SECURITIES AND FUTURES COMMISSION
證券及期貨事務監察委員會

RESPONSES TO THE FOLLOW-UP QUESTIONS RAISED BY THE SUBCOMMITTEE ON 3 AUGUST 2009

12 AUGUST 2009

Follow-up to the hearing on 3 August 2009

Information (including relevant documents and records, if any) on the following issues

1. Please provide explanation on the following:

1a. whether the Securities and Futures Commission (SFC) will be pre-empted from taking any disciplinary or punitive action against the 16 Minibonds distributing banks as they have agreed with SFC and the Hong Kong Monetary Authority on the Minibonds repurchase agreement without admission of liability;

1.1 *Minibond investigations* - under the agreement with the Hong Kong Monetary Authority ("HKMA") and 16 distributing banks (the "Agreement"), the SFC has agreed to discontinue its top-down investigations of the 16 banks in respect of their distribution of Minibonds. The discontinuance is subject to the following exceptions:

i. the SFC has reserved its right to investigate any conduct in respect of the distribution of Minibonds by the banks that involves dishonesty, fraud or deceit or any conduct that may constitute a criminal offence; and

ii. the SFC may re-activate the Minibond investigation if any of the 16 distributing banks commits a material breach of the Agreement.

1.2 *Investigations into sale of other structured products by 16 banks* - the Agreement will not prejudice the SFC's power to investigate into the distribution of non-Minibond structured products by these banks or their future conduct. However, the Agreement includes measures in which the banks are expected to investigate and resolve in a fair and reasonable manner customers' complaints involving the sale and distribution of other unlisted structured products. The SFC and the HKMA will closely monitor the progress of the enhanced complaint handling processes by the banks. If the banks are unable to resolve satisfactorily customers' complaints, then the SFC will take appropriate action, including investigations and, if necessary, disciplinary proceedings, against the banks.

1.3 *Investigations of banks not parties to the Agreement* - the SFC will continue its investigation of other banks that are not parties to the Agreement.

1b. whether SFC will continue its top-down investigation into a distributing bank in the following circumstances:

(i) if only some, but not all, of the eligible customers of the bank accept the Minibonds repurchase offer;

1.4 No, the SFC will not resume the top-down investigations into the sale of Minibonds by these 16 banks, subject to the exceptions set out in 1.1 above. However, eligible customers who do not accept the repurchase offer can still lodge their complaints with the HKMA, which has the power to investigate individual complaints in relation to the sale of Minibonds by the 16 banks.

(ii) **if the bank receives complaints from customers who are not eligible for the repurchase offer or from eligible customers who do not accept the repurchase offer; and**

1.5 No, the SFC will not resume the top-down investigations into the sale of Minibonds by the 16 banks, subject to the exceptions set out in 1.1 above. However, ineligible customers and eligible customers who do not accept the repurchase offer may lodge their individual complaints with the HKMA.

1c. Under what circumstances will SFC re-open its top-down investigation into any of the 16 distributing banks.

1.6 Please refer to 1.1 above.

2. **Please advise whether the 16 distributing banks are required to inform the eligible customers and the regulators on a regular basis of the progress on the realization of the collaterals for Minibonds.**

2.1 No. The distributing banks will become the noteholders of the Minibonds and will disgorge their commission earned for setting up a fighting fund to assist the collateral recovery process. However, they have no direct control over the collateral recovery process. The collateral recovery process is handled by HSBC Bank USA, National Association ("HSBC"), the trustee of the Minibond Series, and PricewaterhouseCoopers ("PwC"), the receiver of the collateral securing certain series of Minibonds. I understand that PwC has published FAQs about its collateral recovery work:

http://www.pwchk.com/home/eng/minibonds_faq.html

2.2 In addition, the Agreement has required the participating RIs to make further payment within 30 days after receipt of collateral disposal proceeds from the trustee.

2.3 The SFC will continue to liaise with the HKMA, HSBC, PwC and the distributing banks in relation to the collateral recovery process.

