Chapter 4 Regulation of the distribution of Lehman Brothers-related Minibonds and structured financial products by banks

4.1 This chapter examines the regulatory regime of disclosure-cum-conduct regulation that prevailed during the period when LB-related Minibonds and structured financial products were offered and distributed by retail banks in Hong Kong[1], and discusses related issues arising from this regime.

Disclosure-cum-conduct regulation

4.2 The distribution of LB-related Minibonds and structured financial products was subject to a disclosure-based regime complemented by regulation of intermediaries' conduct at the point of sale, which rested on two important pillars[2]:

(a) the authorization of product documentation by SFC directed at ensuring adequate disclosure of information on the product; and

(b) a requirement on the intermediary to ensure suitability of the product for the particular investor.

The two pillars were supported by enforcement against non-compliance.

[1] Following the commencement of the Securities and Futures and Companies Legislation (Structured Products Amendment) Ordinance 2011 (No. 8 of 2011) on 13 May 2011, public offers of structured products are regulated by the provisions of the Securities and Futures Ordinance (Cap.571) instead of the Companies Ordinance (Cap. 32). The regulatory regime discussed in this chapter refers to the regime which pre-dated 13 May 2011, unless stated otherwise.

[2] Paragraphs 7.1.1 to 7.1.2 of SFC Review Report.

4.3 A corollary of the disclosure-based regime was that product issuers were free to launch investment products so long as there was adequate disclosure of information to enable potential investors to make an informed investment decision. Where the products were sold through intermediaries such as banks and brokers, the intermediaries must act with skill, care and diligence and in their clients' best interests[3]. Where intermediaries made a recommendation or solicitation in respect of a product, they must assess the suitability of the product for individual investors[4]. Under the prevailing regulatory regime, individual investment products, regardless of their complexity or associated risks, did not require prior authorization from the regulators before they could be offered to investors[5].

First pillar - Authorization of product documentation by SFC

4.4 As the authorization of offer documentation and marketing materials was a specialized function of the Prospectus Team under the Corporate Finance Division (CFD) of SFC[6], the Subcommittee has summoned Mr Brian HO, ED of SFC who headed CFD (ED of CFD), to give evidence in addition to Mr Martin WHEATLEY, then CEO/SFC. Before becoming the head of CFD on 28 August 2006, Mr HO held the position of senior director of CFD between October 2000 and August 2006. The Subcommittee also received evidence from Mr Harold KO, a former employee of SFC who had worked in the Investment Products Department (IPD)[7] of the Intermediaries and Investment Products Division of SFC for more than 18 years.

[3] General principle 2 of the Code of Conduct.

[4] Paragraph 5.2 of the Code of Conduct.

[5] An exception was collective investment schemes which required authorization by SFC under SFO.

[6] CFD comprised four separate teams, namely, the Takeover Team, Listing Policy Team, Dual-filing Team and Prospectus Team. The Prospectus Team was responsible for, amongst others, the authorization of offering documentation and marketing materials relating to unlisted shares and debentures and equity-linked investments.

[7] IPD was a department under the Intermediaries and Investment Products Division responsible for authorizing unlisted investment products mainly in the form of insurance policies and collective investment schemes in accordance with provision in SFO.

Public offer of investment products

4.5 Where investment products were to be offered to the public in Hong Kong, the offer documentation must be authorized by SFC unless an exemption applied. Before the coming into effect of the Securities and Futures and Companies Legislation (Structured Products Amendment) Ordinance 2011 (No. 8 of 2011) on 13 May 2011, the requirements for authorization of product documentation were set out in the Companies Ordinance (Cap. 32) (CO) (i.e. CO prospectus regime) and in SFO (the offers of investments regime). The legal form of the investment product would determine which of these regimes would apply. The majority of LB structured products including Minibonds, LB-CLNs and Pyxis Notes were structured as "debenture" as previously defined in section 2 of CO[8]. The issuer of these products must submit the relevant prospectuses to SFC for authorization for registration in accordance with the requirements under CO before the products could be offered to the public. The prospectus must contain the information specified in the Third Schedule to CO. A specimen copy of the compliance checklist typically completed by the issuer of a structured note in applying to SFC for authorization is at **Appendix 4(a)**.

4.6 As explained by Mr Brian HO at the hearing on 17 July 2009, officers in the Prospectus Team of CFD first checked precedents, vetted the draft prospectus against the content requirements in the Third Schedule to CO based on the information provided by the issuer and consulted any relevant internal practices or guidance of SFC. The directors of the issuer company took responsibility for the accuracy and completeness of the information contained in the prospectus which carried

[8] Before the commencement of the Securities and Futures and Companies Legislation (Structured Products Amendment) Ordinance 2011 on 13 May 2011, "debenture" was defined under section 2 of CO to include debenture stock, bonds and any other securities of a company whether constituting a charge on the assets of the company or not. After commencement of the said Ordinance, "securities" in the definition of "debenture" was replaced by "debt securities" and a definition of "structured product" was added to SFO and CO. The majority of LB structured products which previously fell within the ambit of "debenture" will henceforth fall within the new definition of "structured product".

a statement to the effect that neither SFC nor the Registrar of Companies takes any responsibility as to the contents of the prospectus. The CO also requires that prospectuses must contain, amongst others, sufficient particulars and information to enable a reasonable person to reach a valid and justifiable opinion of the shares or debentures[9].

