

WRITTEN STATEMENT OF PROFESSOR CHAN KA KEUNG
Secretary for Financial Services and the Treasury

GENERAL REMARKS

Introduction

The current wave of global financial tsunami triggered by the sub-prime crisis in the United States has dealt a heavy blow to the economic development as well as financial stability on the global, regional and local levels. In the past few months, we have seen a seismic shift in the international financial landscape. The volatility and nervousness in international markets have been much worse than many had expected.

The Collapse of Lehman Brothers

2. Founded in 1850, Lehman Brothers ("LB") was the world's fourth largest investment bank, a leader in equity and fixed income sales, trading and research, investment banking, private investment management, asset management and private equity. In Hong Kong, Pacific International Finance Limited issued approximately HK\$13.9 billion of unlisted credit-linked notes called Minibonds ("MBs") to investors, which were arranged by a Hong Kong subsidiary of Lehman Brothers Holdings Inc. ("LB Holdings"). MBs are secured on collateral and swap arrangements with another LB subsidiary guaranteed by LB Holdings. Funds raised were used to purchase collateral that was AAA-rated at the time of purchase.

3. Bearing the brunt of the global financial tsunami, LB Holdings collapsed and filed a petition in the United States Bankruptcy Court on 15 September 2008. LB's assets were then frozen by this biggest bankruptcy proceeding in history. At that time, there remained 28 out of 32 series of MBs, with a nominal value of HK\$12.6 billion in the hands of approximately 34,000 investors.

Our Regulatory Regime

4. The destructive force of the financial tsunami, including the meltdown of a number of global financial institutions such as LB, is much stronger and more widespread than the Asian financial turmoil in 1997, and certainly cannot be taken lightly. That said, our financial infrastructure is more robust than it was in 1997, having been strengthened with the experience gained from the previous crisis.

5. Over the past decade, the Administration and our financial regulators, including the Hong Kong Monetary Authority ("HKMA") and the Securities and Futures Commission ("SFC"), have made tremendous efforts in revamping and refining our regulatory regime, which attaches equal importance to market development and investor protection. A notable example is the enactment of the Banking (Amendment) Ordinance 2002 and the Securities and Futures Ordinance ("SFO"), which came into force in 2003. This legislative reform has, inter alia, brought the securities businesses of banks into the regulatory net. They could no longer remain as "exempt dealers", and were required to meet the same fit and proper criteria as those for intermediaries licensed by the SFC.

6. While the Administration is not involved in the day-to-day regulation of the securities and futures industry, we make every effort to ensure that the financial regulators are sufficiently resourced and appropriately empowered to maintain and promote a fair, efficient and orderly financial market to protect investors and facilitate market development. This in turn will enhance our competitiveness 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.

7. The financial tsunami has uncovered inadequacies in financial regulatory regimes of various international financial centres, including New York and London. In this connection, we wish to point out that there is no single regulatory regime which suits all markets, and even the most stringent regulation cannot completely prevent market misconduct and fraud. Although the current financial tsunami has not caused systemic damage to our financial market, we will not underestimate its impact, nor flinch from meeting the challenges, nor rest on our laurels. We will continue to keep our regulatory regime under review from time to time, and stand ready to introduce improvements to ensure the system would evolve with changing market needs.

SPECIFIC REPLIES

8. In response to the questions raised by the Subcommittee vide its Clerk's letter of 23 January 2009, I have prepared the following replies. As many of the questions cover the work of the Financial Services Branch ("FSB") of the Financial Services and the Treasury Bureau and the regulators including HKMA and SFC, I have sought assistance from my colleagues in FSB in perusing relevant files and records and obtaining factual information from the regulators in preparing the replies. I have by this statement responded to the questions raised by the Subcommittee to the best of my knowledge and belief.

Q1. The Government's views on the existing regulatory regime governing banks' conduct of regulated activities (e.g. sale of securities and structured financial products) as enshrined in the Securities and Futures Ordinance (SFO) and the Banking (Amendment) Ordinance 2002, and the Government's assessment of the implementation of the regulatory regime since 1 April 2003.