3. Please obtain from the Minibonds trustee up-to-date information on the value of the collaterals for Minibonds, including the collaterals being sold or already realized. Pending receipt of the information, please provide a copy of SFC's written request to the Subcommittee.

3.1 I attach a copy of our letter dated 6 August 2009 to HSBC, the trustee of Minibonds, requesting information about the current value of the collateral. As at the date hereof, HSBC has not replied to our letter above. **Appendix 1**

4. Please confirm whether the Minibonds holders are entitled to the full realization of the value of the underlying collaterals for Minibonds, including whether there are any pre-conditions for such entitlement.

4.1 Eligible customers who accept the repurchase offer are entitled to the following further payment after the realisation of collateral:

4.1.1 For eligible customers below the age of 65:

- the actual amount recovered, if the percentage of the recovery for that series is less than 10% of the total principal amount of that series;
- 10% of the principal amount, if the percentage of recovery for that series is between 10% and 70% of the total principal amount of that series; or
- the amount in excess of 60% of the principal amount (without any cap), if the percentage of recovery for that series exceeds 70% of the total principal amount of that series.

4.1.2 For eligible customers aged 65 or above, they will receive a further payment of the amount in excess of 70% (without any cap), if the percentage of recovery for that series exceeds 70% of the total principal amount of that series.

4.2 The realisation of collateral is subject to: (i) priority claims made by the liquidators of Lehman Brothers; and (ii) expenses and costs incurred by the trustee and receivers of Minibonds. In relation to (i), we understand that there is ongoing Lehman-related litigation in the UK which may have important implications on the collateral recovery process of Minibonds. In relation to (ii), the expenses and costs incurred by the trustee and receivers of Minibonds should be significantly alleviated by the fighting fund to be set up by the banks pursuant to the Agreement.

5. Please inform the Subcommittee of the dates on which the Chief Executive Officer (CEO) of SFC was not in Hong Kong during the three weeks preceding the announcement of the Minibonds repurchase agreement on 22 July 2009.

5.1 I took seven days of annual leave in the three weeks prior to the announcement of the Agreement on 22 July 2009. I cut short my leave and was in Hong Kong in the week leading up to the signing of the Agreement. While I was away, I was in daily contact with other senior executives of the SFC in Hong Kong. I was fully informed of the negotiation progress and was aware of the terms of all the key documents involved.

6. The attached written questions raised by Mr LEUNG Kwok-hung and handed to CEO/SFC at the hearing on 3 August 2009.

Questions from Hon. Leung Kwok-hung

3 August Document 1

In Paragraph 40.2 of the Report on Lehman Brothers Incident submitted by the SFC to the FS, it was stated that section 201 of the SFO permits the SFC to resolve the disputes with non-complying institutions for the following objectives:

i. To ensure problems do not arise again;
ii. To mitigate the financial consequences of misconduct to the investing public; and
iii. To increase confidence in the capacity of Hong Kong's regulatory systems to solve problems beneficially

Questions related to section 201 of the SFO:

1. What roles does the SFC play in the settlement solutions between each of the RIs, LCs and their clients?

6.1 The SFC plays the following roles in the resolutions with licensed corporations ("LCs"), including Sun Hung Kai Investment Services Ltd ("SHKIS") and KGI Asia Ltd ("KGI"):

(a) the SFC investigates the LC;

(b) the SFC proposes bringing disciplinary action against the LC;

(c) the SFC discusses the possibility of resolving the case by a section 201 agreement with the LC;

(d) once the LC indicates that it is interested in resolving the matter by a section 201 agreement, the SFC and the LC will engage in a without prejudice negotiation;

(e) terms of the section 201 agreement are negotiated with the LC;

(f) once the terms of the section 201 agreement are agreed with the LC, the SFC and the LC will execute the agreement; and

(g) the SFC will continue to monitor the LC's compliance with the section 201 agreement.

