

WRITTEN STATEMENT OF JOHN C. TSANG
FINANCIAL SECRETARY

GENERAL REMARKS

Introduction

In response to the questions raised by the Subcommittee to Study Issues Arising from Lehman Brothers-related Minibonds and Structured Financial Products (Subcommittee) vide its Clerk's letter of 9 November 2009, I have prepared the following statement. Because some of the questions concern the work of the Financial Services and the Treasury Bureau (FSTB) and the regulators including the Hong Kong Monetary Authority (HKMA) and the Securities and Futures Commission (SFC), I have sought assistance from my colleagues in FSTB in perusing relevant files and records and obtaining factual information from the regulators in preparing the statement. I have in this statement responded to the questions raised by the Subcommittee to the best of my knowledge and belief.

Collapse of Lehman Brothers

2. 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.

3. The global financial crisis, which has transformed the local and international financial landscapes, was characterized by its unpredictable onset, unprecedented scope, extreme manifestations, as well as cross-sectoral / cross-border and far-reaching ramifications.

4. The collapse of Lehman Brothers (LB), once the world's fourth largest investment bank, caught the world by surprise. In the first three quarters in 2008, at least 19 prominent financial institutions were reported to have encountered financial difficulties of one kind or another. Before LB filed for bankruptcy protection around mid-September 2008, market views were mixed as to whether LB could survive the spate of financial difficulties; and there were expectations that some form of rescue package would be offered, like what was done in respect of Bear Stearns and subsequently with the American International Group. Unfortunately, these expectations turned out not to be the case.

Division of Labour

5. As the Financial Secretary (FS), I am responsible for determining the policy objectives at a macro level in relation to the financial system, and the Secretary for Financial Services and the Treasury (SFST) is responsible for formulating specific policies to achieve such objectives and for overseeing their implementation through the regulatory authorities and other organizations as appropriate. SFST has a specific responsibility for the efficient functioning of our financial system and is expected to safeguard the independence of the regulatory authorities in exercising their powers and discharging their functions in accordance with the respective statutes.

6. According to the Policy Objectives in Financial Affairs and Public Finance set out by the then FS in his statement in 2003, the Administration should formulate specific policies to promote the efficient functioning of the financial system, and that policies concerning the regulatory regime should aim to provide a regulatory framework that promotes the stability of the financial system, provides an appropriate measure of protection to users of financial services and facilitates competition, and is consistent with the standards and practices of major international financial centres. In furtherance of these policy objectives, the Administration attaches equal importance to investor protection and market development, which is further elaborated in the ensuing paragraphs.

7. In accordance with the division of labour between the Administration and the regulators, 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 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 the competitiveness of Hong Kong as an international financial centre. We also seek to provide various cross-sectoral platforms for effective exchange amongst regulators and between them and the Administration on the regulatory trends and development; ensure that appropriate check and balance is put in place; and keep the regulatory systems under monitoring and review in collaboration with the regulators.

Regulatory Regimes and Policies

(a) Regulatory Framework of Banks' Securities Business

8. Over the past decade, the Administration and our regulators have made tremendous efforts in revamping and refining our regulatory regime, with a view to promoting market development and enhancing investor protection. A notable example is the rollout of the new regulatory framework with regard to the banks' securities business, as enshrined in the Banking (Amendment) Ordinance 2002 and the Securities and Futures Ordinance (SFO), which came into force in 2003. Following the legislative reform, the banks were required to meet the same fit and proper criteria as those for intermediaries licensed by SFC. This has enhanced regulatory oversight over banks' securities business and investor protection.

(b) Disclosure-cum-Conduct Based Regulatory Approach for Authorization and Sale of Structured Financial Products

9. The Administration and regulators adopt a disclosure-cum-conduct based regulatory approach for the authorization and sale of structured financial products. This 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 covered by the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission.

10. 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 SFC in respect of the conduct of its licensed corporations; and by HKMA in respect of securities business conducted by the registered institutions.

11. SFC launched a public consultations in September and October 2009 to solicit public comments on proposals to fine-tune existing regulations governing the sale of unlisted structured products to the public, including the proposal related to the transfer of the regulation of

public offers of structured products (in debenture form) from the Companies Ordinance (CO) to the SFO. That said, it is important to note that these regulatory reforms are still based on the disclosure-cum-conduct based regulatory regime, which both regulators have recommended for its retention in their review reports submitted to me in December 2008.