A1. The present regulatory framework for Hong Kong's securities and futures market as enshrined in the SFO and the Banking (Amendment) Ordinance 2002 commenced operation in April 2003. It is the fruit of a large scale exercise, which consolidated and modernized ten pre-existing ordinances governing the securities and futures markets into a composite piece of legislation. It sought to keep the regulatory regime on a par with international standards and practices. It also sought to streamline and provide a legal regime to ensure fair, efficient and orderly markets that are competitive internationally as well as attractive to investors, issuers and intermediaries.

The present regulatory regime also represented an improvement of the previous regulatory arrangement for the securities businesses conducted by banks. It removed the "exempt dealers" status from banks, and the securities business of banks was for the first time brought into the regulatory net. In 2002, HKMA and SFC signed a Memorandum of Understanding ("MOU") which elaborates on the legal framework and sets out the two regulators' mutual understanding in respect of the regulation and supervision of banks' securities business and their relevant staff.

The present regulatory framework had gone through extensive market consultation and close scrutiny by the Legislative Council ("LegCo") before the Securities and Futures Bill and the Banking (Amendment) Bill 2000 were enacted in 2002. It represented the consensus reached among relevant stakeholders. Since 2003, it has provided a reliable and robust regulatory environment underpinning the development of Hong Kong's financial services sector.

Q2. The Government stated in its consultation paper issued in April 2000 on the preparation of SFO that SFO should (a) provide "a favourable environment for the development of the securities and futures industry and for the continued availability of as wide a range of investment options as the market can offer"; and (b) promote "sound business standards" and ensure "a reasonable level of investor protection". Please advise on the specific measures the Government has taken to attain these objectives in the past few years, and the extent to which these objectives have been achieved.

- A2. Article 109 of the Basic Law requires the Government to provide an appropriate economic and legal environment for the maintenance of the status of Hong Kong as an international financial centre. Following the commencement of SFO in 2003, the Administration and regulators have implemented various initiatives to continue to meet the objectives stipulated in section 4 of the SFO (as buttressed by section 5 (functions and powers of the SFC) and section 6 (general duties of the SFC)), namely –
- (a) to maintain and promote the fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry;
 - (b) to promote understanding by the public of the operation and functioning of the securities and futures industry;
 - (c) to provide protection for members of the public investing in or holding financial products;
 - (d) to minimize crime and misconduct in the securities and futures industry;
 - (e) to reduce systemic risks in the securities and futures industry; and
 - (f) 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.

In a letter from the Financial Secretary (“FS”) to the Monetary Authority dated 25 June 2003, it was stated that the Monetary Authority shall be responsible for, inter alia, co-operating with other authorities in the supervision of business conducted by Authorized Institutions (other than banking business or the business of taking deposits); as well as the development of the debt market in co-operation with other relevant authorities and organizations.

We attach equal importance to investor protection and market development. In our efforts to improve investor protection, we try not to stifle market innovation and limit choices for our investors. For instance, the SFC has issued class exemptions and guidelines under the Companies Ordinance (“CO”) in 2003 to streamline the prospectus regime to facilitate the issue of shares or debentures, while continuing to secure an appropriate degree of investor protection. As part of the review of the prospectus regime implemented through the Companies (Amendment) Ordinance 2004, the civil liability provision in the CO was amended to make clear that (a) persons who acquire shares or debentures in a public offering through an agent or intermediary would be accorded the same investor protection as investors who subscribe for shares or debentures; and (b) omission of

material information in a prospectus would also give rise to liability. As part of its continuous efforts to protect and educate the investors, the SFC has improved its dedicated investor education website and issues monthly Dr Wise articles. It also regularly organizes seminars, produces radio and TV programmes and advertisements on investor education, and publishes educational materials and feature articles in newspapers and magazines with a view to deepening investors' understanding on various investment topics.

At the same time, the HKMA launched the retail Exchange Fund Notes Programme in 2003 to broaden the investor base of Hong Kong's domestic debt market and introduced refinements to the programme in 2005. The HKMA also carried out a review on the domestic debt market; and made efforts to facilitate the launching of Renminbi bonds and Islamic bonds in Hong Kong.