6.2 The procedure for resolutions with registered institutions ("RIs") (e.g. the Agreement) is similar to the above, save that the HKMA participates in the without prejudice negotiation and is consulted by the SFC throughout. The HKMA, as the frontline regulator of RIs, will also take part in monitoring the compliance with section 201 agreements by RIs.

6.3 The SFC's resolutions with LCs and RIs are subject to the following limitations:

- the SFC does not have the power to order LCs or RIs to pay compensation to customers. Whether to compensate and the level of compensation require the consent of the LCs and RIs;

- similarly, the SFC does not have the power to order LCs and RIs to commission internal control reviews or complaint handling reviews. These reviews also require the consent of the LCs and RIs;

- section 201 agreements are only binding between the SFC and the LCs /RIs (and the HKMA, if applicable). As a result, investors are not obliged to accept any compensation offered by the LCs /RIs; and

- the terms and outcomes of the section 201 agreements with different entities will not be identical since the circumstances are different in each case and different entities may agree with different terms and conditions during the negotiations.

2. Has the SFC applied section 201 of the SFO?

6.4 Yes. The resolutions with SHKIS, KGI and the 16 distributing banks were based on section 201 of the SFO. The SFC considered it appropriate to enter into section 201 agreements with these entities in the interest of the investing public or in the public interest.

3. Have the three objectives above been achieved? Please assess them one by one!

6.5 I believe that the three objectives have been achieved by the section 201 agreements with SHKIS, KGI and the 16 distributing banks:

i. To ensure problems do not arise again

6.6 Both SHKIS and KGI agreed to commission independent firms to conduct reviews of their internal control and compliance systems.

6.7 In relation to the Agreement, the banks agreed to commission independent firms to review their internal controls and complaint handling procedures.

6.8 The Agreement will also have deterrence effect because:

- according to Ernst & Young's "Structure and Pricing of Minibonds" report dated 29 December 2008, the value of the collateral for Minibond series 5, 6, 7 and 9 is close to zero and the value of the collateral for Minibond series 15, 16, 17 and 18 is less than 15%. It is likely that the banks will not be able to recover a substantial portion of their money paid to their customers;

- the banks are stripped of the commission earned to form a fighting fund to expedite the collateral recovery process; and

- the banks have to bear the risks of the collateral recovery, which is subject to a number of uncertainties, including the priority claims of Lehman Brothers' liquidators, the time and expenses for realising the collateral.

ii. To mitigate the financial consequences of misconduct to the investing public

6.9 Under the section 201 agreements, SHKIS, KGI and the 16 distributing banks have committed to compensate their customers. The repurchase schemes of SHKIS and KGI have been completed and more than 300 Minibond investors were benefited by the schemes. Around 29,000 customers of the 16 distributing

banks either have received or will receive repurchase offers from the banks shortly.

6.10 These section 201 agreements enabled a very substantial number of Minibond investors to get back all or a good proportion of their investment quickly. They also save these Minibond investors' time, legal costs and risks from not having to conduct their own litigation against the brokers and banks.

iii. To increase confidence in the capacity of Hong Kong's regulatory systems to solve problems beneficially

6.11 The internal control reviews for SHKIS, KGI and the 16 banks, and the complaint handling reviews for the 16 banks, are forward-looking reviews. These reviews are intended to remediate their systems and processes to meet the high regulatory standards that will provide enhanced protection to the investing public in future and give the investing public an assurance that the entities are determined to ensure these events are not repeated.

4. On what conditions has the SFC agreed not to probe the RIs and LCs?

6.12 In relation to the resolutions with SHKIS and KGI, the SFC has agreed not to take any further enforcement action in relation to their sale of Minibonds on the condition that similar concerns do not re-occur within a specified period.

6.13 In relation to the Agreement, the SFC has agreed to discontinue its top-down investigations into their distribution of Minibonds. The discontinuance is subject to the following exceptions:

- the SFC has reserved its right to investigate any conduct in respect of the distribution of Minibonds that involves dishonesty, fraud or deceit or any conduct that may constitute a criminal offence; and

- the SFC may re-activate the Minibond investigation of any of the 16 distributing bank that commits a material breach of the Agreement.