(c) Investor Protection Policies

12. 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 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 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 SFC) and section 6 (general duties of SFC)). These regulatory objectives all work towards better investor protection. HKMA, in discharging its frontline supervisory duties in respect of banks' securities business under the Banking Ordinance ("BO") and the SFO, is also entrusted with the investor protection mandate.

13. The Administration attaches great importance to protecting the interests of the investing public and investor education. At the policy level, investor protection has always been one of our core policy objectives. It is entrenched and reflected in the establishment of the independent regulator for the securities industry and the statutory framework for regulating the securities industry which covers, inter alia, the regulation of (i) exchanges and clearing house, (ii) offer of investment, (iii) intermediaries, (iv) capital requirements, (v) business conduct, (vi) supervision, investigation and discipline work, as well as (vii) the civil and criminal regimes against market misconduct. At the operational level, the regulators are responsible for taking actions to protect the interest of the investing public through day-to-day work, such as licensing and registering intermediaries, setting codes and guidelines, conducting supervisory inspections, enhancing supervisory effectiveness and efficiency in view of market developments, handling complaints, carrying out investigative and enforcement actions, etc. In addition, SFC also carries out various investor education initiatives in order to raise retail investors' understanding of their own rights and responsibilities and

the investment products sold to them.

14. Investor protection and education do not only involve protecting investors from market risks and misconducts. 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. This important policy objective is embodied in regulatory systems. For instance, the regulatory framework of the securities sector affords the investing public with choices in terms of intermediary services; whereas the disclosure-cum-conduct based regulatory regime for the sale of structured products enables investors to have access to different financial products to meet their investment needs subject to intermediaries' suitability assessment which in turn is subject to regulators' supervisory oversight.

Reviews and Reforms

15. 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.

16. 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, I had requested HKMA and SFC to submit reports on their observations, lessons learned and issues identified during the process of investigating the received complaints regarding LB related complaints.

17. On receipt of the review reports submitted by the regulators at the end of December 2008, the Administration has formulated an Action Plan in consultation with the two regulators to take forward the various recommendations to improve our regulatory framework and enhance investor protection in light of the issues identified during the investigation of complaints regarding the LB related products.

18. A phased approach has been adopted in implementing the Action Plan. The initial phase measures focus on enhancing the selling practice of investment products, business conduct of intermediaries and

investor education.

19. For longer-term measures, we are focusing on proposals to establish an Investor Education Council and a financial dispute resolution scheme (commonly referred to as a Financial Services Ombudsman in overseas jurisdictions) etc. As the Chief Executive has mentioned in the 2009-10 Policy Address, we will seek to further achieve the two main objectives of investor protection and financial security when formulating policies on financial regulation. We aim to strengthen investor protection in every aspect, from investor education, authorization of investment products, disclosure requirements, sales practices, conduct of intermediaries to financial disputes resolution.

Concluding Remarks

20. 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.

21. 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, as we have said repeatedly. We will continue to keep our regulatory regime under constant review, and stand ready to introduce improvements to ensure the system would evolve with changing market needs.

22. It is of vital significance to appreciate the speed, scale and unpredictability of the financial tsunami and its ensuing repercussions in studying various issues arising from LB-related Minibonds and structured financial products and considering how best to review and reform our financial regulatory systems. With these preambles, I shall now turn to the specific issues raised by the Subcommittee in its Clerk's letter dated 9 November 2009 (please refer to **Annex**).

Range of issues to be included in the statement of FS

Policy objectives in financial affairs promulgated by FS

1. *In connection with formulating government policies concerning the regulatory regime for the financial system, such policies should aim to provide, amongst others, a regulatory framework that promotes the stability of the financial system and provides an appropriate measure of protection to users of financial services (paragraph 3(c) of A27). Between 1 July 2007 (when the incumbent FS took office) and 15 September 2008 (when Lehman Brothers filed for bankruptcy protection), did FS review the aforesaid policy objectives in the light of:*
 - (a) *the rapid growth in banks' regulated activities (such as the retail sale of structured financial products);*
 - (b) *the risks arising from the United States (US) subprime mortgage problem and its knock-on effects; and*
 - (c) *the risks associated with financial innovation and the growth in the retail sale of structured financial products?*

If yes, please provide the details; if no, the reasons.