While the Administration is not involved in the day-to-day implementation of the regulatory regime, 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 implementation progress of the regulatory regime from a policy angle, and provided adequate resources and appropriate powers to the regulators to carry out their regulatory duties. In addition, we have established effective platforms for exchanges 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 which may require policy attention. In return, the Administration also communicates market views received from time to time to regulators for consideration and follow up.

Q3. Under the existing regulatory regime, the Securities and Futures Commission (SFC) is the regulator for the securities industry, while the Hong Kong Monetary Authority (HKMA) is the frontline supervisor of banks' regulated activities under SFO (e.g. sale of securities and structured financial products) and performs this function following the standards set by SFC. Please advise on the extent to which this division of the regulatory functions between SFC and HKMA has served those objectives for SFO mentioned in Question 2.

A3. Under the present framework, the SFC is the lead regulator for the securities industry. Any entity wishing to carry on business activities regulated by the SFO must be licensed (in the case of licensed corporations) or registered (in the case of banks) by the SFC. The SFC sets the standards, through rules, codes and guidelines issued under the SFO, with which intermediaries should comply in carrying on their regulated activities. The HKMA acts as the frontline supervisor of registered institutions. When a bank applies to

become a registered institution, the HKMA will advise the SFC whether the bank is fit and proper to carry on the regulated activities for which it seeks registration. After registration, the registered institution is supervised by the HKMA and subject to the regulatory requirements devised by the SFC for the intermediaries licensed by the SFC, plus any extra requirements devised by the HKMA solely for registered institutions. While the frontline regulatory duties rest with the HKMA, the SFC retains its investigatory and disciplinary roles in respect of the securities business conducted by banks. The appellate body, the Securities and Futures Appeals Tribunal, provides a common forum to hear appeals from brokers and banks against SFC's disciplinary decisions.

The present division of labour between the SFC and HKMA in respect of the regulation of the securities businesses conducted by banks has broadly achieved the objectives stipulated in section 4 of the SFO. The current regulatory regime has minimized regulatory overlap, as it avoids subjecting banks simultaneously to two separate regulatory processes administered by the HKMA and SFC. In the past few years, the SFC and HKMA have implemented the measures they had pledged to ensure effective enforcement of the new regime. For instance, they have maintained close liaison in both daily supervision and enforcement and set up regular working group meetings to ensure that uniform standards are applied in enforcement; facilitated manpower exchange (through staff secondment) and cross-fertilization in terms of manpower training; and carried out joint inspections of banks to ensure a level playing field for the brokerage and securities arms of banks alike. These have helped to reduce regulatory costs thereby reducing costs to investors and provide more choices to investors by allowing them to conduct a wide range of investment activities via bank branches.

The present regulatory regime, enshrined in the SFO and Banking (Amendment) Ordinance 2002, represented a revamp of the previous regulatory arrangement for the securities businesses conducted by banks. It removed the "exempt dealers" status of banks. In April 2003, the securities business of banks was for the first time brought into the regulatory net. Since that time, banks have been required to meet the same fit and proper criteria as those for intermediaries licensed by the SFC. They are also subject to a number of provisions of the SFO in the same way as SFC licensees in respect of their securities business. They need to comply with various rules and guidelines to be issued by the SFC, such as the Code of Conduct for Persons Licensed by or Registered with the SFC. In addition, banks are required to ensure that their executive officers and employees involved in the conduct of securities business are and remain fit and proper. Since the commencement of SFO, the SFC and HKMA have cooperated closely under an MOU; applied the same codes and guidelines; and ensured consistency in the interpretation of the standards and in the modus operandi

of implementation. These are notable examples to demonstrate that the SFC and HKMA have been able to achieve the regulatory objectives stipulated in section 4 of the SFO.

Q4. The Government's policy stance on banks undertaking non-interest earning businesses or other regulated activities under SFO up to 15 September 2008 when Lehman Brothers Holding Inc. filed bankruptcy protection in the US, and whether there has been any change in the Government's stance since that date.

