

**Response to Letter dated 4 March 2009 from the Legislative Council
Subcommittee to Study Issues Arising from Lehman Brothers-related
Minibonds and Structured Financial Products (“Subcommittee”)
Served upon the Secretary for Financial Services and the Treasury
on 9 March 2009**

GENERAL REMARKS

Introduction

Following the Subcommittee’s third hearing on 27 February 2009, I am requested to provide information on issues including actions/measures taken by me to address concerns about the growth in the retail sale of Minibonds and other structured products, discussions on the stepping up of investor education and investor protection, and the actions/measures taken by me to ensure that the regulators exercised adequate supervision over intermediaries, since I took up the office of Secretary for Financial Services and the Treasury (“SFST”) on 1 July 2007 until the collapse of Lehman Brothers (“LB”) in September 2008.

Investor Protection and Education

2. The Administration attaches great importance to investor education and protecting the interests of the investing public. Back in 1988, the Report of the Securities Review Committee recommended the establishment of an independent commission with the broad functions to ensure the integrity of Hong Kong’s securities markets and protection of investors. This culminated in the establishment of the Securities and Futures Commission (“SFC”) in 1989. In the Administration’s consultation document on the Securities and Futures Bill published in 2000, it was stated at paragraph 1 of the Executive Summary that the primary purpose of the reform for the securities and futures market is to create a modern regulatory and legal framework that, inter alia, secures appropriate investor protection. As stated at paragraph 1.7 of the above-said consultation document, “recent years have also witnessed the arrival of new technologies, new financial products, new market participants, and new trading methods. Such financial innovation reduces costs, enables investors large and small to better manage their money, and should be encouraged. However, it also gives rise to new concerns about investor protection, volatility, and market abuses. There must, therefore, be a balance between facilitating innovation and growth on the one hand, and minimizing market misconduct and systemic risks, together with providing a reasonable degree of investor protection on the other”.

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3. At the policy level, investor protection has always been one of our core policy objectives. Investor protection and education do not only involve protecting investors from market misconduct and risks. While investors are offered greater convenience and more choices in tandem with market development, investors are at the same time empowered to help and protect themselves. Indeed, two of the functions of the SFC under section 5 of the Securities and Futures Ordinance (Cap.571) (“SFO”) are to “encourage the public to appreciate the relative benefits of investing in financial products through persons carrying on activities regulated by the [SFC]” and “to promote understanding by the public of the importance of making informed decisions regarding transactions or activities related to financial products and of taking responsibility therefor.” Over the years, the Financial Services and the Treasury Bureau (“FSTB”) and our financial regulators have made tremendous efforts in revamping and refining our regulatory regime to offer better protection to investors and to enhance investor education.

4. The SFO sets out the statutory framework for the regulation of the securities market in Hong Kong, with the key objectives to, inter alia, secure an appropriate degree of investor protection. The regulatory objectives of the SFC include, inter alia, maintaining and promoting the fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry; providing protection for members of the public investing in or holding financial products; minimizing crime and misconduct in the securities and futures industry; and reducing systemic risks in the securities and futures industry (as stipulated under section 4 of the SFO and buttressed by section 5 (functions and powers of the SFC) and section 6 (general duties of the SFC)).

5. These regulatory objectives all work towards better investor protection. To perform its statutory functions, the SFC has introduced a number of important mechanisms to protect the interests of retail investors. For instance, the SFC has made the Securities and Futures (Financial Resources) Rules (“the Rules”) under sections 145 and 397 of the SFO to require licencees to comply with the capital requirements of the Rules in order to become and remain licensed by the SFC. As a safeguard, the SFC requires licensed corporations to periodically report their financial positions as an early warning reporting system to help the SFC identify potentially risky firms. Besides, the Fit and Proper Guidelines promulgated by the SFC, inter alia, sets out requirements on financial status and solvency and competence requirements. The Code of Conduct for Persons Licensed by and Registered with the SFC (“the Code”) also provides guidance on how an intermediary satisfies the requirement that it is fit and proper to remain licensed and registered, and sets out the “Know Your Client” requirements. The SFC is also equipped with intervention powers under Part X of the SFO to protect investors’ assets held by intermediaries when there is a risk that the assets may be dissipated, misappropriated or improperly dealt with. All these seek to better protect

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investors.

