



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

**Responses to the follow-up questions arising  
from the Subcommittee hearing on 8 January  
2010**

**25 January 2010**



1. In connection with the viewpoint expressed by the Financial Secretary (FS) in his letter dated 12 June 2009 to the Chief Executive Officer of the Securities and Futures Commission (CEO/SFC) (S3(C)(i)) that the current serious public controversy revolving round the Lehman Brothers (LB) Minibonds emanated from SFC authorizing the registration of the prospectus and the issue of the marketing materials for Minibonds, please confirm whether SFC had any written correspondences with the Administration on the relevant issue between the collapse of LB and CEO/SFC's receipt of the aforesaid letter from FS.
- 1.1 We do not have any written correspondences with the Administration on the relevant issue set out in the question between 15 September 2008 and 12 June 2009.



2. **Please provide information/documents, if any, on SFC's discussion with the Government and/or the Hong Kong Monetary Authority between April 2003 and 15 September 2008 on the efficacy of the existing regulatory structure governing the banks' regulated activities and the need or otherwise for reviewing it.**

- 2.1 Please note that we need more time to address this request.



3. In the light of the evidence gathered by SFC in its top-down investigations into the sale of Minibonds by the 16 distributing banks, please advise:
- (a) whether the SFC identified any worst-performing bank(s) in their compliance with SFC's relevant regulatory standards; and
- 3.1 The SFC did not rank the conduct of each Distributor nor did the SFC reach any final views about the conduct of any Distributor as explained in the Thematic Analysis on the Sale of Minibonds.
- (b) prior to the announcement of the Minibonds repurchase agreement on 22 July 2009, whether SFC had ever considered negotiating with the bank(s) in (a) above an agreement involving an offer by such bank(s) to repurchase the outstanding Minibonds at 100% of the principal amount invested.
- 3.2 Given the answer to 3(a), there is no need to answer this question.



4. **Please provide the number of Minibonds-related complaint cases with criminal elements that have been referred by SFC to the appropriate authorities for further investigation.**
- 4.1 The SFC referred one case to the Police in April 2009. The SFC understands that:
  - (a) the referral led to charges being laid against a staff member of one distributor for use of a false instrument and theft in relation to the sale of a Minibond; and
  - (b) the circumstances were ones that could not be attributed to the person's employer, nor were they related to any Code of Conduct issue that arose in the course of the SFC's top-down investigations.



5. Further to the evidence already produced by SFC to the Subcommittee on SFC's authorization of the draft prospectuses of LB-related structured financial products, please provide the following documents where appropriate:
- (a) SFC's reports relating to its authorization of the draft prospectuses of 10 structured financial products which met the following criteria: (i) the prospectuses of such products were authorized by SFC in each of the years between April 2003 to 15 September 2008; and (ii) the relevant products covered by such prospectuses were issued/distributed by LB, Standard Chartered Bank (Hong Kong) Limited, DBS Bank (Hong Kong) Limited and Citibank (Hong Kong) Limited;
  - (b) the checklist completed by the relevant issuers in accordance with Schedule 3 of the Companies Ordinance (Cap. 32) in respect of each application for authorization of the prospectus of the product mentioned in (a) above; and
  - (c) SFC's follow-up questions to the relevant issuers on the aforesaid checklists, and the written responses received by SFC from the issuers.

5.1 Please note that we need more time to deal with this request.



6. In the light of the descriptions used by SFC throughout its document entitled "A Thematic Analysis on the Sale of Minibonds" (S5(C)) on the extent to which the Distributors were involved in the issues identified by SFC's top-down investigations into the sale of Minibonds (such as "a number of Distributors", "some Distributors", "many of the Distributors", "most of the Distributors" and "the Distributors generally..."), please specify the number and names of the Distributors qualified by each such description as used in the relevant paragraphs of the Thematic Analysis.
- 6.1 The SFC is unable to disclose the identities of each Distributor in each case without giving procedural fairness to any person or persons whose interests may be adversely affected by the disclosure as explained in our letter to the Chairman of the Subcommittee dated 21 January 2010 and the submissions attached to that letter.
- 6.2 In any event, the reference to "a number", "some", "many" and "most" denotes that the relevant observation or issue does not arise in the same way with all distributors. The observations are intended to illustrate the thematic issue under consideration. They do not constitute legal findings or judgements against any particular bank.



7. Please advise on the principles and considerations in deciding to accept the different repurchase offers (such as the repurchasing prices and eligibility for such offers) under the following agreements reached by SFC with the relevant distributors engaged in the sale of LB-related structured financial products:

- (i) the Minibonds repurchase agreement applicable to all of the 16 distributing banks;
- (ii) the Lehman Equity Index-linked Principal Protected Notes repurchase agreement applicable to Dah Sing Bank Ltd and Mevas Bank Ltd; and
- (iii) the Minibonds repurchase agreements applicable to the three securities firms, i.e. Sun Hung Kai Investment Services Ltd, KGI Asia and Grand Cathay Securities (Hong Kong).