4.7 According to Mr Martin WHEATLEY, to mirror the eligibility requirements for issuers of listed structured products under the listing rules of The Stock Exchange of Hong Kong Limited, SFC had taken administrative measures to impose certain eligibility requirements in terms of their net asset value and credit ratings on issuers or swap counterparties/swap guarantors of unlisted structured notes[10].

4.8 The Subcommittee has noted that in February 2003, SFC issued the Guidelines on using a "dual prospectus" structure to conduct programme offers of shares or debentures requiring a prospectus under the Companies Ordinance (Cap. 32) [11] which contemplated separate registration of programme prospectus and issue prospectus with respect to programme offers of shares or debentures (i.e. offers made on a repeat or continuous basis or through successive tranches). This "dual prospectus" approach was then provided under the Companies (Amendment) Ordinance 2004 (No. 30 of 2004) which came into effect on 3 December 2004[12]. Under this approach, for structured notes issued in a series under a programme (such as Minibonds and LB-CLNs), a programme prospectus would be prepared containing information on the issuer, the master terms and conditions and other information common to all series of notes under the same programme. Issue-specific information such as the tenor of the notes, interest rates, underlying collateral and investment risks would be set out in a separate issue prospectus. Both the programme and issue prospectuses required authorization by SFC. The

[9] Paragraph 3 of the Third Schedule to CO.
[10] For example, the issuer/guarantor is required to have a minimum net asset value of HK$2 billion.
[11] The set of guidelines is available on SFC's website at http://www.sfc.hk.
[12] Section 39B of CO and section 2 of the Twenty-first Schedule to CO.

Subcommittee notes that in fulfilment of the statutory disclosure requirements under CO, the issue prospectus for Minibond Series 35 dated 16 January 2008, for example, runs to 56 pages and makes reference to the programme prospectus dated 12 March 2007 consisting of 52 pages. In this connection, the Subcommittee has noted from Mr Brian HO that as a result of the Prospectus Team's efforts, the percentages of prospectuses written in plain language had increased gradually from 44% in 2005 to 100% in 2008.

4.9 In response to members' questions on the CO prospectus regime, both Mr Martin WHEATLEY and Mr Brian HO stated that the regulatory focus in the authorization process was on "disclosure" instead of the commercial merits of the product. Authorization of product documentation did not contain or imply any recommendation that the product was suitable for a particular investor. SFC held the view that the duty to ensure suitability should rest with the intermediary.

4.10 As regards marketing materials, issuers were required to comply with the Guidelines on use of offer awareness and summary disclosure materials in offerings of shares and debentures under the Companies Ordinance (CO Marketing Guidelines) issued by SFC under section 399 of SFO. The CO Marketing Guidelines required that the marketing materials must not contain anything inconsistent with the information contained in the prospectus, and that the contents must not be false, biased, misleading or deceptive. Appropriate warnings should also be included. The Subcommittee was informed that internal guidance on points to note when reviewing prospectuses and marketing materials was issued by SFC in 2005. The general requirement on marketing materials was to give balanced information of a product's features and risks. SFC also pointed out that marketing materials were designed to raise investors' interest in the product and were by no means a substitute for prospectuses.

4.11 In response to the Subcommittee, Mr Brian HO, ED of CFD, advised that the Prospectus Team had raised queries and commented on all the prospectuses for Minibonds and LB-CLNs, as well as all their marketing materials submitted for authorization. Mr HO also informed the Subcommittee at the hearings on 17 and 21 July 2009 that the reviews of draft prospectuses and marketing materials were carried out by officers of the Prospectus Team of CFD at the rank of manager or above, and overseen and monitored by a senior director. A senior director, director or associate director was responsible for authorization of prospectuses and marketing materials under a sub-delegation of authority by ED of CFD. Officers of the Prospectus Team possessed university degrees in law, accountancy or other disciplines and working experience of five to 18 years. On-the-job training on various financial products and topical issues such as the impact of sub-prime mortgages was also provided to them.