6.14 The section 201 agreements with SHKIS, KGI and the 16 distributing banks do not affect the SFC's power to investigate into their sale of other structured products. The SFC will also continue to investigate the sale of structured products by other banks that are not parties to the Agreement.

5. Is it true that only the probe against the RIs and LCs for their breach of regulations in relation to the Lehman Brothers minibonds will be dropped, while the investigations and probe into the mis-selling of ELNs, CLNs and Lehman Brothers bonds will still go on? (It is because the SFC cannot sacrifice the clients of ELNs and CLNs to achieve its purposes!)

6.15 The section 201 agreements with SHKIS, KGI and the 16 distributing banks only affect the SFC's power to investigate into the sale of Minibonds by these entities. The agreements do not prejudice the SFC's power to investigate into the sale of other structured products by these entities.

6.16 Having said that, the Agreement includes measures in which the banks are expected to investigate and resolve in a fair and reasonable manner complaints involving the sale and distribution of other structured products. The SFC and the HKMA will closely monitor the progress of the enhanced complaint handling processes by the banks. If the banks are unable to resolve satisfactorily their

customers' complaints, then the SFC will take appropriate action, including investigations and, if necessary, disciplinary proceedings, against the banks.

6.17 In addition, I understand that the HKMA has been continuing with its disciplinary and enforcement action under sections 58A and 71C of the Banking Ordinance against Relevant Individuals and Executive Officers involved in mis-selling of non-Minibond investment products including ELNs and CLNs.

6. The decision of SFC not to further investigation RI misconduct on the sales of Lehman mini-bond should have a condition that a satisfactory settlement solution between the RI and its clients must be reached. Such satisfactory settlement is a collateral agreement in law. It is the pre-condition of your promise not to further investigate the RI misconduct. Therefore, SFC has a strong influence on the content of such settlement. You cannot just say that it is solely between the RI and its clients because you have to make sure that the objective mentioned in your report to the SFC for the use of s201 of the SFO should be achieved.

My question:
Why does SFC decide to endorse a 100% compensation from SHK Finance and only 70% from bank?

6.18 Please refer to 6.3 above in relation to the limitations of section 201 agreements.

6.19 In terms of the percentage of investors' original investment, SHKIS' payments and KGI's payments were higher. This is not an anomalous result. The difference is due to a number of factors including:

- the circumstances of each case being different;
- the SFC is not statutorily empowered to make any compensation order; and
- the amount of compensation to be made requires the consent of the relevant banks and brokers.
- the amounts of commission earned by SHKIS and the banks are different:
  - whereas SHKIS may be able to recoup a substantial portion of the compensation paid to its customers through its commission earned, the banks cannot. In fact, the banks are stripped of the commission earned to form a fighting fund; and
  - the SFC could have proposed a fine for SHKIS that exceeded the amount of its compensation to clients, but the SFC could not have proposed the same for the banks. The total amount of payments to be made by the banks will far exceed the total amount of any fines that can be imposed by the SFC on the banks.

The Roles of the Chairman and Board of Directors of the SFC in the Incident

7. Was the decision to accept and announce the settlement agreement between the SFC and RIs last week made by the SFC Chairman alone or approved by the entire Board of Directors of the SFC or made by you alone?

8. Under which section was the mandate given? Who was mandated?

9. Did you recommend the Board of Directors to accept it?

10. Did you recommend the Board of Directors to accept the settlement between the SFC and LCs?

6.20 The SFC was vested with the power to enter into agreements with investigation targets with whom we have regulatory concerns under section 201 of the SFO that came into force in April 2003. In the same year, the said power, along with various other powers delegable under the SFO, was formally delegated to Executive Directors of the SFC for the proper and efficient fulfilment of their duties under the SFO. The decision and exercise of power in connection with entering into the Agreement was taken by the Executive Director of Enforcement with my full support and the Board had been fully briefed on and supported the final settlement.