A4. In Hong Kong, banks are allowed to undertake non-interest earning businesses. Many banks do so to broaden and diversify their income source, while offering customers greater convenience and more choices. The undertaking of non-interest earning businesses or other regulated activities under the SFO by licensed banks is a commercial decision for these banks, so long as they comply with the statutory requirements, as well as the guidelines/circulars issued by the relevant regulators. We recognize that these regulatory requirements will have to evolve with market needs as investors' aspiration changes and new products are introduced. Indeed, the SFC and HKMA have been introducing new /updated requirements for this purpose. We attach equal importance to investor protection and market development. In our efforts to improve investor protection, we try not to stifle market innovation and limit choices for our investors, a policy that the Administration has continued to uphold since the collapse of LB.

Q5. In its report on "Hong Kong SAR: Preliminary Conclusions of the IMF Mission" published on 7 November 2007, the International Monetary Fund advised that "[c]ontinued monitoring of exposures and valuation of [structured financial] products is important...The rapid rise in valuation and turnover of equities, related structured products and derivatives, and margin financing, calls for continued close monitoring of cross-market risks, especially given global financial market uncertainties. In this regard, the increased co-ordination among Hong Kong regulators should help to detect early signs of stress". Please advise on:

- (a) the Government's understanding of the co-ordination of the regulators up to 2007; and***
- (b) the Government's measures (if any) to step up co-ordination among regulators since 2007; and***
- (c) the Government's views on the need or otherwise to adjust its policy on the promotion of new financial products.***

- A5. (a) Efficient and effective communication and coordination between regulators and the Administration are essential for maintaining financial stability and fostering financial market development. At the regulators' level, there is effective coordination between the HKMA and SFC. In 2002, the HKMA and SFC entered into a new MOU which replaced the previous MOU of 1995. The 2002 MOU elaborates on the legal framework and sets out the two regulators' mutual understanding in respect of the regulation and supervision of registered institutions and their relevant staff. It paved the way for implementing the dual regulatory system. We note that the SFC and HKMA have continued to enhance coordination between themselves and maintained close communication in both daily supervision and enforcement since 2002. They have set up regular working group meetings; 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. They have also carried out a theme inspection on the selling practices of their respective regulatees. The SFC consulted the HKMA before issuance of the codes, guidelines, frequently asked questions ("FAQs") and circulars to brokers and banks e.g. "Questions and Answers on Suitability Obligations" in May 2007.

We have 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 (please also refer to the reply to questions 10 and 11 below). Through these, the Administration also reflects market views received from time to time to the regulators for consideration and follow-up.

- (b) Before the IMF report in November 2007, the regulators had stepped up coordination among themselves on a need basis. For instance, the SFC formulated a set of FAQs on the suitability obligations under the Code of Conduct for brokers and banks in consultation with HKMA following their respective theme inspections conducted in 2006 to address issues about the selling conduct of their respective regulatees. The Administration also steps up its coordination with the regulators as and when necessary, for instance, by holding ad hoc meetings to discuss issues of common concern in market contingency situations.
- (c) As a general principle, financial regulation should be able to evolve with market development to address the changing needs of market participants. In this spirit, the regulatory framework enshrined in the SFO and the Banking (Amendment) Ordinance 2002 was designed to be capable of timely evolution with market development.

For instance, the primary law sets out, inter alia, the broad principles and fundamental requirements, while empowering the regulators to adjust existing regulatory requirements and introduce new ones through the promulgation of codes, guidelines and subsidiary legislation subject to market consultation and negative vetting by LegCo as appropriate. That said, we are mindful of the need to keep our regulatory regime under review, and stand ready to introduce improvements to ensure the system would be able to meet new market needs, in light of market innovation, changing investors' aspiration and international development. In this connection, shortly after the collapse of LB in September 2008, the FS requested the HKMA and SFC to submit, by the end of 2008, reports on their observations, lessons learned and issues identified during the process of investigating the received complaints regarding MBs arranged by LB.

Having received the said reports from the HKMA and SFC on 31 December 2008, the Administration has formulated an Action Plan in consultation with HKMA and SFC for taking forward in phases the various recommendations put forth in their reports. Our immediate focus is on measures to improve the existing regulatory requirements and better protect investors. Specifically, we aim at early implementation of improvement measures in the sale of investment products, business conduct of intermediaries, and investor education.