- 1.1 By and large, the Administration and regulators keep the economic situation under close and constant monitoring and review, including local and international trends and developments. We stand ready to introduce improvements to ensure our financial system would be able to meet new market needs, in light of market innovation, changing investors' aspiration and international development. We attach equal importance to investor protection and market development. In our efforts to improve investor protection, we try not to stifle market innovation, limit choices for our investors, unnecessarily increase the compliance cost or create unnecessary constraints for the financial services industry.
- 1.2 As a general principle, our financial regulation system is able to evolve with market changes with a view to addressing the changing needs of market participants. In this spirit, the regulatory

framework enshrined in the Securities and Futures Ordinance (SFO) and the Banking (Amendment) Ordinance 2002 (BO) was designed to be capable of timely evolution with market development. For instance, the relevant legislation sets out, inter alia, the broad principles and fundamental requirements, while empowering the regulators to adjust existing regulatory requirements and standards and introduce new ones to discharge their statutory objectives and functions through the promulgation of codes, guidelines and subsidiary legislation subject to market consultation and negative vetting by the Legislative Council (LegCo) as appropriate.

- 1.3 In particular, the Administration has been mindful of the changing market conditions and understands that the regulators have taken various actions and initiatives to step up the regulatory efforts. For instance, SFC and HKMA entered into a revised memorandum of understanding (MOU) in 2002 which replaced the MOU of 1995 to strengthen cooperation and have continued to enhance coordination between themselves and maintained close communication in both daily supervision and enforcement ever since. In particular, they (i) have set up regular working group meetings with the aim to align the regulatory standards applied in frontline supervision and enforcement; (ii) have met frequently to discuss matters of mutual interest relating to the performance of their regulatory and supervisory functions; and (iii) have arranged training sessions and staff secondment to share regulatory and supervisory experience. They have also concurrently carried out a theme inspection on the selling practices of their respective regulatees. In addition, SFC clarified certain existing regulatory requirements for the conduct of securities business. e.g. “Questions and Answers on Suitability Obligations” in May 2007.
- 1.4 In particular, HKMA has, since 2005, stepped up its regulatory efforts with regard to banks’ selling of financial products, including undertaking more thematic on-site examinations of the sale of investment products by banks, issuing related circulars to the banking industry, and requiring large, complex or active banks to conduct independent self-assessment of regulatory compliance. In parallel, SFC has stepped up its investor protection drive. Altogether, SFC conducted 107 separate publicity initiatives related to unlisted structured products and the duties of investment advisers in the period from April 2003 to September 2008 prior to the collapse of LB, including articles in printed media, investor leaflets, electronic newsletters, on-line education resources,

television and radio programmes and videos on public buses.

- 1.5 As stated at paragraph 1.1 above, the Administration and regulators have kept both the local and international economic situations under close and constant monitoring and review, including the risks arising from the US subprime mortgage problem and its knock-on effects 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 then FS has 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.
- 1.6 Since late 2007, the Administration has repeatedly warned the public of the substantial downside risks in the global economy associated with the US subprime problem. As early as October 2007, I 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, I further warned of the risk that “the situation might deteriorate in the near future and the fallout may be prolonged”.
- 1.7 All in all, the regulators have exercised their powers responsively and independently to better perform their regulatory roles, enhance communication, facilitate compliance, and protect the investing public in the midst of the evolving market landscape. Besides, as an on-going effort, the Administration and the regulators continuously refine our regulatory regime in the light of operational experience, market development and investors’ aspirations.

2. *Regarding the government policies in relation to the financial system and Hong Kong's status as an international financial centre, the Secretary for Financial Services and the Treasury (SFST) is responsible for overseeing the implementation of such policies through the regulatory authorities (paragraph 4 of A22) with a view to achieving the policy objectives at a macro level determined by FS. Please advise:*

(a) between 1 July 2007 and 14 September 2008, whether FS raised, or was aware of, any concerns about the effectiveness of SFST's oversight of the regulatory authorities' implementation of the government policies in relation to the development and regulation of Registered Institutions' regulated activities?

2.1 The present regulatory system of our securities market, as enshrined in the SFO and the BO, has commenced operation since April 2003. It is the result of extensive consultation and a large scale legislative amendment exercise, which 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.