4.12 In examining the CO prospectus regime, the Subcommittee has also received evidence from Mr Harold KO, a former employee of SFC. At the hearing on 29 January 2010, Mr KO said that SFC could have imposed conditions or requirements under section 342A(1) of CO in the authorization process, similar to the practice adopted by IPD (the Department where he had served) to impose requirements on product structure as appropriate. In this regard, the Subcommittee sought further explanation from Mr Martin WHEATLEY, then CEO/SFC, on SFC's powers to impose conditions in the authorization of product documentation. In response, Mr WHEATLEY stated that the regime administered by CFD under CO and the regime administered by IPD under SFO were applicable to different types of investment products depending on their legal form. He said that section 342A of CO empowered SFC to waive compliance with disclosure requirements set out in the Third Schedule to CO. SFC could waive a requirement and impose a condition related to the requirement waived, but could not impose a condition relating to a completely different matter such as the

structure of product. On whether SFC had power to refuse authorization of Minibonds for registration under section 342C(5)(b) of CO, Mr WHEATLEY stated that if the product documentation complied with CO, it would be an abuse of power for SFC not to authorize it. There had not been any valid grounds to refuse authorization of the Minibonds documentation.

4.13 Mr Harold KO also gave evidence on SFC's "Harmonization Project" carried out in 2005 aimed at aligning the authorization processes administered by CFD and IPD. On how the project had been pursued afterwards, Mr Martin WHEATLEY explained that major changes to legislation were required. In August 2005, SFC published the Consultation Paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance under Phase 3 of the exercise to reform CO[13]. As noted in the Consultation Conclusions on the Consultation Paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance published in September 2006, in the light of the public comments received, the original proposal to create a unified offering regime was modified by retaining two separate public offer regimes under CO and SFO, but carving out "structured products" from the definition of "debenture" under CO[14]. Thereafter, SFC commenced soft-consulting stakeholders. According to SFC, the above initiative, together with other reform initiatives under Phase 3 of the CO reform exercise, were scheduled to be taken forward in tandem with the CO Rewrite Exercise which commenced in mid 2006.

[13] A three-phase review and reform exercise was launched in 2002 to modernize the regulatory framework for public offering of shares and debentures. Phase 1 of the review and reform did not involve amendment to CO and was completed in March 2003 when SFC issued various guidelines and class exemptions. Phase 2 of the review and reform was completed in December 2004 when the prospectus-related amendments contained in the Companies (Amendment) Ordinance 2004 (No. 30 of 2004) came into effect. Phase 3 which was a comprehensive review of the CO prospectus regime was launched in August 2005 when SFC published the consultation paper for such purpose.

[14] Please see the Consultation Conclusions on the Consultation Paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance issued by SFC in September 2006.

4.14 As stated by SFC, owing to the complexity of the law drafting exercise, the initial draft of the relevant draft drafting instructions was only close to its final form by September 2008. Nevertheless, in the wake of the LB incident, SFC took forward the legislative amendments of transferring the regulation of public offers of structured products from CO to Part IV of SFO ahead of the other Phase 3 reform initiatives, and launched the necessary consultation in October 2009. The Securities and Futures and Companies Legislation (Structured Products Amendment) Bill 2010 was introduced into LegCo on 2 July 2010 and passed on 4 May 2011. A summary of the legislative changes is at **Appendix 4(b)**.

4.15 At the hearings held on 8 January and 9 February 2010, in response to the Subcommittee's question on whether some of the problems related to the sale of LB structured products could have been avoided if the proposed legislative changes had been implemented earlier, Mr WHEATLEY said that the legislative amendments would bring about certain changes to the authorization regime administered by SFC. However, investors had incurred losses as result of the collapse of LB. The legislative amendments could not provide a solution if a major investment bank failed.

Investment products offered by private placement

4.16 A prospectus was not required in respect of financial products which were distributed by banks through private placement. The marketing materials of such products also did not require authorization by SFC. The term "private placement" was not defined in law. An offer of financial products was generally regarded as a private placement when the banks made use of any one of the following "safe harbour" provisions in the Seventeenth Schedule to CO to offer the products:

(a) the offer was made to professional investors[15] only;

[15] "Professional investor" is defined in Part 1 of Schedule 1 to SFO.

(b) the offer was made to not more than 50 persons; or

(c) the offer in respect of which the minimum denomination or consideration payable or the minimum principal amount to be subscribed or purchased was not less than HK$500,000.

4.17 For documents (e.g. termsheets stipulating the terms and conditions of the offer) in respect of offers in (b) and (c) above, such documents must contain a warning statement as specified in the Eighteenth Schedule to CO to the effect that the contents of the document have not been reviewed by any regulatory authority in Hong Kong, and that the purchaser is advised to exercise caution and obtain independent professional advice if in doubt. In examining the termsheets for ELNs offered by some banks by way of private placement, the Subcommittee has noticed that a note containing the aforesaid warning was printed on the front page of the termsheet, but in much smaller font size than that used for other parts of the termsheet.

