HAROLD KO

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17 March 2010

Miss Polly Yeung
Clerk to Subcommittee to Study Issues Arising from Lehman Brothers-related Minibonds and Structured Financial Products
Legislative Council, Hong Kong

Dear Madam,

I refer to your letters of 1 February and 4 March 2010 regarding the above. Please accept my apologies for this belated response as I was away from Hong Kong for the whole month of February.

Re Question 1 in the Appendix to Your 1 February letter

1. I would like to clarify at the outset that the relevant personnel of both the Corporate Finance Division ("CFD") and the Investment Products Department ("IPD") of the Securities and Futures Commission ("SFC") were delegated powers under both the Companies Ordinance ("CO") and the Securities and Futures Ordinance ("SFO") to regulate the public offers of non-listed investment products under their respective watch. These products included structured products (see Note 1), which took the form of debentures (as in Minibonds), debenture-like instruments (as in equity-linked investments promoted by Macquarie and others), bank deposits (as in equity-linked deposits promoted by local banks), insurance policies (as in equity-linked assurance schemes promoted by local insurers) and other collective investment schemes (including investment funds that invested in structured notes and other derivative instruments), etc. However, regardless of the legal form a structured product took, the over-arching function of the SFC in product regulation, as stated in section 5(1)(l) of the SFO, was and still is:

> *"to secure an appropriate degree of protection for members of the public investing in or holding financial products, having regard to their degree of understanding and expertise in respect of investing in or holding financial*

products"

2. It is my view that both the CO and SFO provided ample discretionary powers to the SFC to impose any "conditions" (for instance, in the form of disclosure, structural or other requirements) it "thinks fit" or "considers appropriate" in order to properly discharge its function as mentioned above. The relevant powers were contained in section 342A of the CO (for shares or debentures issued by oversea companies) and section 105 of the SFO (for securities, interests in regulated investment agreements or collective investment schemes).

3. As I said in the hearings, while one might ask the Financial Secretary to prescribe companies that issue Minibonds and other structured notes as collective investment schemes under section 393 of the SFO to bring them squarely within the ambit of the legislation (and possibly subjected them to section 104 authorization), this was not really necessary given the discretionary powers to impose conditions provided under section 342A of the CO and, where advertisements or other forms of invitations were authorized, section 105 of the SFO.

4. Unless the SFC was satisfied that it was able to fully and properly discharge its over-arching function as mentioned in 1 above, it should have refused authorization under section 342C(5)(b) of the CO or section 105(5) of the SFO, as appropriate. For instance, it would, in my view, be totally irresponsible to authorize a prospectus merely because it satisfied the disclosure requirements stipulated under the Third Schedule or other requirements under the CO, particularly where waivers were granted using discretionary powers as in the case of Minibonds. It is worth noting that section 105 of the SFO did not even stipulate any requirements for SFC authorization. It would be totally absurd to argue that since no requirements were stipulated, the SFC could then use its discretionary powers to authorize any product documentation or invitations without imposing the necessary requirements - disclosure, structural or otherwise - to secure an appropriate degree of protection for investors and still claimed to have fully and properly discharged its function. As a law enforcement agency, the SFC was duty bound to justify its use or disuse of discretionary powers provided under the law. Failure to do so would, in my view, constitute a dereliction of duty.

Re Question 2 in the Appendix to Your 1 February letter

5. In my view, most of the problems that we have encountered so far with Lehman Brothers-related structured products, both in terms of product and conduct regulation, could have been avoided had the SFC exercised the powers given under the CO and SFO properly and wisely.

6. In respect of product regulation, I can see no justification why the SFC could have adopted the so-called "disclosure-based regime" for Minibonds and other structured products handled by the CFD while its IPD, which had much more experience in regulating investment products, was imposing both disclosure, structural and other requirements to secure an appropriate degree of protection for investors. For the purposes of illustration, I mentioned the case of "guarantor" in my written statement of 19 January 2010. Had the CFD adopted the time-tested guarantor criteria used by the IPD (see Note 2) in vetting Minibonds, it would be inconceivable that Lehman Brothers Holdings Inc. would have been accepted as a guarantor. It goes without saying that the fate of Minibonds investors would have been very different had the guarantor not collapsed...

7. In respect of conduct regulation, apart from the issues and incidents I mentioned in my earlier written statement and during the hearings, I would like to draw the Subcommittee's attention to a few more issues below which not only show how complacent my former colleagues in the Intermediaries Supervision Department were, they also raise doubts on their competency as law enforcement officers:

   (a) "execution-only" clients – in both the First Report (paragraphs 22-24) and the Second Report (paragraph 15) on thematic inspection, there was mention of these so-called "execution-only" clients who "(signed) off on acknowledgement or confirmation forms stating that their advisers did not offer them advice but only carried out their orders." This practice had allowed "investment advisers" not to collect and record "sufficient information on their clients to the standards set out in the Code of Conduct or the Internal Control Guidelines." My understanding of the SFO is that it was in fact illegal for "investment advisers", i.e. persons who were licensed/registered to carry out Type 4 activities, to execute clients' orders on securities trading without providing advice as that would amount to "dealing", which required a Type 1 licence/registration. If my understanding of the law is correct, tolerating this practice would not only

have provided a loophole for investment advisers not to keep proper records on clients and any advice given to them – an easy escape from mis-selling allegations – it also raises serious questions on dereliction of duty on the part of the SFC.

