Statement of Ko, Ping Chung Harold

1. This statement is made by me, Ko, Ping Chung Harold, to the Subcommittee to Study Issues Arising from Lehman Brothers-related Minibonds and Structured Financial Products (the "Subcommittee") in connection with a summons issued by the Subcommittee on me on 30 December 2009.

My Background

2. I started my career in finance in 1978 after graduating from McGill University in Canada that year. I joined the Securities and Futures Commission ("SFC") in February 1990 as a Manager in the Investment Products Department ("IPD"). While in the IPD, I was re-positioned as a Senior Manager in July 1994 and then Head, Insurance-related policies and products ("IPP") in January 2005 until October 2008. I then requested and was transferred to the External Relations Department ("ERD") where I worked until August 2009. I left the SFC and ended my career 6 years early because I believe I can better protect the interests of the investing public by assisting the Subcommittee to find out what went wrong in the Lehman Brothers incident and how to prevent similar incidents from happening in the future.

3. Except for my brief stay of around 10 months in the ERD handling investor complaints, including no doubt many Lehman-related complaints, my entire career in the SFC was devoted to the vetting of applications for authorization concerning public offers of numerous non-listed investment products, including a variety of structured products in the form of deposits and insurance policies handled by the IPD. Other public offers of non-listed structured products in the form of debentures or debenture-like investments, e.g. equity-linked or credit-linked notes, were handled by the Prospectus Team of the Corporate Finance Division ("CFD") as a result of an internal division of labour within the SFC. In my view, this had regrettably created a regulatory arbitrage in product authorization that contributed, at least partly, to the Minibond fiasco. The other part was the lax supervision of intermediaries. I shall explain both in more detail below.

Product Authorization

4. I mentioned earlier that two different units within the SFC, i.e. IPD and CFD,

were responsible for the authorization of non-listed products for public offering.

5. In the case of IPD, public offers of products were typically authorized subject to two sets of requirements – one on <u>product disclosure</u>, e.g. the production of a document that contained all material information about the product, and the other on <u>product structure</u>, e.g. parties involved in the product were suitably qualified to perform the functions they were tasked to perform, for instance, a guarantor must be a Hong Kong authorized financial institution or a substantial financial institution <u>acceptable to the SFC</u> in order to enhance structural safeguards and better protect investors.

6. In the case of CFD, public offers of products were typically authorized subject to <u>disclosure</u> requirements only. The usual argument was that the Companies Ordinance ("CO") is a "disclosure based" regime even though, as I understand it, CFD had also authorized the public offers of other structured products, e.g. non-debenture type equity-linked investments, under section 4(2)(g) of the Protection of Investors Ordinance ("PIO") and, later, section 105 of the Securities and Futures Ordinance ("SFO") based on disclosure requirements only. This disclosure-based approach is awfully inadequate as these structured products were not the traditional, "plain vanilla" fund raising debt instruments issued by ordinary business concerns. These structured products were issued by newly established special purpose vehicles or shell companies having no track records on business performance. This explains why exemptions had to be granted to most, if not all, of the structured notes in connection with paragraphs 27 and 31 of the Third Schedule of the CO which required issuers to produce 3 years financial statements and auditors reports.

7. Regrettably, no efforts were made to align or "harmonize" the two different approaches adopted by IPD and CFD in dealing with structured products until early 2005 when the so-called "Harmonisation Project" was kicked-off, albeit informally, at the working level and only <u>after</u> Ashley Alder, Executive Director of CFD left the SFC. After much prompting by IPD, CFD finally agreed to formally take up the Harmonisation Project sometime in 2006/07 under the SFC Corporate Plan as a "deliverable" in 2007/08. Unfortunately, nothing was "delivered" before Lehman collapsed. (Endnote 1)

8. *Is the CO a disclosure-based regime?* For the purposes of illustration, let's take a look at the CO as of 16 June 2003, the day when the prospectus of Series 5

Minibonds was issued (the earliest Minibond prospectus published on the SFC website). By way of background, in layman terms, initial public offers of structured notes were required to be authorized by the SFC under the CO. However, section 342A(1) of the CO said:

