that of the Chairman as a non-executive director of SFC, the HKEx and the Government in the incident. Mr TO opined that as the Chairman was a non-executive director of SFC, he would be in a conflict of interest situation if he continued to chair the meeting. Given that the Government had indicated that the error in the listing documents of the relevant warrants was very obvious, Mr TO remarked that SFC and HKEx, which charged a fee for authorizing the listing of the warrants, should be held accountable for the errors made in the listing documents. Mr TO queried how SFC and HKEx could overlook the mistakes. Mr TO was concerned that if an issuer could unilaterally modify the terms and conditions in the listing documents of a derivative warrant, and HKEx and SFC allowed such modifications, the interests of investors would not be protected. Mr TO pointed out that paragraph 25 of the HKEx's paper clearly stated that modifications to

the terms and conditions should be approved by the Stock Exchange of Hong Kong. Mr TO remarked that many market participants, including former executive directors of SFC and HKEx, had expressed concern about protection of investors' interests if the issuers of derivative warrants were allowed to modify the terms and conditions at any time. Many market participants opined that the issues relating to the GS warrant incident should be reviewed so as to ensure that the Hong Kong stock market operated in a fair and orderly manner. Mr TO pointed out that for some investors who bought the warrants concerned, the prices of the warrants were twice their purchase prices on 31 March 2011 before the trading of the warrants was suspended. After the suspension of trading, the warrants would not have any market value and Goldman Sachs made a buyback offer of just 10 % over the purchase prices of the warrants. Mr TO was disappointed that the HKEx would consider such a mean offer fair and reasonable. If such an arrangement was accepted, investors would lose their confidence in Hong Kong's stock market. Mr TO reiterated that the Concern Group should be allowed to present their cases to provide the Panel with a clear picture of the incident.

47. Mr LEUNG Kwok-hung remarked that ALA2's advice was that there was no provision in the Rules of Procedure governing the situation where the chairing of a meeting by a Member might give rise to conflict of interest. Mr LEUNG opined that if the Chairman who might have a perceived conflict of interest in the incident would withdraw from chairing the meeting, it would facilitate discussion of the agenda item.

48. The Chairman said that he was not involved in any conflict of interest in the incident and he would continue to chair the meeting.

49. Mr LEUNG Kwok-hung opined that given that SFC and HKEx were vested with the functions and powers to protect the interests of investors and authorize the issue of listed structured products, SFC and HKEx were evading their responsibilities when they took the stance that the investors who were not satisfied with the buyback offer provided by GS should seek redress from the court. Mr LEUNG asked whether SFC and HKEx would provide financial support to the investors concerned to take litigation actions against GS. Mr LEUNG remarked that SFC had the powers to impose sanctions on GS and yet it had done so little to protect the interests of investors. Mr LEUNG queried whether any SFC staff members were former employees of GS or were planning to join GS. Mr LEUNG was dissatisfied that the issuers of structured products were permitted to alter the terms and conditions of the agreements for sale of structured products, which would not be allowed in any other kinds of business.

50. Mr KAM Nai-wai queried why the Chairman did not request SFC to provide a paper on the issue.

51. The Chairman said that the Clerk to the Panel had written to the Administration requesting it to co-ordinate with the parties concerned to provide a consolidated paper to the Panel for discussion of the issue. PAS(FS) pointed out that as indicated in paragraph 3 of the paper, SFC had reviewed the paper prepared by HKEx and SFC's comments had been incorporated into the paper.

52. Mr KAM Nai-wai enquired, given that SFC and HKEx authorized the issue of the structured products concerned, and allowed GS to change the terms and conditions of the listing documents, whether SFC and/or HKEx would shoulder the responsibility of compensating the investors.