11. Did you accept it involuntarily?

6.21 No. The Agreement was a reasonable outcome and is in public interest because it enables 90% or more of investors to recover about 70% of their investment and possibly more depending on the value of the collateral recovered.

12. Has the FS or SFST provided any opinions, either "informal or formal"?

13. (If the answer is "not") Is it that you are not sure about it, or that you are sure that there has been none?

6.22 The FS and SFST have all along been concerned with the Minibonds incident and how it would impact on the public in general. In relation to our investigation into the complaints of Minibonds, the FS has urged us to reach an outcome that "is fair and reasonable and, importantly, acceptable to the relevant supervisory authorities", and that "will serve a wider public interest". The FS has also asked that we "balance the functions of maintaining the financial stability of Hong Kong and investor protection, and as soon as practicable reach a resolution."

14. The RIs and LCs both committed systematic errors which were equally severe, but the settlement solution between the RIs and their clients was so much different from that between the LCs and their clients and the SFC still accepted that. In this sense, has the principle of consistency in law enforcement been violated?

6.23 I do not consider that there is any violation of the consistency principle. Please refer to 6.3, 6.18 and 6.19 above.

Question from Leung Kwok Hung

3 August 2009

Document 2

Questions:

Referring to SCR Ref NoSC(1)- S37

1. **Para 4.11-4.15: You do not include in your power that you may also use the power in section 180 of SFO by asking the MA to authorize a person recommended by SFC to enter, inspect and make copies of papers and make enquires of intermediary if you wish. Please note that this is the power put in SFO and not in BO, so it is also the legislative intent that SFC may use it but with the authorization of MA. If it is solely for the MA to use this power of entering and inspecting, the government should put not only s55, s72A, and s78A into BO but also s180.**

a. **Why you do not include s180 SFO in your answer in above-mentioned para 4.11-4.15?**

6.24 The proposition in question 4 of your written questions of 26 June 2009 was ***"I think it is a wrong interpretation of s5(1)(b)(ii)"***. In the light of this you asked: "***Do you agree that your interpretation of SFC's duties and powers as set by SFO is wrong and your written statement is incomplete relating to SFC's duties and powers of supervising RIs?***"

6.25 In reply I explained that under s. 5(1)(b)(i) the SFC is required to supervise, monitor and regulate the activities carried on by various recognized bodies or persons carrying on regulated activities (e.g. LCs) under any of the provisions of the SFO or the Companies Ordinance ("CO"), other than RIs.

6.26 In contrast s. 5(1)(b)(ii) provides that in relation to RIs the SFC is only required to supervise, monitor and regulate if the SFC is required to do so under any provision of the SFO or the CO. One must therefore look at the remaining provisions of the SFO and the CO to find activities carried on by RIs that are required to be regulated by the SFC.

6.27 In relation to s.180 of the SFO I explained that the section empowers only the HKMA to appoint an "authorized person" to inspect an RI. The point being that under s.180 of the SFO the SFC was not required to supervise RIs within the meaning of s.5(1)(b)(ii). Hence s.5(1)(b)(ii) did not confer a power on the SFC to supervise RIs.

6.28 The fact that the SFC could ask HKMA to exercise its powers to appoint a person recommended by the SFC to enter and inspect etc. does not mean that the SFC "is required to do so under any provision of the SFO or the CO" within the meaning of s.5(1)(b)(ii). Hence s.5(1)(b)(ii) did not confer a power on the SFC to supervise RIs.

6.29 In any event, even if the HKMA appointed an authorized person in these circumstances, the HKMA would continue to control the inspection. Section 180(10) clearly provides that any authorised person can only exercise his powers after consultation with the HKMA –

"(10) Before an authorized person exercises any power under this section (other than subsection (1)(c)(iii) or (3)(c)) in respect of a corporation-

where the corporation is an authorized financial institution or a corporation which, to the knowledge of the authorized person, is a controller of an authorized financial institution, or has as its controller an authorized financial institution, or has a controller that is also a controller of an authorized financial institution, the authorized person shall consult the Monetary Authority;"

b. Are you sure that SFC cannot use s180 of the SFO under all circumstances?