Q6. *On 6 August 2007, SFST told the media that the regulatory regime in Hong Kong was highly effective. In the wake of the Minibonds incident, on 30 September 2008, SFST told the media that mis-selling by banks should not have happened. Please advise on the Government's view on why the highly effective regulatory regime failed to prevent the mis-selling and what have caused the mis-selling in Hong Kong.*

A6. Members may wish to refer to the transcript setting out my remarks on 30 September 2008, which we submitted to the Subcommittee on 6 January 2009. This is extracted below –

“最新數字顯示金管局收到逾二千份有關指銀行誤導或不當銷售這類產品的投訴，我們是很關注這類投訴。我們認為用不當銷售手法，這事情是不應發生。”

I wish to clarify that, the message I meant to convey on 30 September 2008 was that banks should not (不應) have conducted any mis-selling activities. Indeed, I am sympathetic to victims of the MBs incident, especially those who have suffered losses as a result of mis-selling activities.

It is important that we keep our regulatory system under review and if necessary, introduce amendments in light of market development. No single regulatory regime is “fool-proof”, and even the most stringent regulations could not completely prevent misconduct or fraud. The ultimate goal of any regulatory system is to minimize the occurrence of misconduct through effective enforcement and adequate sanctions.

Q7. At the Legislative Council meeting on 22 October 2008, SFST said that Minibonds were also sold in other places in Asia and Europe, and that here in Hong Kong, there was no statutory restriction on the types of structured financial products that could be sold to retail investors. Please provide a comparison of the current regulatory regime in Hong Kong with those in other jurisdictions in regulating the sale of structured financial products to retail investors.

A7. We adopt a disclosure and conduct-based regulatory regime for the sale of structured products. The regime rests on two important pillars – disclosure and suitability assessment. The first pillar ensures that sufficient information is disclosed in the product documentation by the issuer to enable a reasonable person to make an informed decision. This is enforced by the SFC under the SFO and CO governing the offering of different investment products. SFC’s authorization of the disclosure documentation is not tantamount to its endorsement of the product as a sound and suitable investment. Suitability assessment, the second pillar, gives the intermediary a responsibility to make sure that the product is suitable for a particular investor taking into account a full understanding of the client’s profile and investment needs and the full product disclosure provided under the first pillar. This is enforced by the SFC in respect of the conduct of its licensed brokers; and the HKMA in respect of securities business conducted by the registered institutions.

In general, the sale process for all securities products offered by banks regulated by HKMA or brokers regulated by SFC are both governed by the Code of Conduct for Persons Licensed by and Registered with SFC. The Code requires intermediaries to explain to the clients the products and the risks involved. In the case of derivative products (including MBs), the Code also requires intermediaries to ensure that their clients understand the nature and risks of the products and have sufficient net worth to be able to assume the risks and bear the potential losses of trading in the products (Clause 5.3 of the Code of Conduct). In this connection, it is noteworthy that banks carrying out securities business are subject to the same regulatory standards and the same possible range of disciplinary sanctions as brokers in the event of breaches.

As regards overseas practices, there do not appear to be absolute restrictions

on the sale of structured products to the retail public in any of the jurisdictions the HKMA has reviewed. Generally, it appears that jurisdictions such as the UK, the US, Australia, Singapore, the Netherlands and Germany adopt a broadly similar approach based upon (a) disclosure by product issuers in public offers; (b) licensing of financial intermediaries; and (c) requirements on financial intermediaries to treat customers fairly, assess their suitability for products recommended to them, and disclose adequate information about these products to enable the customers to make informed investment decisions.

Q8. The Government's arrangements, if any, that have been put in place to monitor the work of the regulators in following up the Minibonds incident.

A8. The Administration is not involved in the day-to-day regulation of the securities and futures industry, but we endeavour to provide sufficient resources and appropriate powers to our regulators to regulate our financial markets for the better protection of investors. Immediately following the collapse of LB, the Administration had convened frequent meetings with the regulators to understand the scope of the implications and to provide steer to the handling of the MBs incident. On complaints-handling, the Administration has tasked the regulators to conduct the investigation in an expedient and fair manner. On review, the FS sought reports from both regulators on the lessons learnt and proposals to improve on the regulatory system. To monitor the regulators' performance including its work in following up the MBs incident, we have established channels for regulators to report progress and convey their views to the Administration where necessary. Through day-to-day contact and regular liaison meetings, we have inquired and monitored the regulators' progress in handling the MBs incident. We have also asked for updates on relevant statistics including complaint figures on MBs from time to time, and closely monitor the progress of the investigations, including reviewing the regular updates on complaints referred by the HKMA to SFC.