> "Where it is proposed to offer to the public by a prospectus issued generally any shares in or debentures of a company incorporated outside Hong Kong…, there may, on the request of the applicant, and <u>subject to such conditions (if any) as the Commission thinks fit</u>, be issued a certificate of exemption from compliance with any or all of the requirements of sections 44A(2) and 342(1) and (3), that is to say, a certificate that, having regard to the circumstances of the case, compliance with any or all of those provisions would be either irrelevant or unduly burdensome…"*(emphasis added)*

9. While I understand that all Minibonds were issued certificates of exemption under section 342A(1), CFD had not thought it fit to impose any conditions, for instance, in the form of requirements on guarantors to enhance structural safeguards and better protect investors. This is particularly mind-boggling when one takes a closer look at the structure of Minibonds and, for that matter, practically all structured notes. These notes were typically issued by a thinly capitalized shell company which used moneys raised from investors (minus fees and charges, of course) to buy financial assets thought to be able to generate a steady flow of income (and eventually, the return of capital) for investors. However, this money had to flow through a swap counterparty before reaching the investors. A bigger company within the same group as the swap counterparty would usually step in to guarantee the latter's obligations as the swap counterparty was usually highly specialized but relatively small in size.

10. Given this typical structure of a structured note, it was not difficult to see why the guarantor was so crucial to the investors as they were effectively taking on the credit risks of the guarantor which, in the case of Minibonds, was Lehman Brothers Holdings Inc. Questions:

    (1) If IPD thought it fit to impose stringent requirements on guarantors for products they authorized, why wouldn't CFD do the same?
    (2) Could CFD have thought that a big name with a big balance sheet must be a good guarantor? If so, they were surely mistaken. A good guarantor is a substantial financial institution subject to good prudential supervision to

ensure its financial stability. Investment banks which were subject to no prudential supervision and leveraged up to 30-50 times were bad candidates as guarantors.

(3) If CFD felt they had no power to impose structural requirements under section 342A(1) because the CO was essentially a so-called "disclosure-based" regime, but nevertheless realized that there was a need for such a power, shouldn't they have sought legislative changes through Government as stipulated under section 5(1)(p) of the SFO. Indeed, legislative changes were made to the CO in 2004 but, instead of strengthening regulation, it was "de-regulated" by introducing further exemptions! Instead of amending the CO, the SFC could also have asked the Financial Secretary to prescribe structured notes as "collective investment schemes" under section 393 of the SFO and this would have made them fall squarely within the ambit of the SFO even though this was not really necessary as advertisements of structured notes were already authorized under section 105 of the SFO (formerly section 4(2)(g) of the PIO) which empowered the SFC to impose any conditions "it considers appropriate, including conditions on the matter to which the advertisement…relates".

(4) Should CFD have exercised power under section 342C(5)(b) to refuse authorization if they were not satisfied with the product structure but felt powerless to change it? It is worth noting that these Minibonds, and probably all structured notes, were not authorized for sale to the retail public in any major jurisdiction overseas (e.g. U.S., U.K. and Australia). This alone should have raised a red flag and demanded extra caution.

(5) This begs the question of what caused CFD to ignore all these points and proceed with authorization as they did?

11. *Would the lack of experience on the part of staff be a contributing factor?* The Prospectus Team of CFD was headed by William Pearson, Director of CFD, when the first wave of structured notes landed on the SFC in, I think, about 2001. As far as I know, Pearson had no regulatory experience prior to joining the SFC. The same applied to his new boss, Ashley Alder, who joined the SFC in October 2001. The year of 2001 was particularly critical for the SFC as we saw a major exodus of highly experienced regulators in top management. Four executive directors, namely Laura Cha, Andrew Procter, Paul Bailey and David Stannard all left in that same year. The departure of Laura Cha was particularly damaging to the SFC, not only because she was a well experienced regulator, but also because she was often the one who dared challenge Government to do the

right thing. The four were replaced by Alexa Lam, Ashley Alder and Alan Linning and, as far as I know, none of them had any regulatory experience, either locally or overseas, prior to joining the SFC.