6.30 I am sure that the SFC cannot use s.180 to supervise RIs under all circumstances. That power is reserved to the HKMA.

c. Do you think that it is unfair to ask SFC to take the sole responsibility of protecting investor while not giving you the power to use s180 directly? (Please note that the government refused to add protection of investors into the BO as an express function for the MA, though Hon Margaret Ng, insisted on the putting such clause into BO in her comment made in the second reading of the SFO).

6.31 I do not think that the SFC was given sole responsibility to protect investors.

2. Section 5(1)(b) provides that the function of SFC is to supervise, monitor and regulate. Section is written in such a way that (i) is for organisations other than RIs and (ii) is for RIs only. How is the monitoring of RI done?

6.32 Section 5(1)(b) does not provide that the function of SFC is to supervise, monitor and regulate. Under s. 5(1)(b)(i) the SFC is required to supervise, monitor and regulate the activities carried on by various recognized bodies or persons carrying on regulated activities (e.g. LCs) under any of the provisions of the SFO or the CO other than RIs.

6.33 In contrast s. 5(1)(b)(ii) provides that in relation to RIs the SFC is only required to supervise, monitor and regulate if the SFC is required to do so under any provision of the SFO or the CO.

6.34 The term "monitor" is not used again in the SFO. Since we are not required to "monitor" any activities of RIs under any of the relevant provisions, and we have no power to supervise RIs we presume these words simply require that we monitor the persons referred to in subparagraph (i). HKMA monitors the banks.

6.35 This interpretation is consistent with the legislative intent and the principles behind the separation of the roles of the SFC and HKMA under the SFO and the BO which I set out in the response to question 4 of your written questions of 26 June 2009 :

"the SFC is responsible for setting regulatory standards, deciding whether to grant approval for registration of the securities business of banks, revoking the relevant registration, making investigations and taking disciplinary actions. The HKMA is the front-line regulator of banks and responsible for routine inspection and supervision."

3. **Why with all the monitoring work you have done, you still let all the widely spread mis-selling practice taken place without being notice?**

6.36 I have explained that the SFC was not empowered to, and did not, monitor RIs.

4. **In the second reading of the SFO in 2002, the Secretary for Financial Services said that**

We clearly understand the grave importance of enhancing the accountability and transparency of the SFC. Therefore, apart from retaining all existing accountability arrangements, a number of additional checks and balances have also been introduced in the Bill to avoid the possible abuse of power. There are, for example, inclusion of regulatory objectives of the SFC so that the public and the industry can use them as the criteria for assessing the performance of the SFC.

The regulatory objective are listed in section 4 SFO which provides that

(a) to maintain and promote the fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry;
(b) to promote understanding by the public of the operation functioning of the securities and futures industry;
(c) to provide protection for members of the public investing in or holding financial products;
(d) to minimize crime and misconduct in the securities and futures industry;

And in carrying your function, you have decided to rely wholly on MA to carrying out your supervisory work on RI, not to exercise your discretionary power in applying s180 of the SFO, and not to put an effectively monitoring system in place to monitor the RI.

The MOU is not a statutory document and has no legal effect as provided in paragraph 4 of the MOU and is subject to amendment at the SFC's and MA's discretion. And you have not sought to amend it earlier.

a(i). **Do you agree that the above are fact? If not, which part is not? If not, why not?**

6.37 Under the SFO we do not have a supervisory role in relation to banks. As I have mentioned above, the roles of the SFC and HKMA are different. The legislative intent and the principles behind the separation of roles is as follows :

"the SFC is responsible for setting regulatory standards, deciding whether to grant approval for registration of the securities business of banks, revoking the relevant registration, making investigations and taking disciplinary actions. The HKMA is the front-line regulator of banks and responsible for routine inspection and supervision."