Division of Labour

6. While the Administration is not involved in the day-to-day regulation of our financial markets and the performance of investor education work by relevant statutory regulators, we make every effort to ensure that the financial regulators are sufficiently resourced and appropriately empowered to maintain and promote a fair, efficient, transparent and orderly financial market for the better protection of investors. This will in turn enhance the competitiveness of Hong Kong as an international financial centre. We also seek to provide various platforms for effective exchange amongst regulators and between them and the Administration on the regulatory regime. Separately, the Hong Kong Monetary Authority (“HKMA”) and SFC are also accountable to the Legislative Council (“LegCo”). For example, it has been an established practice for the SFC to submit its proposed Budget to the LegCo Panel on Financial Affairs (“FA Panel”) for discussion before the end of the current financial year. The Annual Report of the SFC is also tabled before LegCo as required under section 15(3) of the SFO. At the same time, the Chief Executive of HKMA (“CE/HKMA”) briefs the Panel thrice a year on the work of the HKMA. On top of these, promulgation of codes, guidelines and subsidiary legislation by the regulators is subject to market consultation and negative vetting by LegCo as appropriate.

7. In a note setting out the responsibilities of the Financial Secretary and the SFST, which was released in response to a recommendation of the Financial System Stability Assessment conducted by the International Monetary Fund’s (“IMF”) in 2003, it was stated that “SFST has a specific responsibility for the efficient functioning of our financial system. Where this requires regulation, the regulatory authorities shall exercise their powers and discharge their functions independently in accordance with the respective statutes. SFST is expected to safeguard that independence”.

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8. In response to the issues raised by the Subcommittee vide its Clerk’s letter of 4 March 2009, I have prepared my response as set out in the ensuing paragraphs. As many of the issues cover the work of the Financial Services Branch (“FSB”) of the FSTB and the regulators including the HKMA and SFC, I have sought assistance from my colleagues in the FSB in perusing relevant files and records and obtaining factual information from the regulators in preparing the replies. I have, by this paper, responded to the issues raised by the Subcommittee to the best of my knowledge and belief.

SPECIFIC RESPONSE

Supervision of Securities Businesses Conducted by Banks

9. Since I assumed office as the SFST on 1 July 2007, in particular after the US subprime mortgage problem had started to surface, I have attached importance to, inter alia, investor protection, financial stability and market regulation (including the regulation of sale of financial products by intermediaries), which are all closely intertwined and inter-related.

10. In July 2007, I learnt from the HKMA that the implementation of the revised Memorandum of Understanding (“MOU”) concerning the supervision of banks’ securities activities between the HKMA and SFC had helped to enhance the effectiveness of the communication and cooperation on enforcement matters.

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11. Regulators reported the implications of the subprime mortgage problems since the third quarter of 2007. I understood from the HKMA that the US subprime problem would not cause any systemic implications for banks in Hong Kong; and from the SFC that de-leveraging and redemption of hedge funds specializing in collateral debt obligations could result in further market uncertainty, and that the SFC would continue to monitor closely although no problems had emerged. Furthermore, I also understood that the SFC had been encouraging financial institutions and intermediaries to conduct stress tests and enhancing the investors’ education to increase the general awareness of investment risks and the importance of risk management.

12. In this connection, I was given to understand that the SFC and HKMA had maintained close communication in both daily supervision and enforcement since 2002, set up working group meetings organized under their MOU, and facilitated manpower exchange and cross-fertilization in terms of manpower training to ensure that the same regulatory standards were applied to banks and brokers. As stated in my witness statement provided to the Subcommittee on 11 February 2009, the Administration has provided regular channels and cross-sectoral platforms for the regulators to exchange views with the Administration and each other on market regulatory and development issues, especially those which require joint efforts by the regulators.

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Investor Education and Protection

13. As some Members may recall, I highlighted the need to enhance investor education and protection at my first two attendances at the FA Panel in July 2007 and October 2007. In July 2007, I mentioned that the FSTB had a number of policy initiatives to improve market quality, including enhancing

corporate governance, enhancing investor protection and education, as well as rewriting the Companies Ordinance. In respect of investor protection in particular, apart from improving corporate governance as mentioned earlier, I said that good investor education not only afforded protection to investors personally, but also had a positive effect on the stability of Hong Kong's financial industry as a whole and on boosting international investors' confidence in the Hong Kong market. In October 2007, I reiterated that the SFC would step up its investor education and protection work. On both occasions, I mentioned that the SFC had been exploring ways of utilizing part of its levy income to enhance investor protection and education, which was also referred to in the 2007-08 Budget Speech.