12. *Would Government policy be another contributing factor?* For a good many years before the Lehman collapse, the most popular buzzword within the SFC was probably "quick wins", which was often mentioned in daily conversations and emails among colleagues (Endnote 2). My first encounter with this was sometime in 2001 when our then Chairman, Andrew Sheng, came knocking on our (i.e. team heads within the IPD who were three tiers down the corporate ladder from his esteemed position) doors and asked for "quick wins" to report to Government as he had a meeting with Government officials the following week. Hence, the previously shelved case of "hedge funds" was revived. By way of background, "hedge funds" in those days was a commonly used term in the U.S. to describe funds that were totally unregulated and not allowed to be sold to the retail public – much like structured notes. Luckily, IPD at the time was still staffed by well experienced regulators who thought it fit to impose stringent structural requirements to safeguard investors' interests and possibly averted another major disaster.

13. While on the subject of SFC/Government interactions in 2001, there were times when one could easily be forgiven to have mistaken SFC as a product developer rather than a regulator when reading what was reported to Government (Endnote 3). If what was reported to Antony Leung, then Financial Secretary, by Andrew Sheng, then Chairman, was indeed true, it begs the question whether the SFC was acting within the statutory regulatory objectives as set out in the SFO. They were:

(1) to maintain and promote the fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry;
(2) to promote understanding by the public of the operation and functioning of the securities and futures industry;
(3) to provide protection for members of the public investing in or holding financial products;
(4) to minimize crime and misconduct in the securities and futures industry;
(5) to reduce systemic risks in the securities and futures industry;
(6) to assist the Financial Secretary in maintaining the financial stability of Hong Kong by taking appropriate steps in relation to the securities and futures

industry.

Intermediaries Supervision

14. The Subcommittee and the public at large have probably heard enough about "mis-selling" by intermediaries since the collapse of Lehman. This actually came as no surprise to me and many colleagues in the SFC given how outdated our conduct regulations were and how little we did to combat mis-selling despite the high stakes involved. I couldn't agree more with Geoff Harris, then Senior Director of Enforcement Division, when he said: "Mis-selling applies across the board; we need to impose better sales practices on all intermediaries…". When re-iterating his long held view that the SFC should not be "facilitating market development" as this did not appear in its statutory regulatory objectives, he said: "Facilitation has allowed mis-selling. We need to regain the lost ground by proposing and implementing sales practices, disclosures and procedures that the industry will resist but are necessary for the protection of the investing public." (Endnote 4)

15. As we have learned from the Minibond and other mis-selling incidents, most mis-sellings by intermediaries were caused by making "unsuitable" recommendations to investors. While major jurisdictions overseas had long set detailed guidelines for intermediaries on how to ensure suitability, the SFC's Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission ("Code of Conduct") had only one short paragraph (i.e. 5.2) on the subject matter when Lehman collapsed, supplemented by a list of questions and answers ("FAQs") issued on 8 May 2007. However, these FAQs were not even published under section 399 of the SFO as codes or guidelines and did not have the force of such. According to Hing Hing Chung, Director of IIP, they "have crafted the FAQs carefully such that they do not introduce any new requirements to the broad principles already contained in the Code of Conduct or Internal Control Guidelines. This approach has the advantage of obviating the need to go for formal consultation…" (Endnote 5) This is rather outrageous given that:

    (1) There was already very little said about "suitability" in the Code of Conduct. If the FAQs were crafted such that they did not introduce any new requirements, what value would they add in enhancing standards?
    (2) These FAQs were issued around the time when the Report on Findings of

Second Round of Thematic Inspection of Licensed Investment Advisers ("Second Report") was published (see SFC website). The Second Report "revealed that a similar range of issues and deficiencies noted amongst the 15 firms during the first round of thematic inspections also exist in the other 10 firms selected for this second round." These included: *insufficient knowledge of clients; no proper due diligence on the products sold; lack of justification to illustrate suitability of advice; ineffective management supervision; poor documentation; and non-compliance with licensing requirements.* If two theme inspections, conducted two years apart, had revealed the same serious problems, shouldn't this call for tough new measures to be taken immediately to rectify the situation instead of just issuing FAQs "crafted…carefully such that they do not introduce any new requirements" to avoid public consultation? How serious was the SFC in combating mis-selling by intermediaries? My experience: Not particularly. Let me explain.