Observations on the CO prospectus regime

4.18 In examining whether the CO prospectus regime could achieve the objective of enabling a prospective investor to reach an informed opinion on the product in question, the Subcommittee has the following observations:

Name of the product

4.19 The Subcommittee has found that one of the points included in SFC's internal guidance issued since 2005 was that when reviewing prospectuses and marketing materials, reviewers in CFD should also consider whether the name given to a particular series of notes is misleading to prospective investors. A subject of concern to the Subcommittee is the name "Minibonds" given to the series of

credit-linked notes with embedded derivatives, as the name was suggestive of traditional bonds issued by corporations or sovereign governments to raise funds, but in smaller denominations, as denoted by "Mini". Bonds are commonly understood by the general public as a relatively safe investment with periodic fixed payment of interests during the product tenor.

4.20 When testifying at the hearings held on 23 and 26 June 2009, Mr Martin WHEATLEY informed the Subcommittee that "Minibonds" was a product name that carried no regulatory meaning; and that the term was not in itself misleading. The important question was whether the product was accurately described and explained in the prospectuses and in the selling process. Mr WHEATLEY stated that it was the duty of the intermediary to explain the product and ensure its suitability for the prospective investor who should not make an investment decision based on the product name only. He also told the Subcommittee that before the collapse of LB, SFC had not received any complaint that "Minibonds" was a misleading name for the credit-linked notes. Only isolated cases (about 1%) among the complaints received by SFC after September 2008 alleged that the name "Minibonds" was misleading.

4.21 The Subcommittee has sought to ascertain whether the product name of "Minibonds" ("迷你債券") had given rise to any regulatory concern when the relevant product documentation were reviewed by CFD of SFC for authorization. As testified by Mr Brian HO, ED of CFD, at the hearing on 17 July 2009, the Minibonds issuer had advised that the prefix "Mini" ("迷你") denoted the smaller denominations of US$5,000 or HK$40,000 in which the Minibonds were offered. Referring to the issue prospectus for Minibonds Series 35 as an example, members questioned the appropriateness of the Chinese rendition of the term "Notes" as "債券", instead of "票據". According to Mr Brian HO's evidence, as far as usage was concerned, there was no mandatory Chinese term for "notes", as both

"bonds" and "notes" could be translated as "債券"[16]. He also confirmed that CFD did have internal discussion on the Chinese term and had raised the matter with the issuer. However, as the same Chinese term had all along been used in the prospectuses of earlier series of Minibonds, unless there were compelling grounds that it was not in order, there was no legal basis for SFC to reject the name or require the issuer to adopt a different product name. Mr HO nevertheless said that it had never been envisaged that there was such overwhelming concern expressed by the public after the collapse of LB over the use of the term "債券" versus "票據". He also highlighted the obligations on intermediaries to ensure suitability of the product for individual investors.

Information disclosed to investors

4.22 The Subcommittee notes from Mr Martin WHEATLEY that as the issuer of Minibonds did not specify any target group of prospective investors and the product was mainly distributed by retail banks, SFC's assumption was that the product was to be marketed to the public subject to suitability assessment for each prospective investor by the intermediary. As SFC was aware at the outset that Minibonds would likely be distributed to the general public through retail banks, the Subcommittee considers that in vetting product documentation received from issuers, SFC should take into account the needs of the general public, including their perception or understanding of certain basic facts such as the product name/description.

4.23 As advised by Mr Brian HO, SFC had no power to refuse authorization of a prospectus for registration if it contained the requisite information specified in the Third Schedule to CO, and satisfied other requirements under CO[17]. Nevertheless, the Subcommittee is concerned

[16] As explained by Mr Brian HO at the hearing on 17 July 2009, both bonds and notes are debt instruments. Bonds commonly refer to instruments with a longer term and notes, with a shorter term.

[17] Sections 38, 38B, 38C, 342, 342B and 342C of CO.

about the quality of the disclosure, in terms of whether the information had been disclosed in a manner which could effectively apprise the prospective investor of key product features and risks. Copious documents do not necessarily facilitate understanding of the product by prospective investors. Few investors are likely to read a full prospectus. The Subcommittee is highly doubtful whether an ordinary investor, without investment advice, would be able to understand the risks of Minibonds which were embedded not only in the reference entities but also in the underlying collaterals (details not known as they were to be acquired by the issuer with the issue proceeds) and counterparties.

4.24 On reading the section "INVESTMENT RISKS" on page 16 of the issue prospectus of Minibond Series 35, the Subcommittee notes the statement that the investor is exposed to the credit risk of the reference entities. This, read in conjunction with the ensuing information on the credit-worthiness of the seven reference entities[18], would easily lead an investor to believe that his risk exposure is mainly to the credit risk of the reference entities. In comparison, the Subcommittee considers that the centrality of the CDS and the roles of LBHI and its related companies in the product structure and their potential risks have not been duly highlighted in the issue prospectus.