2.2 Since I took up the post of FS on 1 July 2007, I noted that the regulatory authorities' implementation of the policies in relation to the regulation of banks' securities business, as overseen by SFST, continued to achieve the policy objectives underlying the current regulatory systems: it has minimized regulatory overlap, as it avoids subjecting banks simultaneously to two separate regulatory processes administered by separate regulators. SFC and HKMA have implemented various measures with the aim to align the regulatory standards applied in frontline supervision and enforcement (as stated in paragraphs 1.3-1.4 above) to ensure a level playing field for banks and brokers alike. These measures have reduced regulatory costs thereby reducing costs to investors and provided more choices to investors by allowing them to conduct a wide range of investment activities.

(b) given that government officials have been questioned whether they have adequate market knowledge and experience, to what extent was the Government equipped with the necessary expertise to oversee the effective implementation of its policies by the Hong Kong Monetary

Authority (HKMA) and the Securities and Futures Commission (SFC), and to keep itself abreast of the market developments (such as the development of complex structured financial products) prior to 15 September 2008?

- 2.3 The Administration is responsible for providing an appropriate economic and legal environment for the maintenance of the status of Hong Kong as an international financial centre. Consistent with the policy and legislative intents underlying the statutory regulatory system and international practices, the Administration leaves the day-to-day regulatory functions to the regulatory agencies. We perform our function by appointing the regulators, making sure that the regulators are independent and vested with the necessary powers and resources; and equipped with the necessary professional expertise to discharge their statutory duties and perform their regulatory functions.
- 2.4 Specifically, the Administration determines the policy objectives, formulates specific policies to achieve such objectives and oversees their implementation through the regulatory authorities as appropriate at a macro level. We are not involved in the day-to-day regulation of the securities industry, nor individual regulatory actions / decisions.
- 2.5 In our macro oversight of the implementation of our regulatory policies, the Administration seeks to put in place sufficient and effective checks and balances within the system (paragraph 3.3 below refers). We act also as a coordinator of the various regulators of the different financial sectors and seek to provide various platforms for effective exchange amongst regulators and between them and the Administration on the regulatory regime. For instance, the Financial Stability Committee (FSC) was established to, inter alia, monitor on a regular basis the functioning of the financial system of Hong Kong, and deliberate on events, issues and developments with possible cross market and systemic implications. Likewise, the Council of Financial Regulators (CFR) is responsible for, inter alia, reviewing local and international developments in financial sector regulation and to draw lessons for Hong Kong.
- 2.6 The Administration also maintains contacts with market practitioners; and keeps in view local and overseas market developments. The Administration keeps the regulatory

framework under constant review from a policy perspective with a view to ensuring our market operates in a fair, transparent and orderly manner.

- 2.7 The Administration, together with the regulators, is kept abreast of market developments on an ongoing basis through the above-mentioned cross-sectoral and multi-disciplinary forums, communication networks with the regulators (which in turn maintain close contact with their overseas counterparts via day-to-day communications and international cooperative forums), regulatees and other market practitioners. We believe that the Administration is capable of overseeing the effective implementation of our policies by the regulators at a macro level and from a policy perspective; and that the current division of labour between the Administration and the regulators is crucial for maintaining and promoting a fair, efficient and orderly financial market to protect investors and facilitate market development.

3. ***As stated in paragraphs 4 and 6 of A22, SFST is responsible for overseeing the implementation of government policies through the regulatory authorities to achieve the policy objectives determined by FS at a macro level. At the same time, SFST is expected to safeguard the independence of HKMA and SFC in exercising their statutory powers and functions. Prior to 15 September 2008, was there any mechanism in place for FS to ensure that: (a) SFST's oversight would in no way compromise the independence of HKMA and SFC in discharging their statutory functions; and (b) HKMA and SFC would exercise their statutory powers and functions effectively and in a proper and appropriate manner?***

- 3.1 As stated in paragraphs 2.3-2.4 above, the Administration (including SFST) is not involved in the day-to-day regulation of the securities industry and SFST exercises oversight at a macro level of the implementation of regulatory policies through the regulatory authorities.
- 3.2 On the one hand, the Administration (including SFST) seeks to ensure that the regulators are sufficiently resourced and appropriately empowered to take regulatory actions independently and perform statutory functions flexibly and responsively, in terms of registration of banks in conducting securities business, giving

consent or registering market practitioners, as well as carrying out supervisory, enforcement and disciplinary actions without the Administration's involvement. In his oversight of the implementation of regulatory policies from a policy angle with a view to achieving the Administration's policy objectives, SFST is to safeguard the independence of regulators in exercising their statutory powers and regulatory functions effectively.