16. As a member of the Complaints Control Committee ("CCC") (Endnote 6) for many years, I always had a pretty good idea how serious the issue of mis-selling by intermediaries was. So, it came as no surprise to me when the findings of the Report on Selling Practices of Licensed Investment Advisers ("First Report") were published in February 2005. Sensing how complacent my colleagues in the Intermediaries Supervision Department ("ISD") were, I volunteered and was given permission by Alexa Lam, then Executive Director of IIP, to lead a project to deal with mis-selling ("IA Project") in about mid-2005 despite the fact that I was not part of the ISD. By September 2005, a game plan was formed (Endnote 7). While detailed guidelines for investment advisers on how to ensure suitability of advice was no doubt a must-do in the plan, much emphasis was put on having intense interactions with industry participants throughout the process, both before and after the issuance of guidelines, to ensure that they understood what was required and had no doubts about our resolve to enhance standards and practices. This was in stark contrast to the laid-back attitude of our ISD colleagues as depicted by Hing Hing Chung's memo mentioned above.

17. After much pushing and shoving, we finally managed, in February/March 2006, to get all departments/divisions' agreement on a set of detailed suitability guidelines (Endnote 8), which was supposed to be sent to the Hong Kong Monetary Authority ("HKMA") and Insurance Authority ("IA") for soft consultation pending Alexa Lam's green light. Unfortunately, that green light

never came. I wrote to Alexa Lam twice in May 2006 (Endnote 9) begging her to move the project forward as planned, but to no avail. The project was finally handed over to ISD colleagues. I heard nothing about the project since…unless we consider the FAQs as its end product...

18. For some strange reasons, my ISD colleagues seemed to be seriously gripped by a complacent attitude when dealing with issues concerning mis-selling. Could this have something to do with senior management's belief that the SFC was doing fine when compared with the HKMA and IA? When commenting on a draft of the First Report in 2004, Stephen Po, then Senior Director of IIP, said: "mis-selling problems at banking and insurance sector is more prevalent" than among SFC licensees. He also said: "The key issue is that the paper as it is currently drafted makes the SFC in the entire opposite position of the IA industry. The downside risk of this paper is that retail investors will think SFC's licensed IAs are not good then shifted all the businesses to banking or insurance side. This will backfire the SFC". (Endnote 10) 'Was the SFC more concerned about licensees' business than investor protection? Or, was the over-riding concern one of self-interest?

Conclusion and Recommendation

19. One question I have often asked myself in the past year was: Could we have avoided the Minibond fiasco had we dealt with structured notes properly by imposing appropriate structural requirements and vigorously pursued the IA Project to enhance and ensure the suitability of investment advice? My answer is: Most likely. If so, what should we do to avoid the future re-occurrence of similar incidents?

20. While the SFC was supposed to be established as an <u>independent</u> regulatory body within the government according to the 1988 Ian Hay Davidson Report, this "independence" has waned substantially over the years, particularly since the establishment of the political appointment system for Government officials who, like all political appointees, are inclined to press for short-term gains, i.e. "quick wins", and pay little attention to longer-term consequences. This, coupled with the fact that all executive directors are appointed by Government on short-term contracts, has meant that these supposedly "professional regulators" are under intense pressure to toe the Government line and do it's bidding regardless of the statutory regulatory objectives.

21. To remedy the situation, I suggest that the Legislative Council assume an active role in the appointment / re-appointment of executive directors of the SFC to provide the necessary "checks and balances" and ensure that only the right people with the relevant experience are hired and that their main focus is on protecting the interests of the investing public rather than "facilitating market development". This active role may, for instance, take the form of "confirmation hearings" as in the case of "Senate Confirmation" for the appointment of members of regulatory commissions and other presidential appointments in the United States.