4.25 The Subcommittee has also observed that the names of the seven reference entities are prominently displayed in a picture in the marketing leaflet of Minibond Series 35, which easily attracts attention upfront on these entities and overshadows other product features and risks which appear in the same sheet, but in much smaller font size. Nothing was mentioned that the product was not suitable for everyone. Although marketing materials are not meant to capture all the information provided in the prospectus, the Subcommittee considers it an important document for understanding the returns and risks of a product at a glance. Hence, a

[18] The seven reference entities included the People's Republic of China and six other well-known corporations.

balanced presentation of the relevant information should be given in such materials.

Second pillar - Regulation of intermediaries' conduct at the point of sale

Regulatory requirements and standards

4.26 Mr Joseph YAM, then MA, has informed the Subcommittee that HKMA's focus in its regulation of the securities business of banks is on conduct regulation. As specified in the relevant module in HKMA's supervisory policy manual (SPM)[19], the general approach adopted by HKMA is "to require RIs to comply with standards equivalent to those applied by SFC to licensed corporations (LCs) in their regulated activities"[20].

4.27 The Code of Conduct stipulates, amongst others, a set of nine general principles (GP) fundamental to the undertaking of regulated activities by intermediaries. GP1 to GP9 as stipulated in the Code of Conduct are in **Appendix 4(c)**. For example, GP2 (Diligence) requires intermediaries to act with due skill, care and diligence in the best interests of their clients. Under GP4 (Information about clients), intermediaries are required to observe a number of "know your client" (KYC) requirements. In making a recommendation or solicitation, intermediaries should ensure the suitability of the recommendation or solicitation for that client is reasonable in all the circumstances. In respect of derivative products[21], it is the intermediary's duty to ensure that the client understands the nature and risks of the products and has

[19] The SPM was issued under section 7(3) of BO and the relevant module is entitled "Supervision of Regulated Activities of SFC-Registered Authorized Institutions".
[20] Paragraph 2.1.1 of Module SB-1 of SPM.
[21] LB structured products incorporated derivatives in their product structure.

sufficient net worth to be able to assume the risks and bear the potential losses of trading in the products.

4.28 To assist intermediaries to comply with the requirements under the Code of Conduct to maintain satisfactory internal control systems, SFC issued the Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the Securities and Futures Commission (Internal Control Guidelines)[22]. The Internal Control Guidelines specifically require that an intermediary should document and retain the reasons for the recommendation and advice. It also contains various suggested internal control techniques and procedures to enhance compliance with the relevant legal and regulatory requirements.

4.29 The Subcommittee notes that in May 2007, SFC issued the Suitability FAQ in the light of its findings of the second round of themed inspection conducted on 10 selected firms in 2006 to assess their selling practices and compliance with the relevant regulatory standards. The Suitability FAQ was brought to the attention of all RIs by a circular issued by HKMA on 7 May 2007, which reminded the RIs to enhance their systems and controls where necessary to meet the suitability obligations. The key suitability obligations on intermediaries are:

(a) Know their clients;

(b) Understand the investment products they recommend to clients;

(c) Provide reasonably suitable recommendations by matching the risk return profile of each investment product with the personal circumstances of each client;

(d) Provide all relevant material information to clients;

[22] The Internal Control Guidelines were first issued in May 1997 and updated in April 2003.

(e) Employ competent staff and provide appropriate training; and

(f) Document and retain the reasons for each product recommendation.

4.30 On the legal effect of the Code of Conduct and the Suitability FAQ, Mr Martin WHEATLEY explained at the hearing on 9 February 2010 that although the two documents do not have the force of law, failure to comply with the relevant requirements is a serious matter and may call into question whether an intermediary is fit and proper to carry out the regulated activities. In taking regulatory action against intermediaries in mis-selling cases for breaches of suitability obligations under the Code of Conduct, SFC would take into account the extent to which the guidance set out in the Suitability FAQ has been followed.

HKMA's supervisory activities on RIs

4.31 The Subcommittee notes that in exercising its regulatory functions under BO and SFO over the regulated activities of RIs, HKMA carries out on-site examinations (including thematic examinations), off-site surveillance, and issues guidelines and circulars from time to time.

Circulars

4.32 As stated by Mr Joseph YAM, circulars have been issued since 2003 by HKMA to RIs to provide practical guidance on the required standards and expected industry practices in the conduct of regulated activities. These included guidance on restrictions on unsolicited calls, sharing of examination findings, and drawing RIs' attention to regulatory requirements issued by SFC which also applied to RIs[23].

[23] The circulars issued to RIs are available on HKMA's website at http://www.hkma.gov.hk.

On-site examinations

4.33 According to the testimony of Mr Joseph YAM, on-site examinations were conducted by HKMA regularly to ascertain that regulated activities of RIs were in compliance with relevant legal and regulatory requirements. The Subcommittee was informed that between the commencement of SFO in April 2003 and December 2008, HKMA conducted 170 on-site examinations of RIs which covered their regulated activities. These examinations included 37 Tier 1 examinations, 37 Tier 2 examinations[24], and 96 thematic examinations[25].