3.3 On the other hand, since the establishment of SFC and HKMA, care has been taken to ensure that the exercise of the above-said powers and functions are checked by efficient safeguards, without jeopardizing the regulatory independence. For instance, the powers, functions and responsibilities of SFC and HKMA are set out in the SFO and the BO, among others. Furthermore, the regulators' powers to update and adjust existing regulatory requirements and introduce new ones through the promulgation of codes, guidelines and subsidiary legislation are subject to market consultation and negative vetting by LegCo as appropriate. Other well-established checks and balances include –

- (a) the regulatory actions of HKMA and SFC are subject to appeal to be heard and determined by an independent Securities and Futures Appeals Tribunal chaired by a full-time judge;
- (b) members of the public who are aggrieved by the regulators' decisions in the performance of its functions may apply for judicial review;
- (c) complaints against the actions of the regulators or any of its staff may be lodged with the Office of the Ombudsman;
- (d) as a public body, under the Prevention of Bribery Ordinance, the regulators' practices and procedures are subject to review by the Independent Commission Against Corruption (ICAC); and
- (e) the Director of Audit may examine the records of the regulators,

so as to ensure that the regulators exercise their statutory powers and functions flexibly, effectively, independently and in a proper and appropriate manner.

4. *According to the letter dated 25 June 2003 from FS to the Monetary Authority (MA) (paragraph 8 of A16), FS, assisted by SFST, is responsible for policies for the maintenance of the stability and integrity of the financial system of Hong Kong. In support of these policies, MA shall be responsible for, inter alia, co-operating with other relevant authorities in the supervision of business conducted by Authorized Institutions (other than banking business or the business of taking deposits). Prior to 15 September 2008, how did FS ensure that the cooperation between MA and SFC was effective in relation to the regulation of Registered Institutions' regulated activities?*

4.1 Section 7(2) (e) of the BO provides that one of the functions of the MA is to “co-operate with and assist recognized financial services supervisory authorities of Hong Kong or of any place outside Hong Kong, whenever appropriate, to the extent permitted by this or any other Ordinance”. Besides, section 5(1)(h) of the SFO provides that one of the functions of SFC is “to co-operate with and provide assistance to regulatory authorities or organizations, whether formed or established in Hong Kong or elsewhere”.

4.2 In view of the above legislative provisions, the regulators are duty-bound under the statute to collaborate with and provide assistance to each other in discharging their statutory functions. Against this context, the letter dated 25 June 2003 from the then FS to the then MA is to recapitulate this statutory duty and set out the division of functions and responsibilities in monetary and financial affairs between FS and MA more clearly.

4.3 In the legislative process leading to the existing regulatory regime, the regulators pledged to the Administration and LegCo to undertake a number of initiatives to enhance mutual communication and bilateral coordination, and have diligently delivered their undertakings over the years. For example, as stated at paragraph 1.3 above, SFC and HKMA entered into a revised MOU in 2002 which replaced the MOU of 1995 to strengthen cooperation and have continued to enhance coordination between themselves and maintained close communication in both daily supervision and enforcement ever since. 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 regulatory system of the securities industry. In particular, the regulators have (i) set up regular working group meetings with the aim to align the regulatory standards applied in frontline supervision and enforcement; (ii) met frequently to discuss matters of mutual interest relating to the performance of their regulatory and supervisory functions; and (iii) arranged training sessions and staff secondment to share regulatory and supervisory experience. They have also concurrently carried out a theme inspection on the selling practices of their respective regulatees. SFC has consulted HKMA before issuance of the codes, guidelines, or amendments to codes or guidelines under the SFO, insofar as such codes, guidelines or amendments (as the case may be) apply to banks.

- 4.4 We have also provided regular channels and cross-sectoral platforms for the regulators to collaborate with one another in, among others, exchanging views among themselves and with the Administration on market regulatory and development issues, especially those which require joint efforts by the regulators (please also refer to paragraph 2.5). Through these, the Administration also relays market views received from time to time to the regulators for consideration and follow-up. These measures have played an instrumental role in enhancing the effectiveness of the cooperation between HKMA and SFC in relation to the regulation of banks' securities activities.