(b) commission rebates from product providers to investment advisers – again, there was mention of this in both the First Report (paragraphs 14-16) and the Second Report (paragraphs 17-18). My understanding of the Prevention of Bribery Ordinance is that it was an offence for investment advisers, as "agent", not to disclose to their clients, as "principal", this practice of receiving commission rebates from product providers. If my understanding of the law is correct, tolerating this non-disclosure would not only have created a conflict of interest situation conducive to mis-selling, it again raises serious questions on dereliction of duty on the part of the SFC.

8. As regards the issue of "Government's pressing SFC for short-term gains", I believe I have already revealed quite some information on the actions of some high-ranking SFC staff to provide "quick wins" for Government. In respect of Lehman Brothers-related products specifically, the best persons to ask about this are Andrew Sheng, Ashley Alder and William Pearson, who were believed to have direct and frequent contacts with Government at the relevant time. I would suggest the Subcommittee seriously consider summoning these persons for questioning. As a first step, the Subcommittee may wish to consider ordering the SFC to provide copies of all correspondence/meeting notes between the SFC and Government on matters relating to bonds/structured products between 2001-2004 for an initial investigation. In any event, with or without Government pressure, it was undeniably the responsibility of the SFC and its personnel to ensure due and proper discharge of its functions and powers under the SFO. Failure to do so would have constituted a dereliction of duty.

Observations re Subcommittee hearing of 9 February

9. Since returning to Hong Kong, I have had the opportunity to review on YouTube the Subcommittee's hearing on 9 February 2010 and have the following observations:

(a) If I am not mistaken, Martin Wheatley revealed that in vetting Minibonds, the CFD had, borrowing from Listing Rules 15A, imposed a net asset value requirement of $2 billion on issuers. If so, firstly, this seems to conflict

with earlier information provided by the SFC in previous hearings that it only looked at disclosures. Secondly, this confirms that the SFC did have discretionary powers under the law to impose structural and other requirements in authorizing prospectuses under the CO. Thirdly, this raises the question of why the CFD chose to impose requirements on the issuer only and not on other operators, such as guarantor, to align its practice with that of the Stock Exchange and, more importantly, the IPD which had much more experience in vetting non-listed products?

(b) Unlike FAQs, codes issued under sections 169 or 399 of the SFO are admissible in court. Also, FAQs are subject to change without notification which makes them difficult to track and follow. For the purposes of illustration, I have attached two extracts, one from a set of FAQs on Regulated Activities published on the SFC website on 23 June 2004 and the other set published on 19 September 2006 (see Attachment I and II respectively). The contents of the two sets were essentially the same except for paragraph 1.11. The earlier version prompted many insurance intermediaries who marketed ILAS (i.e. investment-linked assurance schemes) to obtain securities licences from the SFC only to be told later to surrender their licences when the SFC decided to change its stance on the law and amended the FAQs without prior notification or public announcement, causing much confusion and discontent in the market! One simply cannot do that for codes issued under sections 169 or 399.

(c) Martin Wheatley was apparently confused when asked about the "Harmonisation Project". The Project was meant to align the different practices adopted by the CFD and the IPD in vetting structured products while the CO revision exercise (frequently referred to internally as CO Phase III) was going on. Unfortunately, this Project, like the IA Project, was not actively pursued and, consequently, failed to deliver its intended results to afford better protection to investors.

I hope the above assists. Please let me know if you have any questions.

Yours sincerely,

Ko, Ping Chung Harold

Cc Mr. John Clancey, Ho, Tse, Wai & Partners

Notes:

(1) In its Listing Rules, under Chapter 15A, the Stock Exchange of Hong Kong Limited describes structured products as those that "provide the holder of that product with an economic, legal or other interest in another asset (the "underlying asset") and hence derive their value by reference to the price or value of the underlying asset."

(2) Paragraph 8.5(b) of the Code on Unit Trusts and Mutual Funds sets out the general criteria for guarantors adopted by the IPD. They are: (i) a licensed banking institution authorized under the Banking Ordinance; or (ii) an authorized insurer authorized under the Insurance Companies Ordinance. IPD may also consider other substantial financial institutions to act as guarantor on a case-by-case basis but it must be satisfied that the institution is, on an on-going basis, subject to regulatory supervision and of acceptable financial standing.