4.34 As advised by Mr Joseph YAM, HKMA's on-site examinations were not focused on issuer-specific products but adopted a risk-based approach to review transactions involving products with high sales volume, high number of complaints, and which attracted high commission. An on-site examination would typically include reviews and evaluation of the effectiveness of the RI's internal control process, discussion of existing operational practices with management and staff at different levels, sample checks of securities-related transactions to evaluate the effectiveness of relevant internal controls and regulatory compliance. During some of the thematic examinations, HKMA staff also interviewed selected frontline staff in order to assess their knowledge on the investment products and their ability to explain the nature and risks of the products distributed by them. The Subcommittee notes that reciprocal secondment of inspection staff between HKMA and SFC had been arranged in some of the examinations, such as the thematic examinations on investment advisory activities conducted in parallel by HKMA and SFC in 2006. The findings of each examination were followed up with the RIs concerned to ensure that appropriate actions had been taken by the

[24] Tier 1 examinations cover the high level operational controls of RIs over their regulated activities. Tier 2 examinations are detailed examinations on the internal controls and status of compliance with regulatory requirements.

[25] Out of the 96 thematic examinations, 85 were related to RIs' sales practices related to investments, while the other 11 examinations were not.

RIs to rectify the identified issues or implement the improvements required.

Other measures

4.35 As regards other measures, the Subcommittee has noted that in the light of increasingly volatile market conditions, HKMA conducted a survey from December 2007 to early 2008 on RIs' sale of retail credit-linked notes with sub-prime mortgages as underlying collateral, or with collateral that might include CDOs[26]. Among the 16 RIs surveyed, HKMA advised those eight RIs, which adopted a "medium" or "low" risk rating for retail credit-linked products without full principal protection, to adopt a "high" risk rating for such products. In February 2008, HKMA started to conduct thematic examinations on RIs' selling of retail credit-linked notes. This round of thematic examinations was intended to cover 11 RIs but only four examinations were completed by September 2008[27].

Outcomes of certain thematic examinations/themed inspections by HKMA and SFC

4.36 As both HKMA and SFC conducted examinations on the investment advisory activities of intermediaries respectively regulated by them, the Subcommittee has enquired on the outcomes of these examinations, the co-operation between the two regulators and how the issues identified were addressed. In this regard, the Subcommittee has noted that SFC conducted themed inspections on 15 selected investment advisory firms in 2004 to gauge the prevailing market practices of selling investment products. According to SFC, its themed inspections would always involve a sample review of actual sale transactions and client files,

[26] Please see also paragraph 3.29 of Chapter 3.

[27] As explained by Mr Y K CHOI, then DCE/HKMA, this was because regulatory resources were re-deployed to conduct an urgent round of thematic examinations on stock accumulators from April to August 2008 and after September 2008, substantial resources were deployed to handle the work occasioned by the collapse of LB.

focusing on high mis-selling risk scenarios, such as high commission rebate, long lock-in periods and complex structures. A final draft of the report for this round of inspections was sent to HKMA on 24 January 2005. The report, which was published by SFC on 23 February 2005, identified areas of unsatisfactory practice of investment advisers, particularly in their conduct of product due diligence, explanation of product risks, knowing their clients and ensuring suitability of the product for them[28]. The Subcommittee has noted that the said report was circulated to all RIs by a circular issued by HKMA on 1 March 2005 in which HKMA asked RIs to study the report and put in place systems and controls to ensure compliance with the recommendations set out in the report.

4.37 SFC conducted a second round of themed inspections in 2006 to assess the prevailing selling practices adopted by 10 other licensed investment advisers and to review any improvements since the issuance of the last report in 2005. This round of inspection was done in parallel with HKMA's examination of the selling practices of selected RIs. SFC sent its final draft report to HKMA on 21 May 2007 and published its report on 31 May 2007[29]. The Subcommittee has noted that in the light of the findings of the second round of themed inspections, SFC took enforcement action against five of the 10 investment advisers. In one case, the responsible officer (counterpart of "executive officer" under BO) was suspended for 12 months and the firm was reprimanded and fined HK$170,000 for internal controls and supervisory failures. SFC also issued the Suitability FAQ on 7 May 2007.

4.38 Referring to the findings of the thematic examinations conducted in parallel by HKMA on 10 selected RIs from September to November 2006, the Subcommittee notes that according to the circular

[28] The Report on Selling Practices of Licensed Investment Advisers published by SFC on 23 February 2005 is available on SFC's website at http://www.sfc.hk.