5. *The ongoing regulatory policy governing the sale of financial products comprises a disclosure-based approach underpinned by requirements of the conduct of intermediaries at the point of sale. Given the phenomenal growth in Registered Institutions' regulated activities and the diversity of complex structured financial products offered to the investing public, prior to 15 September 2008, did the Government consider the need to review this regulatory policy? If yes, please provide the details; if no, the reasons.*

- 5.1 It is important to appreciate that the regulatory system for the sale of structured products adopted in Hong Kong is a disclosure-and-conduct-based one. The regime rests on two important pillars – (i) disclosure-based principles and (ii) suitability obligations that an intermediary has to discharge in recommending products or soliciting subscriptions from investors.

The first pillar ensures that sufficient information is disclosed in the product documentation and sale process by the issuer and intermediary respectively to enable a reasonable person to make an informed decision. This is covered by the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission.

- 5.2 It is also important to note that 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 SFC in respect of the conduct of brokers; and HKMA in respect of securities business conducted by banks.
- 5.3 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 the Securities and Futures Commission". The Code requires intermediaries to ensure, inter alia, that, when making a recommendation or solicitation, the suitability of the recommendation or solicitation for the client is reasonable in all the circumstances (Clause 5.2 of the Code of Conduct refers). In the case of derivative products (including Minibonds), 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 refers). It follows that the role of intermediaries, as overseen by the regulators, is most instrumental in ensuring the effective operation of the disclosure-and-conduct-based regulatory regime in respect of the sale of financial products, especially structured products.
- 5.4 With the above preamble and in view of the market development since 2003, the regulators have continued to step up their statutory regulatory functions, as elaborated below.
- 5.5 On HKMA's front, the selling of investment products by banks has become one of HKMA's key supervisory priorities. As a result, more thematic examinations focusing on the sale of investment

products have been conducted, major and active registered institutions have been required to perform annual compliance self-assessment, and supplementary guidance or requirements have been issued.

- 5.6 On SFC's front, SFC has also encouraged issuers to use plain language in prospectuses to facilitate prospective investors' understanding of the key features and risks of their products, with the percentages of prospectuses adopting plain language increased from 44% in 2005 to 100% in 2008. As regards the intermediaries, SFC issued "Questions and Answers on Suitability Obligations" in May 2007. Amongst other things, licensed investment advisers were reminded of their duties to conduct product due diligence including the nature of the underlying investments; and provide reasonably suitable recommendations by matching the risk return profile of each product with the personal circumstances of each client to whom it is recommended. Regarding investors, SFC has also continued to exercise its statutory mandate to promote investor education, with a view to educating and empowering investors to protect themselves. As stated in the written statement of CEO/SFC dated 10 June 2009, SFC has conducted 107 separate publicity initiatives related to unlisted structured products and the duties of investment advisers in the period from April 2003 to September 2008, including articles in printed media, investor leaflets, electronic newsletters, on-line education resources, television and radio programmes and videos on public buses.
- 5.7 In order to carry out their regulatory roles effectively, the two regulators maintain very close coordination and communication with the aim to align the regulatory standards applied in frontline supervision and enforcement. A revised MOU was signed in December 2002 to further strengthen the co-operation. In addition to MOU meetings held between the two regulators, there are frequent contacts at the working level to discuss issues of common regulatory interest (paragraph 4.3 above refers).
- 5.8 The regulators have reviewed the implementation of this disclosure-cum-conduct regulatory regime following the Lehman Minibond incident and have come up with a slate of proposals, some of which are under consultation. We also note that jurisdictions such as the UK, the US, Australia, Singapore, the Netherlands and Germany also 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. Both regulators have suggested retaining the disclosure-and-conduct-based regulatory regime, which could be further strengthened.

- 5.9 In this connection, we wish to point out that even the most stringent regulation cannot completely prevent market misconduct and fraud. If regulatory breaches are identified in the course of day-to-day supervision, enforcement actions would be necessary to serve punitive and deterrent effects.
- 5.10 To sum up, the Administration and regulators have kept the local market developments, inter alia, under close and constant monitoring and review. The Administration also noted that the regulators have proactively and vigorously enhanced their supervisory, regulatory and investor education efforts to address the regulatory challenges and protect the investing public.