53. H(L)/HKEx responded that the amendment clause was commonly used in the listing documents of structured products in Hong Kong and overseas markets, and it was the first time the clause had been invoked in Hong Kong in more than 20 years, despite the fact that over 14,000 structured products were issued each year. The legal advice given to HKEx was that GS was entitled to make the amendment to the listing documents of the derivative warrants. As far as compensation was concerned, HKEx had offered GS general guidance on the principles it believed GS should follow in formulating a compensation proposal to warrant holders in the interest of maintaining confidence in a fair and orderly warrant market, including allowing freedom for an individual to pursue any legal claims that they might consider they had against the issuer if their warrants expired in-the-money, and giving warrant holders sufficient time to consider GS's proposals. H(L)/HKEx stressed that the buyback arrangements were GS's proposals, and HKEx had not endorsed the arrangements. GS decided the payment amounts, and was concerned that there might be institutional investors among the parties affected. If investors were dissatisfied with GS's proposals, GS might have to modify the proposals. The Stock Exchange of Hong Kong would not rule whether the proposals were adequate.

54. Noting H(L)/HKEx's advice that the amendment clause had been included in the listing documents for all derivative warrants and other structured products in line with international practice in the past 20 years, the Deputy Chairman enquired how, as an international financial centre, Hong Kong could strike a balance between protecting the interests of investors and the contractual rights of issuers. The Deputy Chairman pointed out that the purchase contracts for derivative warrants were entered into based on mutual agreement, and did not require endorsement by the Stock Exchange of Hong Kong or SFC.

55. PAS(FS) concurred that a balance had to be struck between smooth operation of the stock market and protection of investors. PAS(FS) said that the crux of the issue was whether the error in the formulae for the Cash Settlement Amount of the derivative warrants concerned was an obvious error which could be amended by the issuer. Based on the legal advice obtained by the Stock Exchange of Hong Kong and the issuers, the error in the formulae was an obvious error. It had no relevance to the existing arrangements for regulation of the listing and trading of derivative warrants.

56. The Deputy Chairman pointed out that as a result of the error made by GS, the trading of the relevant derivative warrants had to be suspended. The Deputy Chairman enquired about the role of the Government in assessing whether the buyback offer made by GS was reasonable or not.

57. PAS(FS) responded that the Stock Exchange of Hong Kong had offered GS general guidance on the principles it believed GS should follow in formulating a compensation proposal to warrant holders in the interest of maintaining confidence in a fair and orderly warrant market. Whether the buyback proposals made by GS was reasonable and acceptable would be a matter for the investors to decide.

58. Noting the rapid upsurge of the number of bull and bear contracts, and derivative warrants contracts authorized to be listed in the Hong Kong stock market, Ms Starry LEE expressed concern that the Stock Exchange of Hong Kong was in a conflict of interest situation as it would earn more income in allowing more derivative products to be listed in the Hong Kong stock market, and yet it was responsible for authorization of the listing and regulation of the trading of the products.

59. PAS(FS) responded that in authorizing the listing of derivative structured products in the Hong Kong stock market, the Stock Exchange of Hong Kong had to ensure that the listing of the products was in compliance with the relevant Listing Rules authorized by SFC under the Securities and Futures Ordinance (Cap. 571) (SFO), including the requirements in Listing Rule 15A which covered provision of the information of the issuers, the disclosure requirements etc. In addition, all the fees charged by the Stock Exchange of Hong Kong had to be approved by SFC. PAS(FS) stressed that the existing arrangements for authorization of the listing of structured products and regulation of the trading of the products were in line with international practices, and there was no conflict of interest for the Stock Exchange of Hong Kong to authorize the issue of the products, and regulate the trading of the products. The Senior Director of the Corporate Finance Division, SFC (SD(CF)/SFC) supplemented that there were different arrangements in different jurisdictions for authorization of the listing of structured products. In

places where a lot of structured products were listed in the stock exchange each year, such as Germany, individual approval for issue of each derivative warrant was not required. The stock exchange in Germany only processed the listing of derivative warrants rather than authorizing the listing of the products.

60. Ms Starry LEE requested the Administration to provide information on the practices of overseas jurisdictions on the regulation of listed structured products, e.g. whether the same body was responsible for approving the listing and regulating the trading of listed structured products, and to address the issue of whether the present arrangement that the Stock Exchange of Hong Kong was responsible for approving the listing and regulating the trading of listed structured products would give rise to a conflict of interest.

(Post-meeting note: The information provided by HKMA was circulated to members vide LC Paper No. CB(1)2501/10-11(01) on 16 June 2011.)