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14. I have stayed in close touch with relevant regulators as to how to enhance the cross-sectoral investor education work and coordination among the regulators after I assumed office as SFST. Having been aware of the time involved in any legislative proposal and discussed with the regulators, we have adopted a pragmatic approach by taking forward the matter under a two-step approach, whereby additional resources should be allocated to step up the investor education work as an immediate measure in view of the rapid development of the financial market; whereas action to explore other longer-term measures in consultation with relevant parties which might require legislative amendments should continue in parallel. In this connection, it should be noted that the SFC Budget 2008-09 included additional resources to step up investor education work, i.e. a provision of \$20 million to allow for the implementation of additional investor education initiatives.

15. In parallel, I noted that the SFC has continued to step up its investor education and protection work, with some salient examples set out at Annex.

Structured Financial Products

16. As illustrated above, the Administration and regulators have stayed in close touch and exchanged views on issues related to investor protection and education on an ongoing basis. The Administration has reminded investors of the implications of the subprime turmoil from time to time in general, while the SFC has repeatedly reminded investors of the high risk nature of structured financial products, and has made a lot of efforts to bring investors' attention to various issues which they should consider carefully before investing in these products.

17. In addition to the above, the Administration has all along kept a watchful eye on possible misconduct in the selling of over-the-counter structured products, discussed issues of concern with relevant regulators, and reviewed their reports on the complaint handling and investigation process,

particularly when there was an increasing number of complaints relating to the mis-selling of a popular type of structured product called “accumulators” in the first quarter of 2008. In March 2008, I exchanged views with regulators regarding complaints on accumulators, and gathered from the HKMA that a number of investors had lodged complaints with the HKMA about alleged mis-selling of accumulators including incomplete disclosure of risk. At that time, the SFC also reported that it was collecting information on highly-g geared products sold through the private banking network, and that the SFC would also step up education on the importance of knowing and managing investment risk.

18. The Administration and regulators have henceforth reviewed the latest situation regarding allegations on mis-selling of accumulator contracts. I learnt that the HKMA had received 12 complaints on accumulators up to mid-April 2008. We have also obtained figures on complaints relating to accumulators, derivative warrants and other derivative products received by the HKMA, SFC and Consumer Council since 2006, details of which were subsequently set out in my written reply to Hon James To’s question asked at the LegCo sitting of 23 April 2008. A24

19. On 7 July 2008, the Administration together with the HKMA and SFC discussed the regulation of sale of structured products or derivative products at the FA Panel meeting. In the Administration’s paper entitled “Regulation of Sale of Structured Investment or Derivative Products”, we pointed out that regardless of who the client was, the sale process for all securities and futures products offered by banks regulated by the HKMA or non-bank intermediaries regulated by the SFC were both governed by the Code. We also pointed out that in choosing which products to invest, investors were strongly advised to first understand the product features, contract terms, tenors and potential risks of the products concerned, and that our financial regulators would continue to actively carry out investor education activities to enhance investors’ awareness of various investment products and the potential risks involved. In the HKMA’s submission to FA Panel, they pointed out, inter alia, that as the front-line supervisor of banks’ regulated activities, the HKMA had a duty to ensure that banks comply with the requirements of the Code, and that this had been one of the HKMA’s key supervisory priorities in the past few years in line with banks’ growing securities business. In the SFC’s submission, the SFC outlined, among other things, its plan to strengthen investor education to keep pace with the launch of new investment products from time to time. A25

20. In August 2008, I continued to stay in close touch with regulators on accumulators. I understood from the HKMA that 33 complaints in relation to accumulators were received by the HKMA. In this connection, I wish to highlight that, compared to the number of complaints relating to accumulators and derivative warrants, the SFC and HKMA had only received one and two

complaints respectively relating to Minibonds before the collapse of LB on 15 September 2008.

