財政司司長 曾俊華
John C Tsang, JP
Financial Secretary

1 February 2010

Miss Polly YEUNG
Clerk to Subcommittee to Study Issues Arising from
Lehman Brothers-related Minibonds and Structured Financial Products
Legislative Council
8 Jackson Road
Hong Kong

Dear Miss YEUNG,

Subcommittee to Study Issues Arising from Lehman Brothers-related Minibonds and Structured Financial Products

I refer to your letter dated 24 December 2009 ordering a paper covering all, or several papers jointly covering all, the questions on Q.5(12-14) stated in the letter dated 21 December 2009 from the Hon Mrs Regina Ip; and the interim reply issued by the Financial Services and the Treasury Bureau (FSTB) dated 6 January 2010. As stated in the FSTB's interim reply, the questions set out in the above-said letter dated 21 December 2009 requires factual inputs from the Securities and Futures Commission. Please find attached the consolidated response at **Annex**.

Yours,

中華人民共和國香港特別行政區政府財政司司長辦公室
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Annex

The Administration's response to the questions on Q.5(12-14) stated in the letter dated 21 December 2009 from Hon Mrs Regina Ip

Q.5(12-14): The SFC's Consultation Conclusions in 2006 (Conclusions06) indicates clearly that "The SFC acknowledges that a derivative issuer could not reasonably be expected to give that same level of information on the underlying asset as the issuer of the underlying asset itself when it engages in fund-raising" ("relevant statements"), yet SFC failed to do anything substantial to close this loophole in CO other than completing an "initial draft of the draft drafting Instructions before mid-September 2008".

(a) What actions did SFC undertake since they published the Conclusions06 to better protect the investing public? Specifically, what "soft-consulting" work did SFC initiate; and what were the obstacles that hamper SFC from taking immediate action to correct the system loophole?

(b) As "the 'Administration was kept abreast of the progress of this proposed initiative', what were FS or SFST's comments on the SFC's delay to implement this much needed correction in CO?

(c) In FS's opinion, if the loophole mentioned above and other potential problems identified in Conclusions06 were properly addressed by SFC soon after the report was released, could it have been possible that fewer Hong Kong citizens would have bought Lehman-related structured financial products such as Minibonds, as more accurate underlying asset and other information are disclosed?

Reply

Question (a)

Question (a) asks about the actions the Securities and Futures Commission (SFC) undertook since it published the Consultation Conclusions on the Consultation Paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance. While it would be appropriate for the Subcommittee to approach SFC direct for a factual response to Question (a), the Administration has made an effort to assist the Subcommittee to obtain the required information from SFC in view of the Subcommittee's specific request. Please find attached SFC's response at **Appendix**.

Question (b)

2. As the Subcommittee has been aware of, according to the review reports submitted by the Hong Kong Monetary Authority (HKMA) and SFC to me in December 2008, both regulators have recommended for the retention of the disclosure-cum-conduct based regulatory approach for the authorization and sale of structured financial products in Hong Kong. This regime rests on two important pillars: disclosure and suitability assessment. The first pillar ensures that sufficient information is disclosed in the product documentation by the issuer to enable a reasonable person to make an informed decision. This is covered by the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission.

3. From a policy perspective, regardless of the different regulatory reform proposals contained in (i) the SFC's Consultation Paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance published in 2005 (SFC's Consultation05); (ii) the SFC's Consultation Conclusions on the Consultation Paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance (SFC's Conclusion06) and (iii) the SFC's Consultation Paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance and the Offers of Investments Regime in the Securities and Futures Ordinance (SFC's Consultation09), it is of vital importance to note that all proposals are premised on the same regulatory regime, i.e. a disclosure-cum-conduct based one. Indeed, both SFC and HKMA recommended for its retention

in their review reports submitted to me in December 2008, as stated in the preceding paragraph.

4. According to the SFC's Consultation05, its purpose is to encourage the raising of capital and the issuance of securities and investments in Hong Kong by adjusting and refining the legal framework to facilitate offers while ensuring satisfactory standards of investor protection. The goal is to create a legal framework that accommodates the financial market's needs in the 21st Century, caters for issuers and investors alike and supports Hong Kong's continuing role as an international financial centre. In particular, the proposal to harmonize the public offering regimes primarily aims at streamlining and enhancing the flexibility of the legal framework.

5. On the time taken to undergo the consultation progress, according to the SFC's Consultation05, the consultation paper should be regarded as a "concept release" designed to promote discussion and feedback. Some of the more specific proposals might proceed towards the legislative stage of the reform process under different time-lines, reflecting their relative complexity or difficulty in implementation. The SFC's Consultation05 also states that it would not be possible to predict whether or when any specific legislative proposals that might emerge in due course would become law. Given the potential complexity associated with some of the proposals, it would be prudent to assume that it would take some time (perhaps a few years) to complete the reform process in relation to the proposals.