6.38 I do not accept that we have a discretionary power in relation to RIs under s.180 of the SFO nor do we have a duty to monitor RIs or the powers to do so.

6.39 This division of roles is manifested in s.5(3) of the SFO, which I referred to at paragraph 42 of the Statement, which provides that -

"The Commission, in performing any of its functions in relation to-

(a) any authorized financial institution as a registered institution . . .

may rely, in whole or in part, on the supervision of such authorized financial institution or person (as the case may be) by the Monetary Authority."

The failure of SFC to hold RIs liable for their system failure and to compensate fully of the loss of the Lehman mini-bond and structural products has not help to reinstall the confidence of the investing public to the regulators and our regulatory system. And it has not served as an effective deterrence to prevent future happening of the problems and hence fails to achieve the objectives of the application of s201 of the SFO.

a(ii). Do you agree that the above are fact? If not, which part is not? If not, why not?

6.40 I disagree with the above statement.

6.41 As I mentioned in the subcommittee hearing held on 3 August 2009, the Agreement will help achieve the following outcomes:

- *Benefit the investors* - the repurchase scheme offered by the banks pursuant to the Agreement will enable 90-95% of Minibond investors to recoup a substantial proportion of the principal invested;

- *Expedite the recovery of the collateral* – the banks will pay out over $200 million of commission earned to set up a fighting fund to assist the trustee and receiver of Minibonds to recover the collateral. This will not only benefit the eligible customers but will also benefit eligible customers who do not accept the offer and ineligible customers.

- *Improvement of internal controls* – forward-looking internal control reviews will be conducted by independent firms for each of the banks. These reviews will be monitored by the regulators and the banks have committed to implement the recommendations of the reviewers.

- *Complaint handling reviews* - the Agreement also provides a framework for the banks to assess, investigate and resolve complaints about other structured products and pay appropriate compensation where warranted according to law.

6.42 The Agreement is beneficial to both the investors and the banks because the investors will get a reasonable compensation offer, and the banks' systems and controls will be enhanced through the reviews. This Agreement is more about how to improve the system in future so that the investors can benefit in the long run. It will also give a deterrence effect on the banks, as I mentioned in 6.5 – 6.11 above.

The Director for Corporate Finance, Mr. Ho, confessed in the last testimony that Schedule 3 of CO has outdated provisions for the regulation of disclosure in the mini-bond type of debentures.

a(iii). Do you agree that the above are fact? If not, which part is not? If not, why not?

6.43 Although the Third Schedule to the CO has been in place prior to the emergence of structured products, the overall disclosure standard imposed by paragraph 3 of the Third Schedule (which requires the disclosure of "*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 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*" (emphasis added)) applies as a general principle to the products being offered by the relevant prospectuses regardless of their nature and complexity. The amount, nature and degree of particulars and information necessary to comply with this requirement is a question of fact in each case and would be relevant to disclosures in prospectuses.

6.44 The essence of a disclosure-based regime is one where the prospectus for an issue discloses sufficient details on product features and risks for an individual to form a balanced view of the product at the time of the issue of the prospectus. There has been internal guidance as to, amongst others, how reviewers should apply provisions of the Third Schedule to prospectus disclosures for different types of structured products such as equity-linked notes and credit-linked notes – please see Appendix C to Mr. Brian Ho's written statement dated 7 July 2009. This is coupled with the obligation of the intermediary, who has direct interface with each particular investor, to properly explain the product after its own product due diligence in addition to the prospectus disclosures, and to ensure that it is suitable taking account of the individual's circumstances. W17(C)

6.45 The prospectus law reform involves a package of proposals to modernise the public offering regime for shares and debentures in Hong Kong, many of which have market-wide implications but were not specifically designed to address the issues raised following the collapse of Lehman. The package of reform initiatives to be taken forward involve wide-ranging impact on the interests, practice and procedures of a cross-section of stakeholders involved in the public offering process (including IPOs). After publication of the consultation conclusions in September 2006, the SFC undertook a substantial amount of work including soft-consulting various stakeholders on the detailed logistics and technical aspects of certain proposals to reduce any process risk associated with the implementation of these proposals. The SFC had completed an initial draft of the draft drafting instructions.