Regulatory Roles

21. Further to paragraphs 6-8 above setting out the division of labour between the Administration and the regulators, my witness statement provided to the Subcommittee on 11 February 2009 and the evidence provided at the hearings held on 20, 24 and 27 February 2009, I would like to emphasize that under the present regulatory regime as laid down in the statutes, the Administration does not and should not micro-manage how the regulators perform their statutory functions, including the regulators' work in the day-to-day regulation of the securities and futures industry and in supervising the intermediaries and safeguarding the investing public against the mis-selling of structured financial products. That said, we have established a legal framework for the regulation of Hong Kong's financial services sector and kept it under review from time to time. We have also monitored the progress of implementation of the regulatory regime from a policy angle, and provided adequate resources and appropriate powers to the regulators to carry out their regulatory duties independently. In addition, we have established effective platforms for exchange amongst the regulators and provided regular channels and sufficient platforms for the regulators to communicate with the Administration to express their views on market regulation, supervision and development issues, and report issues (especially cross-sectoral ones) which may require policy attention. At the same time, the Administration also communicates market views received from time to time to regulators for consideration and follow up.

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22. In short, the regulators have been monitoring global and local financial markets closely, and shared their views on the latest situation as well as the stresses and risks faced by the financial markets with other regulators and the Administration from time to time. Since assuming the office of SFST on 1 July 2007, I have noted that the HKMA and SFC have continued to co-operate closely under the existing regulatory regime on the supervision of banks' securities business to ensure the regulators exercise adequate supervision over intermediaries. I have also been aware of the need to step up investor education and protection to safeguard investors' interests. On the sale of structured products, I have also exchanged views with the regulators and expressed my concerns on allegations of mis-selling of structured products, and have kept in view the efforts which the regulators have made in handling complaints and promoting investor education in this regard.

23. In line with international practice, we believe that the Administration should position ourselves as a policy maker, facilitator and a co-ordinator and not as a regulator, leaving market forces to work within the

broad policy framework under the supervision of independent and autonomous regulators such as the SFC and the HKMA and without political interference, as it is a well-tested principle that the Administration should distance itself from the day-to-day regulation of the securities industry. Looking ahead, the Administration will continue to endeavour to provide an appropriate economic and legal environment for the maintenance of Hong Kong as an international financial centre, while maintaining the independence of regulators which are vested with the necessary powers, resources and expertise to regulate Hong Kong's financial markets and educate investors, with a view to offering better protection to investors.

Professor Chan Ka Keung
Secretary for Financial Services and the Treasury
March 2009

Examples of the SFC's Investor Education and Protection Work

The SFC announced in December 2007 that it decided to name January 2008 as the "Investor Education Month" to kick off a series of investor education initiatives. With the theme of "Know Your Risk", the SFC implemented a wide range of investor education initiatives during its investor education month, which included featured articles, seminars, workshops, investor education radio programmes and messages on radios, and the first "Investment Triathlon", a cross-media financial knowledge quiz, broadcast in TV, etc.

2. Other investor education initiatives, many of which focus on reminding investors of the risks of structured products, are set out as follows -

- (a) the SFC published a newspaper article in August 2007 describing and introducing to investors how credit-linked notes worked.
- (b) a revised leaflet on equity-linked instruments ("ELIs") was published by the SFC on 18 March 2008 to educate investors of the risks relating to these products;
- (c) a series of eight feature articles on structured products were published on the SFC's InvestEd website in March 2008 to discuss various things investors need to know before investing in structured products and outlining the common features of structured products, such as early call and knock-out, etc;
- (d) eleven newspaper articles on structured products were published intensively from April to June 2008 to alert investors to the risks of structured products. A number of these articles focused on important concepts which are relevant to investors of all types of structured products, such as to understand clearly about the investment products before investing; ask questions before investing in structured products; read the relevant offer documents; and consider product suitability, etc;
- (e) noting that retail banks were offering their clients low deposit rates, and that some investors might consider structured products, in search of higher returns, in April to June 2008, the SFC also issued three articles in its monthly e-newsletter: "Equity Linked Investments Are Not Low Risk Products", "Structured Products: Understand First, Then Invest" and "Learn More About Equity-linked Instruments". The articles were published on the InvestEd website to remind

investors that many structured products are not low risk and have complex features;

- (f) at least monthly, the SFC publishes “Dr Wise” articles to discuss key issues of investing and to explain regulatory issues in increasingly complex markets. For example, on 29 April 2008, the SFC published a press release and a Dr Wise article – “Structured Products: Understand First, Then Invest” - to remind investors that most structured products are not capital protected, and that investors should fully understand the risk-return profile of a particular structured product; and
- (g) since August 2008, two series of investor education videos relating to structured products have been broadcast on public buses to further widen the coverage of the SFC’s investor education messages.