6. While the Administration supported in principle the proposal to modernize the public offering regime to cater for the evolving market needs without compromising investor protection, the Administration understood that SFC needed to map out specific legislative proposals and conduct further market consultation, as stated in the SFC's Conclusion06, to better address the market's concerns.

7. The Administration noted that following the publication of the SFC's Conclusions06, SFC undertook a substantial amount of work including soft-consulting various stakeholders on the technical aspects of certain proposals and started to produce the first draft of the draft drafting instructions. In the SFC's review report submitted to me in December 2008, SFC re-visited its proposals contained in the SFC's Conclusions06

to, among other things, subject public offers of all structured products to regulation under the offers of investments regime under the Securities and Futures Ordinance (SFO).

Question (c)

8. We have no particular comment to make on this hypothetical question.

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Appendix

SFC's Response to the questions on Q.5(12-14) stated in the letter dated 21 December 2009 from Hon Mrs Regina Ip

The questions appear to be based on an incorrect premise that the statement in the 2006 Consultation Conclusions on Possible Reforms to the Prospectus Regime in the Companies Ordinance ("**2006 Consultation Conclusions**") means there is a loophole in the Companies Ordinance, Cap. 32 ("**CO**").

2. The statement in the 2006 Consultation Conclusions that "...a derivative issuer could not reasonably be expected to give the same level of information on the underlying assets as the issuer of the underlying asset itself when it engages in fund-raising" was made in the context of Proposal 5 of the 2005 Consultation Paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance ("**2005 Consultation Paper**"), which was a "concept release" to generate market discussions. The original proposal was to seek the market's views whether to merge the CO prospectus regime with the Securities and Futures Ordinance ("**SFO**") investment advertisement regime and create a unified regime. Neither the 2005 Consultation Paper nor the 2006 Consultation Conclusions suggested that the Third Schedule to the CO is not suitable for regulating debt capital raising by companies operating a derivative business. Instead the 2005 Consultation Paper proposed a unified regime where a statutory disclosure standard on the lines of that set out in paragraph 3 of the Third Schedule to the CO[1] is required. This indicates that the present CO regime already includes the key element for any new regime.

3. In response to the comments from the market the 2006 Consultation Conclusions suggested that Proposal 5 be refined by providing for two regimes rather than one to reflect the inherent difference between the nature of direct investments in equity and debt and derivative products. The 2006 Consultation Conclusions did not suggest any change

[1] Paragraph 3 of the Third Schedule to the CO requires a CO prospectus to contain "Sufficient particulars and information to enable a reasonable person to form as a result thereof a valid and justifiable opinion of the shares or debentures and the financial condition and profitability of the company at the time of the issue of the prospectus, taking into account the nature of the shares or debentures being offered and the nature of the company, and the nature of the persons likely to consider acquiring them."

to the proposal to include a statutory requirement for disclosure on the lines of that set out in paragraph 3 of the Third Schedule to the CO. In the September 2009 Consultation Paper on Proposals to Enhance Protection for the Investing Public, a similar disclosure principle was incorporated in the draft Code on Unlisted Structured Products.

4. It should be noted that based on the complaints SFC received, the main issue relating to Lehman-related structured financial products such as Minibonds is of misselling.

(a) What actions did the SFC undertake since they published the Consultations06 to better protect the investing public? Specifically what "soft consulting" work did the SFC initiate and what were the obstacles that hamper the SFC from taking immediate action to correct the system loophole?

5. SFC would like to stress that no loophole about disclosure requirements in the CO was mentioned or identified in the 2006 Consultation Conclusions.

6. After the publication of the Conclusions Paper in September 2006, the SFC undertook a substantial amount of work including:

(a) hiring a special consultant who used to be a senior officer of the Law Drafting Division of the Department of Justice to assist preparation of the draft drafting instructions and this was completed in mid-2008. His appointment was solely for this project;

(b) conducting soft consultations with the Standing Committee on Company Law Reform and market practitioners including law firms and investment banks with a view to refining and revising the concept proposals and seeking technical and drafting comments from these parties; and

(c) in October 2009, SFC issued a Consultation Paper on Possible Reforms to the Prospectus Regime in the CO and the Offers of Investments Regime in the SFO. This will enable the regulatory regime to cater for financial innovation by

allowing SFC to have greater flexibility to regulate public offers of unlisted structured products in codes or guidelines.

7. SFC has continued to require issuers to fulfill the disclosure requirements in the Third Schedule to the CO and other applicable additional requirements (please refer to paragraph 3 of the written statement of Mr Brian Ho dated 7 July 2009).