If CEO/SFC considers that he is unable to provide the information on the grounds of *sub judice*, the secrecy provision under section 378 of the Securities and Futures Ordinance (Cap. 571) and/or other reasons, please set them out in writing.

7.1 The SFC provides the following response without conceding that this question is one that, in fact, arises or is within the terms of reference of the Subcommittee.

#### **Section 201: SFC Policy and Legal issues**

7.2 The SFC's approach in considering whether to resolve any contemplated or actual disciplinary case under section 201 was the subject of questions from members of the Subcommittee to me on 23 June 2009, 22 July 2009 and 3 August 2009. The SFC refers and relies generally on those responses and adds the following.

7.3 In general, the SFC's policy in negotiating and entering into agreements under section 201 is to seek outcomes that:

- (a) provide reasonable remediation arising from the consequences flowing (or alleged to flow) from any regulatory concerns that have been identified, keeping in mind the SFC has no power to compel compensation;
- (b) ensure any systems and control deficiencies are rectified and that measures are put in place to reduce the chance of re-occurrence; and
- (c) provide a deterrent or lesson to other market participants.

7.4 In our Report on Lehman Brothers-related issues submitted to the FS in December 2008, in discussing the SFC's lack of power to compel compensation by licensees or registered institutions, the SFC also added that resolutions under section 201 can also assist in increasing confidence in the capacity of the regulatory system to solve problems beneficially (see para 40.3 of the Report).





- 7.5 Before entering into any agreement under section 201 with a person, there are two statutory pre-conditions. First, the SFC must be contemplating the exercise of one of its disciplinary powers against the person and, secondly, the SFC must consider that the agreement is one that is appropriately in the interests of the investing public or the public interest generally.
- 7.6 The SFC contends all three agreements meet both the legal requirements and the SFC's policy rationale.

#### **Specific Observations about the Three Agreements**

- 7.7 Given the decision to enter into the first named agreement with the 16 banks is the subject of proceedings in the High Court, the SFC is constrained in making further comment, as explained in our letter dated 21 January 2010 and the submissions attached to it.
- 7.8 However, in order to be helpful, let me make the following comments and observations about each of the three agreements:

#### *Remediation Facilities*

- 7.9 Each agreement contains measures to provide reasonable remediation to customers through two different remediation facilities.
- 7.10 The first remediation facility is a repurchase offer in which the distributor agrees to make an offer to repurchase outstanding Minibonds from eligible customers. Under the repurchase offers, eligible customers are able to receive remediation without the need to establish fault on the part of the distributor.
- 7.11 The second remediation facility is through the enhanced complaints-handling procedures where professional and experienced customers are able to obtain a merits-based assessment of their complaint. Relevant customers are able to obtain remediation based on a fair assessment of the merits of his or complaint and without having to establish fault on the part of the distributor.
- 7.12 In both cases there is an appropriate financial remediation facility that operates:
- (a) at no cost to the customer;
  - (b) without the need for the customer to commence his or her own proceedings (individual action would take considerable time and incur substantial legal costs not all of which would be claimable even if the customer is successful); and
  - (c) without the customer having to prove fault on the part of the distributor or actual loss or damage.

#### *The Different Repurchase Offer Rates*

- (a) *Sun Hung Kai Investment Services Ltd ("Sun Hung Kai"), KGI Asia and Grand Cathay Securities (Hong Kong) ("Grand Cathay")*



- 7.13 Sun Hung Kai, as co-ordinating distributor of Minibonds, earned commission revenue from the sale of Minibonds to its own customers and also from the sale of Minibonds by each of the other distributors, including the 16 banks.
- 7.14 In negotiating the repurchase rate at the original investment of each eligible customer, the SFC ensured the total amount of financial redress to Sun Hung Kai customers under the repurchase offer was not less than the amount of revenue earned by Sun Hung Kai.
- 7.15 The SFC persuaded Sun Hung Kai that, together with the other remedial measures contained in the section 201 agreement, this was an appropriate basis to resolve the SFC's concerns.
- 7.16 The repurchase rates set by KGI Asia and Grand Cathay were the result of voluntary decisions by the senior management of the firms to resolve the SFC's concerns. The SFC considered the repurchase offers to be fair and reasonable in the circumstances and sufficient justification for resolving the cases under section 201.
- (b) *The 16 Banks*
- 7.17 The repurchase offers in the Minibond agreement provides each eligible customer with significant financial redress which, in many cases, may become a substantial amount depending on the recoverable value of the collateral.
- 7.18 The establishment of the fighting fund through the disgorgement of commission income, the prospect of additional payments to customers and the prospect of financial remediation to ineligible customers through the enhanced complaints-handling process distinguishes the 16 bank agreement from the agreement made with Sun Hung Kai and KGI Asia.
- 7.19 The repurchase rate needs to be considered as part of a financial remediation process that includes the disgorgement of commission income by the 16 banks and the creation of a fund to realise the collateral so that additional amounts can be paid to customers and taking into account the SFC has no power to order compensation for customers or to direct a firm to pay any more than it is prepared to pay.
- 7.20 The total amount paid out to customers under this process is approximately HK\$5.2 billion. This sum does not take into account the amounts paid (or to be paid) to customers under the enhanced complaints-handling procedures nor any additional payments out of the collateral that may be made to those who accepted the banks' repurchase offer of Minibonds.
- 7.21 This amount is substantially greater than the amount that could have been imposed on any of the 16 banks by way of financial penalty.
- 7.22 The amount of financial redress is substantially greater than was achieved in relation to almost identical circumstances in other jurisdictions in which a Lehman-related Minibond product was sold.