Q9. Details of any review(s) conducted by the Government on the impact of the US subprime crisis on Hong Kong's financial market and details of the Government's policy on financial innovations following the subprime crisis.

A9. The Administration has kept the economic situation under constant monitoring and review, including the impact of the US subprime crisis on our economy and financial markets. In particular, the Economic Analysis and Business Facilitation Unit ("EABFU") headed by the Government Economist ("GEcon") publishes quarterly (including annual reports on economic background and prospects) to monitor and analyse the economic

developments in Hong Kong. Since the first quarterly economic report 2007 published in May 2007, EABFU has started to cover the possible impact of the sub-prime turmoil in the United States.

Separately, the FS and GEcon have briefed the LegCo Panel on Financial Affairs ("FA Panel") on macro-economic issues on a regular basis since mid-1999. Such briefings are normally held in June and December of every year. Members may wish to refer to the papers prepared by EABFU and minutes of the relevant FA Panel meetings for further details.

While no one could have predicted the outbreak of the global financial turmoil on such a disruptive scale, since late 2007 the Administration has repeatedly warned of the substantial downside risks in the global economy associated with the US subprime problem. As early as October 2007, the FS had pointed out (in the Motion of Thanks Debate for the Policy Address) that "the impacts of the turbulence on the external economic environment have yet to fully emerge" and "we will have to pay attention to the second, or even the third round effect on the Hong Kong market". Then, in the Budget Speech 2008-09 delivered on 27 February 2008, the FS further warned of the risk that "the situation might deteriorate in the near future and the fallout may be prolonged".

As an on-going effort, the Administration and the regulators continuously refine our regulatory regime in the light of operational experience, market development and evolving international standards. Financial regulation should not stifle financial innovation and create unnecessary constraints for the financial services industry, with equal importance attached to investor protection and market development.

Q10. Detailed information on the Financial Stability Committee (chaired by SFST), including the Committee's objectives, work plans and operation, as well as the following:

- (a) the Committee's monitoring (if any) of the impact of the US subprime crisis on Hong Kong's financial market;***
- (b) the Committee's discussion (if any) on the co-ordination or gaps between SFC and HKMA in regulating banks' selling of structured financial products (notably Lehman Brothers-related Minibonds and structured financial products);***
- (c) the Committee's consideration (if any) on the risks of the retail sale of Lehman Brothers-related Minibonds and structured financial products by banks to small investors and the impact of the Minibonds incident on investors' confidence in banks and in turn***

the stability of the financial markets of Hong Kong; and

- (d) the Committee's monitoring (if any) of the ongoing developments of the Minibonds incident and its report (if any) to the Financial Secretary.*

Q11. *Detailed information on the Council of Financial Regulators (chaired by the Financial Secretary), including the Council's objectives, work plans and operation, as well as the following:*

- (a) the Council's monitoring (if any) of any the impact of the US subprime crisis on Hong Kong's financial markets;*
- (b) the Council's discussion (if any) on the co-ordination or gaps between the Securities and Futures Commissions and the Hong Kong Monetary Authority in regulating banks' selling of structured financial products (notably Lehman Brothers-related Minibonds and structured financial products);*
- (c) the Council's consideration (if any) on the risks of the retail sale of Lehman Brothers-related Minibonds and structured financial products by banks to small investors and the impact of the Minibonds incident on investors' confidence in banks and in turn the stability of Hong Kong's financial markets; and*
- (d) the Council's monitoring (if any) of the ongoing developments of the Minibonds incident and report regularly to the Financial Secretary.*

A10&11. Bearing in mind the importance of financial stability to Hong Kong, the Financial Stability Committee ("FSC") was established to –

- (i) monitor on a regular basis the functioning of the financial system of Hong Kong, including the banking, debt, equity, insurance and related markets;
- (ii) deliberate on events, issues and developments with possible cross market and systemic implications, and where appropriate, formulate and co-ordinate responses; and
- (iii) report regularly, and at any time where necessary, to the FS covering matters in (i) and (ii) above.