8. As mentioned in the written statement of Mr Martin Wheatley that was sworn in on 23 July 2009, SFC vigorously exercises its statutory mandate to promote investor education – educating and empowering investors to protect themselves is a top priority. SFC strives to keep investors educated, informed, and alert to the risks of investing. This includes promulgating a proper investment attitude, promoting better understanding about the markets, products and investment risks and factors they should consider in making their investment decisions.

9. Since 2006, SFC has as a matter of practice urged structured notes issuers to use plain language in prospectuses to facilitate prospective investors' understanding of the key features and risks of their products. SFC stepped up its investor education initiatives in explaining product features and risks, clarifying misconceptions and reminding investors to ask the right questions when considering potential investments. These include, on the day the Structured Product Investor Survey findings were published on the SFC's website in 2006, (1) a press release summarising the findings; (2) a Dr Wise article on retail structured notes and an accompanying press release; and (3) a circular to all issuers of unlisted structured products alerting them to the findings of the survey and suggesting that they inform their distributors of the findings and remind those distributors to ensure that prospective investors understand their structured products, including the underlying risks.

10. Following the Structured Product Investor Survey and in view of the increasing availability of these products in the market, SFC continued to enhance its investor education efforts on complex structured products, in particular in relation to equity-linked products because SFC's research indicated that the issue size of equity-linked products was much greater. Subsequently, SFC's Retail Investor Survey which was published in December 2008 found that of those surveyed relatively few investors wrongly perceived such products as a long-term investment or a tool to

help them preserve their capital.

11. In addition to disclosures and investor education, the SFC's regulatory regime also rests on conduct regulation to ensure suitability. As mentioned in Mr Martin Wheatley's written statement, the SFC's regulatory regime rests on 6 elements – (a) disclosure; (b) conduct regulation to ensure suitability; (c) licensing / registration of intermediaries and their representatives; (d) supervision of intermediaries; (e) investor education and (f) enforcement action against those who do not comply with the requirements. For further information about these 6 elements, please refer to paragraphs 11 to 90 of the said statement.

12. "The suitability rule is designed to address the lack of sophistication of retail investors, who, *irrespective of the level of risk disclosure*, may not be able to adequately analyse their investment needs or develop strategies to achieve their investment goals."[2] Accordingly, regulating intermediary conduct at the point of sale is essential – only at this point is it possible to understand the investment objectives and risk profile of a particular investor and to determine whether a particular product is suitable for him.

13. Over the last 3 years, SFC has conducted approximately 140 onsite inspections of licensed corporations ("**LCs**") each year. These inspection teams are also responsible for conducting specific thematic inspections of LCs to look into topical issues or concerns over particular market practices.

14. In particular, the report on the thematic inspection of selling practices of licensed investment advisers issued by SFC in February 2005 ("**the 2005 Report**") sets out the regulatory concerns at the time and identifies areas of unsatisfactory practice noted during the review. The 2005 Report explained at paragraph 20 that investors had complained that the nature of and the risks associated with a financial product were not adequately explained by intermediaries and that on occasions, risks associated with products were misrepresented, so that they were led to believe that they were investing in a lower risk product when, if properly

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[2] *Financial Markets and Investment Products: Promoting competition, financial innovation and investment,* Corporate Law Economic Reform Program, Proposals for Reform: Policy Statement no 6, Australian Treasury, 1997, p 102.

described, the product was higher risk and therefore not suitable for conservative investors.

15. A second round of thematic inspection of selling practices of licensed investment advisers was conducted in 2006 with a view to assessing the prevailing selling practices adopted by 10 other licensed investment advisers and reviewing whether any improvement had been made since the issuance of the 2005 Report. This second thematic review revealed similar issues and deficiencies. SFC has since taken appropriate enforcement action in relation to 5 of these 10 investment advisers covered in this thematic review.

16. To help raise the standard of the industry, SFC issued guidance in May 2007 on requirements relating to the suitability of advice in the Code of Conduct for Persons Licensed by or Registered with the SFC ("**Code of Conduct**"). Amongst other things, investment advisers were reminded of their duties to (a) conduct product due diligence including the nature of the underlying investments; (b) provide reasonably suitable recommendations by matching the risk return profile of each product with the personal circumstances of each client to whom it is recommended; and (c) not to use high-pressure or unfair techniques to force or entice any client to make hasty investment decisions. Investment advisers were asked to make their own enquiries and obtain full explanations from product issuers about the risks inherent in the investment products. It is also not advisable for investment advisers to rely on prospectuses and marketing materials as necessarily being self-sufficient and self-explanatory. The second thematic review report was also issued in the same month.

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