*The Number of Eligible and Ineligible Customers*



- 7.23 Approximately 25,000 customers were eligible to receive a Minibond repurchase offer from the banks. This represented the vast majority of customers whose claims had not already been the subject of voluntary settlements with the banks. A very large majority of this number accepted the offer and have already received financial redress under this facility.
- 7.24 Approximately 1100 customers were ineligible for the repurchase offer. These customers include institutions, professional investors and experienced investors, the latter being those with considerable, demonstrated experience in purchasing structured products like Minibonds. We are informed by HKMA, on the basis of bank data, there were 879 experienced investors.
- 7.25 The definition of 'experienced investors' set a very high benchmark of demonstrated experience in purchasing products like Minibonds, namely 5 or more transactions within the 3 years prior to the first purchase of a Minibond. (Accordingly, the Minibond had to be the sixth structured product purchase in the preceding 3 years). Accordingly, an experienced investor had to be a person with very recent experience and familiarity with products like Minibonds.
- 7.26 The SFC considered it was reasonable for experienced investors to be treated differently to inexperienced investors. Accordingly, experienced investors were (and remain) able to take advantage of the enhanced complaints-handling process. In this way, the agreement with the banks makes clear provision for experienced investors to receive financial remediation if banks were actually at fault as assessed under the enhanced complaints-handling process.

(c) *Dah Sing Bank Ltd/Mevas Bank Ltd and Lehman Equity-linked Principal Protected Notes*

- 7.27 The repurchase offer by Dah Sing Bank Limited and Mevas Bank Limited for customers who purchased Lehman Equity Index-linked Principal Protected Notes (PPNs) is specific to this case. The PPNs, in this case, are different to Minibonds (for example, there was no collateral held for these products).
- 7.28 The repurchase rate of 80% provides customers with very substantial financial redress taking into account the fact that the SFC has no power to order compensation for customers or to direct a firm to pay any more than it is prepared to pay.

**Overall Comments on the Agreements**

- 7.29 The SFC was satisfied that the three agreements represented the best deal for customers and that it would have been contrary to the interests of affected customers for the SFC to have prevented these offers being made.
- 7.30 The SFC had special regard to the fact that these agreements provided financial redress for well over 90% of affected customers without any of them having to establish fault, prove loss or damage or otherwise expend any other money to obtain it.



- 7.31 The SFC is also satisfied that the negotiations were appropriately forceful and robust and that the point had been reached when the only other option for the SFC was to exercise the contemplated disciplinary powers.

#### **The Exercise of Disciplinary Powers**

- 7.32 The SFC also took into account the potential exercise of the contemplated disciplinary powers and the likely consequences for customers.
- 7.33 The SFC considered it is hard, if not impossible, to see how SFC disciplinary action would have assisted customers in obtaining any financial redress because:
- (a) the SFC's disciplinary powers do not provide the SFC with the means to compel a party to pay financial compensation to any person (any financial penalty imposed on a party is paid to the Hong Kong Government and cannot be used to defray losses to members of the public);
  - (b) the resolution of disciplinary proceedings would have taken considerable amount of time, potentially years, given the number of contemplated cases, the size of each case, the complex issues involved as well as the stakes for a large number of institutions; and
  - (c) a finding by the SFC that a person has breached the Code of Conduct does not give rise to a private civil cause of action (see section 399(6) of the SFO) and there is no mechanism in the SFO for the SFC to provide private litigants with access to SFC evidence and material so that a private litigant can use SFC findings as a shortcut to prove liability against a bank.
- 7.34 Of course, it is also possible the SFC would not have been successful in any contemplated disciplinary proceedings against any of the 16 banks.



8. **Please provide an index of the existing documents in CEO/SFC's possession containing the evidence gathered by SFC in its investigation into the sale of LB-related Minibonds and structured financial products by each of the 19 distributing banks, with sufficient description to enable each document to be identified.**
- 8.1 The SFC prepares a full index of evidentiary documents for the purposes of disciplinary proceedings. Given the SFC did not get to the stage of starting disciplinary proceedings in all cases, a full index in respect of all investigations into the sale of Minibonds is not available.



9. **Whether SFC has also detected any breaches or failings in the sale of LB-related non-Minibond products by the 16 distributing banks in the course of its top-down investigations into the sale of Minibonds by such banks, and if yes, please provide an analysis of such breaches or failings.**
- 9.1 The SFC has not resolved investigations into the sale of non-Minibond products by the 16 banks.