22. If thought fit, I shall be more than pleased to share further and in more detail with the Subcommittee my experiences and views on how to strengthen the present regulatory structure to better protect the investing public including issues concerning: (i) one super-regulator vs multiple regulators; (ii) investor restitution and redress; and (iii) qualifications for executive directors.

23. The information in this statement is provided by me to the best of my knowledge and belief at the time of writing this statement.

Ko, Ping Chung Harold
19 January 2010

Endnotes:

(1) See 2 emails titled "Fw: Harmonisation" on: (i) 26/06/2006 at 10:03 AM from Gary Ho, Senior Manager of IPD to Sandy WS Au, Senior Manager of CFD; and (ii) 03/10/2007 at 05:19 PM from Harold Ko, Head of IPP to Sonia Leung, Director of CFD. [Attachment I]

(2) In an email titled "Draft guidelines on awareness marketing, registration formalities etc" on 10/12/2002 at 09:56 AM from Alice Law, then Director of Intermediaries and Investment Products Division ("IIP"), to Alexa Lam, then Executive Director of IIP, and others, Law told Lam that the attached file contained "the latest version of the draft Guidelines that William's team (author's note: referring to William Pearson's Prospectus Team) has prepared for the Government as "quick wins" for facilitating the HK market in equity

and debt offerings…." [Attachment II]

(3) In an email titled "Asia 50" on 03/08/2001 at 12:02 PM from Andrew Sheng, then SFC Chairman, to Antony K Leung, then Financial Secretary, and others, Sheng described in some detail what he and others in the SFC had done to solicit interests from fund managers in creating an exchange traded fund. [Attachment III]

(4) See email titled "Message from Geoff Harris re: Regulatory Challenges and Responses" on 08/03/2006 at 04:19 PM from Joyce Yim, then Harris' secretary, to Ian Johnston, then Advisor to the SFC. [Attachment IV]

(5) See email titled "IA project" on 11/01/2007 at 03:16 PM from Hing Hing Chung, Director of IIP, to Alexa Lam, Executive Director of IIP. [Attachment V]

(6) CCC was an internal committee comprising of senior executives of various departments within the SFC to look into investor complaints.

(7) See email titled "IA Project – Game Plan" on 02/09/2005 at 07:32 PM from Gary Ho, Senior Manager of IPD to Alexa Lam, Executive Director of IIP and others. [Attachment VI]

(8) See email titled "IA Project – Draft Suitability Guidelines" on 01/03/2006 at 10:06 AM from Gary Ho, Senior Manager of IPD to Alexa Lam, Executive Director of IIP and others. [Attachment VII]

(9) See 3 emails all titled "Re: work allocation" on: (i) 09/05/2006 at 07:07 PM from Harold Ko, Head of IPP to Alexa Lam, Executive Director of IIP; (ii) 10/05/2006 at 06:35 PM from Alexa Lam to Harold Ko; and (iii) 10/05/2006 at 08:15 PM from Harold Ko to Alexa Lam. [Attachment VIII]

(10) See email titled "IA paper" on 09/11/2004 at 11:22 AM from Stephen Po, Senior Director of IIP to Yvonne Mok, Director of IIP and another. [Attachment IX]

(11) Some useful documents to facilitate discussions during hearings:

(i) Letter titled "Proposal to amend the definition of "securities" in the Securities and Futures Bill" on 21/01/2000 from Laura Cha, then Acting SFC Chairman, to Rafael S. Y. Hui, then Secretary for Financial Services [Attachment X]; and

(ii) Memo titled "Regulation of offer documents and different investment products – comments on draft Commission paper prepared by CFD" (with handwritten notes by Ashley Alder, then Executive Director of CFD) on 27/11/2001 from SFC's Legal Services Division to Andrew Sheng, then SFC Chairman, and others. [Attachment XI]