6.46 One of the reform initiatives to be taken forward is the proposal to transfer the regulation of public offers of structured notes from the CO to Part IV of the SFO. In view of the financial crisis and the current public sentiment, the SFC believes that there is merit to take forward the reform initiatives. It is believed that after the amendment of the relevant provisions of the CO, the regulation of public offers of structured products under Part IV of the SFO through product codes will rationalise the current public offering regime in Hong Kong.

6.47 For the reasons set out in our report dated 31 December 2008 to the Financial Secretary, the proposed product code would be premised on the two pillars (of the six pillars) in our regulatory framework in the offering of investment products – namely disclosure-based principles and the suitability obligations that an intermediary has to discharge in recommending products to or soliciting subscriptions from investors. Whilst the product code that the SFC proposes for authorising structured products for public offerings would seek to set out certain structural features and codify the disclosure requirements applicable to structured products offered to the public in Hong Kong, these measures are not and cannot serve to guarantee an authorised product is failure-proof. S36

6.48 It is proposed that a consultation paper on the proposed product code will be published by the SFC for public consultation in the third quarter of 2009.

b. Your failure to deliver the outcomes/regulatory objectives, in (a), (c) and (d) is due to the ineffective application of the power in SFO and CO conferred to SFC. Do you agree?

6.49 I do not agree that there has been an ineffective application of the power in SFO and CO conferred to SFC.

SECURITIES AND FUTURES COMMISSION
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6 August 2009

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Global Head, Corporate Trust and Loan Agency
HSS Securities Services
The Hong Kong and Shanghai Banking Corporation Ltd
Level 30, HSBC Main Building
1 Queen's Road Central
Hong Kong

By Hand

Dear Sirs,

Re: Collateral for Lehman Bros minibonds series 5-7, 9-12, 15-23 and 25-36 (Outstanding Minibonds)

I am writing to you at the request of the Hong Kong Legislative Council Subcommittee to Study Issues Arising from Lehman Brothers-related Minibonds and Structured Financial Products.

Mr Martin Wheatley, the SFC's CEO, appeared before the Subcommittee on 3 August 2009 to answer questions. During that hearing, he was asked several questions about the present value of the collateral for the Outstanding Minibonds. He answered that we are only aware of the "Structure and Pricing of Minibonds" report dated 29 December 2008 prepared by Ernst & Young and submitted to the Legco Panel on Financial Affairs by the Task Force re Lehman Incident of the Hong Kong Association of Banks on the same date and are not aware of any subsequent valuations. However, at the request of the Subcommittee he undertook that the SFC would ask you as trustee of the Oustanding Minibonds about this issue.

Subsequently, on 4 August 2009, the Subcommittee has written to Mr Wheatley asking the SFC to "Please obtain from the Minibond trustee up-to-date information on the value of the collateral for Minibonds, including the collateral being sold or already realized." Given this request, we would be grateful for any information you could provide to us to relay to the Subcommittee. The Subcommittee has asked that we provide the information as soon as possible and at the latest by 12 August 2009. We would be grateful if you could endeavour to reply by this deadline.

We should draw to your attention that the Subcommittee request at present has no force of law, though it has powers of compulsion under the Legislative Council (Powers and Privileges) Ordinance should it decide to exercise them. We should also make clear that this request from the SFC is not under compulsion. However, we would be grateful for any assistance you can extend to the Subcommittee.

We must also point out that the Subcommittee has asked us to produce a copy of this letter to it.

Yours faithfully,

Eugène Goyne
Senior Director
Enforcement

c.c.: Legislative Council Subcommittee

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