[29] The Report on Findings of Second Round of Thematic Inspection of Licensed Investment Advisers published by SFC on 31 May 2007 is available on SFC's website at http://www.sfc.hk.

issued by HKMA to all RIs on 1 March 2007, all the RIs examined had implemented the baseline control requirements. The issues identified were that some RIs did not document information on clients' investment experience by types of products, while a number of RIs did not have specific procedures requiring frontline staff to properly compare the investment horizons of clients and the product tenors during the selling process of investment products. HKMA also reported on a number of good practices adopted by RIs, which included special handling procedures for cases of risk mismatch, additional safeguards for transactions involving clients classified as "vulnerable clients", conduct of "mystery shopper" inspections and formal checklists to remind frontline staff to provide all required offering documents to clients during the selling process.

4.39 Regarding HKMA's thematic examinations which focused on the selling practices of RIs, the Subcommittee has noted that three rounds of thematic examinations on retail wealth management business were conducted in 2005, 2006 and 2007. According to the information available to the Subcommittee, these examinations aimed to identify areas for improvements and good practices. No serious irregularities had been reported. In the round of thematic examinations conducted in parallel to SFC's themed inspection (paragraphs 4.37 and 4.38 above) in 2006, one of the aims was to ascertain the level of compliance. Another two rounds of thematic examinations were conducted by HKMA from February to August 2008 and from March to August 2008 in relation to the sale of credit-linked notes and stock accumulators respectively, during which the examination teams had deployed most resources on ascertaining the level of compliance with relevant regulatory requirements, and on identifying and handling possible cases of non-compliance. Suspected mis-selling cases involving 123 customers were detected in these two rounds of examinations.

4.40 With a view to acquiring a more in-depth understanding of how HKMA conducted its on-site examinations and the irregularities detected before the collapse of LB, in particular in respect of thematic examinations covering the selling practices of investment products, the Subcommittee ordered for the production of 68 thematic examination reports. Both Mr Joseph YAM and Mr Y K CHOI said that they were constrained from producing the said reports to the Subcommittee by the secrecy provision under section 120 of BO, which prohibits them from disclosing information obtained by MA in the course of the exercise of his functions under section 55 of BO. A summary of the case is at **Appendix 4(d)**.

Off-site surveillance

4.41 In addition to on-site examinations, HKMA also carried out off-site surveillance on RIs by reviewing the semi-annual returns on regulated activities submitted by them. The Subcommittee was informed that since 2005, an increasing number of large, complex or active RIs have been required by HKMA to commission annually an independent unit (such as their compliance department) to review the RI's compliance with the regulatory requirements of SFC and HKMA in conducting their regulated activities. The number of such RIs stood at 50 in 2008.

Enforcement

4.42 As explained in Chapter 3, the present enforcement framework over RIs' conduct of regulated activities involves the exercise of regulatory powers by MA and SFC under the relevant legislation, often requiring one regulator to consult the other before disciplinary sanction is taken against the RI and its staff. HKMA is the frontline regulator overseeing all the activities of banks including regulated activities. MA is vested with statutory powers to investigate into suspected breaches of the Code of Conduct and other regulatory requirements. However, MA

does not have the power to impose sanctions on RIs under SFO. Such powers rest with SFC and are to be exercised after consultation with MA. In his evidence given at the hearings held on 15 and 22 May 2009, Mr Joseph YAM considered that MA had sufficient powers to investigate into suspected non-compliance by RIs, and that the regulatory work of HKMA could be enhanced if MA was also empowered to discipline RIs and their staff in respect of their regulated activities.

4.43 At the hearings on 23 and 26 June 2009, the Subcommittee enquired whether it is feasible for SFC to initiate investigation into suspected misconduct of RIs under the existing enforcement framework. In response, Mr Martin WHEATLEY said that SFC may carry out an investigation into an RI only where it has reason to inquire whether an RI is guilty of misconduct and after consultation with MA[30]. However, as SFC has no power to carry out day-to-day inspections on RIs to gather the necessary information relating to any suspected breach (this power is vested with MA), it would have practical difficulty in establishing a case for launching an investigation on its own accord. Mr WHEATLEY also informed the Subcommittee that during the period from April 2003 to mid September 2008, SFC had not initiated any investigation prior to receiving a referral from HKMA.

4.44 From April 2003 to September 2008, as reported in Chapter 3[31], HKMA handled 178 cases of suspected mis-selling of investment products by RIs, of which 72 cases were detected from day-to-day regulation[32]. However, the Subcommittee notes that of the 72 cases, only 22 were detected before 2008. During the same five-year period, nine cases had been referred by HKMA to SFC for appropriate action and SFC had taken enforcement actions in three of these cases. Meanwhile, MA suspended

[30] Section 182(1) and (4) of SFO.
[31] Please see paragraph 3.33 of Chapter 3.
[32] The other 106 cases came from customer complaints.

the registration of one ReI from the public register for one month for breaches of the Code of Conduct in June 2007[33].