61. The Chairman said that given that HKEx had authorized the issue of the derivative warrants concerned, market participants would consider that the error in the formulae for Cash Settlement Amount was unforgivable. Any alteration of the terms and conditions of the listing documents after the warrants had been traded in the market was inappropriate. The investors concerned should be compensated for any loss resulting from the error. The regulatory bodies should also consider whether sanctions should be imposed on the issuer regarding the error. The Chairman enquired whether HKEx was aware of the number of transactions on the warrants concerned on 31 March 2011, and the number of investors who had accepted the buyback offer of GS. The Chairman was of the view that if the trading of the relevant warrants was suspended earlier, the impact of the incident on the investors would be reduced.

62. H(L)/HKEx responded that 106 transactions of the four derivative warrants concerned were recorded on 31 March 2011, involving 38 investors. As the case might be heard by the Listing Committee of HKEx, he had to be cautious about his comments on the case at the meeting. H(L)/HKEx said that a number of issues had to be considered in dealing with the incident, namely the making of the error in the formulae for Cash Settlement Amount, the delay in correcting the error, the fact that GS had not acted earlier until the relevant derivative warrants had been traded in the market for more than an hour, the need to uphold the integrity of the market and restore the confidence of investors, the adequacy of the compensation arrangements, and adequacy of communications with the investors. H(L)/HKEx pointed out that while disciplinary actions might be considered in relation to the incident, HKEx would take time to impose any disciplinary actions as it did not have investigation power and would need to rely on voluntary co-operation. H(L)/HKEx remarked that one of the sanctions that could be considered by the

Disciplinary Committee would be to deny GS the facilities of the market, and GS might be banned from issuing any warrants for a period of time or for good. Before disciplinary actions were considered, during the interim period assessment would be made as to whether GS was suitable for issuing any warrant, taking into account whether GS had an effective mechanism in the documentation for issuance of derivative warrants, identification of unusual trading of derivative warrants, communication with the HKEx and the investors, etc. Pending the outcome of GS's compensation proposals, assessment of the suitability of GS for issuance of derivative warrants would be undertaken.

63. Noting that GS had extended the deadline for acceptance of its buyback proposals to 27 May 2011, the Chairman remarked that the relevant Government bureau and organizations should help to co-ordinate the arrangements between GS and the investors. Pointing out that the Panel's discussion would focus on the policy for regulation of the issue and trading of derivative warrants, rather than on individual incidents, the Chairman said that the Government and the regulatory bodies concerned should regularly review and further improve the relevant arrangements, in view of the growing volume of derivative warrants listed and traded in the local stock market.

Motion moved by Mr James TO

64. Mr James TO pointed out that investors would not normally hold the derivative warrants until the cash settlement deadline and the value of the warrants would change over time. Mr TO opined that GS's offer of buying back the warrants at the higher of 110% of a holder's acquisition cost and 110% of the offer price was unreasonable. Mr TO remarked that if the issuer was allowed to change the terms and conditions of the Warrant Instruments after the warrants were listed, the interests of the investors would not be protected. Mr TO moved the following motion, which was seconded by Mr KAM Nai-wai.

"本事務委員會不滿政府、證監會和港交所到現時為止的處理方法。本事務委員會要求上述機構與相關發行人繼續商討合理與公平的解決方案。"

(Translation)

That this Panel is not satisfied with the way in which the Government, SFC and HKEx have handled the matter so far, and requests the above authorities to continue the discussion with the relevant issuer for a reasonable and fair resolution.

65. In view that the Panel did not have a quorum at the material time, the Chairman requested the Clerk to ring the voting bell. Given that the bell had been rung for two minutes, and a quorum was still not present, the Chairman noted Mr James TO's request that the motion should be dealt with at the next Panel meeting.

(Post-meeting note: Mr James TO's motion was voted on and passed at the Panel meeting on 9 June 2011. The Administration's response to the motion was issued to members vide LC Paper No. CB(1)2775/10-11 on 19 July 2011.)

III Any other business

66. There being no other business, the meeting ended at 11:45 am.

Council Business Division 1
Legislative Council Secretariat
26 September 2011