With the objective of contributing to the efficiency and effectiveness of regulation and supervision of financial institutions, the promotion

and development of the financial markets and the maintenance of financial stability in Hong Kong, the Council of Financial Regulators (“CFR”) was established to -

- (i) facilitate cooperation and coordination among its members;
- (ii) share information and views on regulatory and supervisory issues and important trends in the financial system, particularly those which may have a cross-sectoral impact;
- (iii) minimize duplication or gaps in the regulation and supervision of financial institutions, paying close attention to the need to keep regulatory costs to a minimum;
- (iv) review international developments in financial sector regulation and to draw lessons for Hong Kong;
- (v) discuss regulatory and supervisory issues relating to individual financial institutions that may have a cross-sectoral impact; and
- (vi) oversee trends, issues and developments which may have implications for financial stability in Hong Kong.

FSC meetings are generally chaired by me (with effect from July 2007) and attended by the Chief Executive of HKMA (“CE/HKMA”), the Chief Executive Officer of SFC (“CEO/SFC”) and the Commission of Insurance (“CI”). CFR meetings are chaired by FS and attended by myself and heads of regulators, including CE/HKMA, CEO/SFC, CI, and the Managing Director of the Mandatory Provident Fund Schemes Authority (“MD/MPFA”).

My response to the above questions is set out below –

Following the commencement of the SFO in 2003, regulation of securities business conducted by banks was discussed at CFR meetings in 2004 and 2006, and it was reported that the cooperation between the HKMA and SFC had been working well.

Regulators started to report at the FSC the implications of the subprime mortgage problems in August 2007, when Hong Kong dollars strengthened as a result of heavy unwinding of carry trades triggered by the US subprime mortgage problems. Since then, implications of the subprime problem and assessments were reported to FSC from time to time.

I am not aware of any specific reports from the regulators or

substantial discussions on issues relating to any gaps between the SFC and HKMA in regulating banks' selling of structured financial products (including LB-related MBs and structured financial products) during FSC meetings.

Following the collapse of LB in September 2008, the FSC meeting discussed the credit risk arising from this incident and its implications on Hong Kong's banking system. The regulators did not report any other issues relating to the risks of the retail sale of LB-related MBs and structured financial products by intermediaries to small investors at that meeting. At another FSC meeting in September 2008, members discussed various follow-up actions stemming from the failure of LB, including the MBs incident. The meeting agreed to work closely together to manage the crisis and agreed to ensure transparency of and effectiveness in handling the complaints.

Following the collapse of LB, regulators reported on the latest progress of handling the MBs incident and its ongoing developments at the FSC and CFR meetings held in September 2008 and December 2008 respectively.

The CFR meeting also considered in December 2008 differences among standards of disclosure and selling processes of different financial products and their regulatory implications.

Q12. Credit-rating agencies lowered the long-term credit ratings of Lehman Brothers between June and July 2008. The share price of Lehman also dropped substantially during September 2008. Please provide information on the Government's discussion (if any) with SFC and HKMA from June to mid-September in 2008 on the possible impact of the financial difficulties of Lehman Brothers on the financial market and investors of Lehman Brothers-related structured financial products in Hong Kong.

A12. The regulators are equipped with the necessary resources, expertise and experience to monitor the development of the global financial market and expected to report to the Administration any significant implications to our financial market. From time to time, they share information and views among themselves on regulatory and supervisory issues and important trends in the financial system, particularly those which may have a cross-sectoral impact. Exchange platforms such as the FSC and CFR have been established to allow the regulators to convey their observations to the Administration and each other from time to time and to discuss regulatory and supervisory issues relating to individual financial institutions that may have a cross-sectoral impact; and oversee trends, issues and developments

which may have implications for financial stability in Hong Kong.

During the period from June to mid-September 2008 (i.e. before the collapse of LB), the Administration did not receive any reports or alerts on the possible impact of the financial difficulties of LB on the financial market and investors of LB-related structured financial products in Hong Kong.

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