Enclosures:

Extracts of FAQs on Regulated Activities published on 23 June 2004 (Attachment I) and 10 September 2006 (Attachment II)

Attachment I

Topic
1

Regulated activities

What are the types of regulated activities?

Posted on 17.03.2003

1.1 Regulated activities are defined under Schedule 5 to the SFO. They include:-

- Type 1: dealing in securities,
- Type 2: dealing in futures contracts,
- Type 3: leveraged foreign exchange trading,
- Type 4: advising on securities,
- Type 5: advising on futures contracts,
- Type 6: advising on corporate finance,
- Type 7: providing automated trading services,
- Type 8: securities margin financing, and
- Type 9: asset management.

Will a person engaging in stock option business be required to apply for a licence to carry on Type 1 or Type 2 regulated activity?

Posted on 17.03.2003

1.2 Type 1.

(2) prepare a demonstration to the SFC of the business operations via the Internet when ready; and

(3) notify the SFC in writing the effective date of launching Internet services and the address of the website.

If a licensed or registered intermediary intends to launch a corporate website to provide stock quotes, account status and financial commentaries to clients, is it required to submit any application for approval to the SFC?

Posted on 23.06.2004

1.10 No. However, it should complete and submit the relevant part(s) (sections 11 & 17) of Form 5 (Notification - Licensed Corporation, Registered Institution, Licensed Representative and Substantial Shareholder) to notify the SFC of the proposed change in business scope and any new website address.

Is a person engaging in the marketing of investment-linked assurance products (ILAS) or MPF schemes considered to be giving advice on securities or dealing in securities (Type 4 and Type 1 regulated activity respectively)?

Posted on 18.06.2003

1.11 A person who engages in the marketing of ILAS products or MPF schemes without entering into any discussion on the underlying securities will not be considered as engaging in "dealing in securities" or "advising on securities". The person may pass on certain factual information such as the composition of the product, e.g. proportion of equity against bond and allocation of assets to different geographical markets, without being considered as discussing the underlying securities.

However, whenever a person enters into a discussion with a customer on the underlying securities in the process of marketing ILAS products or MPF schemes, it

is hard to establish that he is not attempting to induce the customer to enter into an agreement in respect of securities where such inducement constitutes dealing in securities as defined under the SFO.

Therefore, if such a person is not licensed or registered with the SFC, it is considered to be an exception. He should be prepared to justify his case if queried.

Do we need to be licensed for Type 1 regulated activity (dealing in securities) or Type 4 regulated activity (advising on securities) if we only advise clients on securities investments and/or issue securities research reports to subscribers?

Posted on 10.03.2004

1.12 To be licensed for Type 4 regulated activity is appropriate in this case. Generally speaking, Type 1 regulated activity will be required if the activities concerned include execution of securities dealing transactions by the intermediary on behalf of clients and/or distribution of securities such as unit trusts and mutual funds. For fund managers licensed for Type 9 regulated activity (asset management), please also refer to Questions 10.4 and 10.6 under the topic – Incidental exemption.

Attachment II

Topic
1

Regulated activities

What are the types of regulated activities?

Posted on 17.03.2003

1.1 Regulated activities are defined under Schedule 5 to the SFO. They include:-

- Type 1: dealing in securities,
- Type 2: dealing in futures contracts,
- Type 3: leveraged foreign exchange trading,
- Type 4: advising on securities,
- Type 5: advising on futures contracts,
- Type 6: advising on corporate finance,
- Type 7: providing automated trading services,
- Type 8: securities margin financing, and
- Type 9: asset management.

Will a person engaging in stock option business be required to apply for a licence to carry on Type 1 or Type 2 regulated activity?

Posted on 17.03.2003

1.2 Type 1.

(2) prepare a demonstration to the SFC of the business operations via the Internet when ready; and

(3) notify the SFC in writing the effective date of launching Internet services and the address of the website.

If a licensed or registered intermediary intends to launch a corporate website to provide stock quotes, account status and financial commentaries to clients, is it required to submit any application for approval to the SFC?

Posted on 23.06.2004

1.10 No. However, it should complete and submit the relevant part(s) (sections 11 & 17) of Form 5 (Notification - Licensed Corporation, Registered Institution, Licensed Representative and Substantial Shareholder) to notify the SFC of the proposed change in business scope and any new website address.

Do we need to be licensed for Type 1 regulated activity (dealing in securities) or Type 4 regulated activity (advising on securities) if we only advise clients on securities investments and/or issue securities research reports to subscribers?

Posted on 10.03.2004

1.11 To be licensed for Type 4 regulated activity is appropriate in this case. Generally speaking, Type 1 regulated activity will be required if the activities concerned include execution of securities dealing transactions by the intermediary on behalf of clients and/or distribution of securities such as unit trusts and mutual funds. For fund managers licensed for Type 9 regulated activity (asset management), please also refer to Questions 10.4 and 10.6 under the topic – Incidental exemption.