Observations on the regulation of conduct of RIs

4.45 The Subcommittee is of the view that an essential component of any effective regulatory system is its ability to identify problems before they intensify and become systemic. Equally important is the effectiveness of the regulators' ongoing work in supervising regulated persons. As outlined in paragraphs 3.33 and 4.44 above, prior to the collapse of LB in September 2008, the ongoing regulatory process of HKMA as described in the foregoing paragraphs had not detected any serious problem of mis-selling investment products among RIs. This stood in sharp contrast to the large number of complaints that erupted after the collapse of LB alleging that LB structured products had been mis-sold to investors by retail banks.

4.46 As described in Chapter 3[34] and paragraphs 4.36 and 4.37 above, the findings of studies, surveys and inspections conducted by SFC in 2005 and 2006 had revealed the increased exposure of retail investors to structured financial products sold through banks, and the inadequate understanding of many investors of such products. These should have alerted HKMA of the need to deploy more resources to ensure that RIs and their sales staff had properly complied with regulatory requirements when conducting the sale of structured financial products. Nevertheless, as noted in paragraph 4.39 above, not until early 2008 did HKMA adjust the focus of its thematic examinations by deploying most resources to ascertain the level of compliance by RIs. The results of HKMA's survey highlighted in paragraph 4.35 above clearly showed that the surveyed RIs had not carried out product due diligence on retail credit-linked notes on a continuous basis in the light of changing market conditions in accordance

[33] Please see paragraph 3.33 and footnote 34 of Chapter 3.
[34] Please see paragraphs 3.28 of Chapter 3.

with the Suitability FAQ. However, apart from advising certain RIs to revise their risk ratings on the products and conducting another round of thematic examinations in February 2008, there is no evidence that MA himself or through HKMA had taken other immediate measures specifically directed at ensuring that RIs would henceforth conduct product due diligence in accordance with the applicable regulatory requirements.

4.47 The current regulatory arrangements are also not conducive to the early detection and rectification of irregularities, and some major problems are as follows:

(a) HKMA is the regulator of the banking sector and responsible for both its prudential and conduct regulation. However, HKMA does not license or approve ReIs as such, but requires the senior management of the RI to ensure the proper conduct of these individuals. The LB crisis has called into question the ability and determination of the banks to exercise sufficient vigilance over the conduct of their ReIs, given the keen competition in the industry for business and profit.

(b) Notwithstanding the MoU and various exchanges between the two regulators, whether RIs and LCs were subject to the same extent of regulatory oversight remains doubtful. For instance, the Subcommittee has noted that there was a relative lack of findings in HKMA's report on its thematic examinations on investment advisory activities published on 1 March 2007, in contrast to the more solid findings of SFC on the same subject, bearing in mind that HKMA's examinations were conducted in 2006, a period during which the sale of structured financial products, including

LB structured products, to retail investors by banks was blooming.

(c) As analyzed in the foregoing discussion, disciplinary decisions and imposition of sanctions on RIs and their EOs/ReIs often require referral and consultation between the two regulators. MA, for example, does not have statutory powers to impose disciplinary sanctions on RIs in respect of their regulated activities under SFO, and referral to SFC will be required. Meanwhile, SFC may carry out an investigation into an RI only where it has reason to inquire whether an RI is guilty of misconduct and after consultation with MA. In addition to operational complexities, this process inevitably takes time, not to mention the need to address any difference in views between the two regulators which may arise.

4.48 As the Subcommittee has noted in paragraph 4.32 above, HKMA had from time to time issued circulars to the chief executives of RIs drawing their attention to the findings of surveys/inspections conducted by SFC, as well as the regulatory requirements promulgated by SFC that were applicable to RIs. It was often stated in these circulars that HKMA would monitor the progress of RIs' follow-up action in its ongoing supervisory process. In this regard, the Subcommittee finds it useful if HKMA could, after such monitoring, publish the findings on how RIs had followed up the regulatory concerns.

4.49 Incidentally, the Subcommittee has examined the secrecy provision in section 120 of BO, which prohibits the disclosure of information obtained by MA under section 55 of BO except in specified circumstances, principally for the purposes of criminal investigation[35]. The view taken by MA is that section 120(4) of BO would bar him from

[35] Section 120(4) and (5) of BO.

complying with an order of the Subcommittee under LCPPO. Meanwhile, the Subcommittee also notes the secrecy obligations on staff of SFC under SFO. However, section 378 of SFO allows the disclosure of information under specified circumstances including in response to "a requirement made under a law"[36], which includes the Subcommittee's orders made under LCPPO. Noting that both section 120 of BO and section 378 of SFO are intended to preserve secrecy over the information obtained by the regulators in the course of performing their respective statutory functions, the Subcommittee considers that the secrecy provision under section 120 of BO should be aligned with that under section 378 of SFO to achieve consistency in the circumstances permitting disclosure under both Ordinances.

[36] See section 378(2) of SFO.