Development of banks' regulated activities

6. ***FS announced in his 2002-2003 Budget speech the Government's intention to attract more financial product issuers to Hong Kong. It is noted that in the ensuing years, the Government took a number of initiatives to promote the issuance of bonds and structured products in Hong Kong, such as attracting more financial product issuers to Hong Kong and simplifying procedures for retail bond issues. Since taking up office in July 2007, has FS conducted any review of the initiatives taken, particularly in relation to the development of the retail market of structured financial products sold by Registered Institutions?***
- 6.1 The then FS announced in his 2002-2003 Budget Speech the importance of increasing liquidity, capital and investors from the Mainland and overseas. One of the initiatives to implement this policy direction was to review and reform the regulatory framework for offers of shares and debentures, which was introduced decades ago and fell short of catching up with market development.

- 6.2 In reply to a LegCo question on “promoting development of retail bond market” at the LegCo sitting on 5 December 2001, the then Secretary for Financial Services stated that existing legislation, in particular the Companies Ordinance (CO), contained very stringent requirements over the disclosure of information for the retail offer of debentures and shares. Preparation of prospectuses and marketing materials under this stringent framework entailed substantial financial and time costs. In view of the rapid development of the markets, the Administration and the regulatory bodies were taking steps to streamline the procedures and requirements, so as to strike the right balance between facilitating market development and protecting investors.
- 6.3 To take forward the matter, guidelines were issued and legislative amendments were introduced to the CO in 2003 to, inter alia, simplify the procedures for the registration and issue of prospectuses. Notwithstanding the procedural improvements to facilitate market development, it is important to note that the statutory disclosure standard was not lowered, nor was the investor protection compromised. For instance, 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.
- 6.4 As stated in paragraph 1.1 above, the Administration and regulators have kept the local market developments, inter alia, under close and constant monitoring and review. Apart from noting that the regulators have continued to enhance their supervisory, regulatory and investor education efforts; the Administration is also aware of the regulators’ drive to continue reviewing and reforming the public offering regime to create a legal framework that accommodates the financial market’s needs in the 21st Century and caters for issuers and investors alike. Specifically, SFC published a consultation paper in 2005 on reform initiatives relating to the CO prospectus regime. I understand that after publication of the consultation conclusions in September 2006, SFC undertook a substantial amount of work including soft-consulting various stakeholders on the detailed logistics and technical aspects of

certain proposals to reduce any process risk associated with the implementation of these proposals. SFC has completed an initial draft of the draft drafting instructions for the proposed legislative amendment work.

7. *It is noted that FS is the Chairman of the Banking Advisory Committee (BAC) established under section 4(1) of the Banking Ordinance (Cap. 155) to advise the Chief Executive of the Hong Kong Special Administrative Region on matters relating to the Banking Ordinance, in particular matters relating to banks and the carrying on of banking business. Between April 2003 and 14 September 2008, did BAC submit any advice to the Chief Executive on the development of banks' non-interest-income generating business, such as promoting the retail market of securities-related financial products? If yes, please provide the details of such advice.*

7.1 During the period from April 2003 to September 2008, the BAC did not tender any advice by giving any opinions or making any recommendations to the Chief Executive on the development of banks' non-interest income generating business, such as promoting the retail market for securities-related financial products.

7.2 That said, the BAC did discuss aspects of the regulation of banks' securities business such as enhanced regulatory reporting requirements on securities-related activities. As part of its regular review of general banking conditions in Hong Kong, the BAC also discussed banks' non-interest income in the context of its contribution to banks' overall income generation and profitability. The growth of the securities or retail wealth management business conducted by banks was also referred to in HKMA's annual reports, which are available in the public domain.

Work of the Council of Financial Regulators (CFR)

8. *The Securities and Futures Ordinance (SFO) (Cap. 571) and the Banking (Amendment) Ordinance 2002 (Cap. 155) commenced operation on 1 April 2003. Given the importance of the new regulatory framework enshrined in these two Ordinances, please advise:*

(a) did CFR actively monitor or keep itself posted of the work undertaken by the two regulators (i.e. SFC and HKMA) in preparation for the implementation of the new framework in April 2003? If yes, please provide the details; if no, the reasons.

8.1 After the Securities and Futures Bill was passed by LegCo on 13 March 2002 and before the SFO came into force on 1 April 2003, the regulators had put in place various preparatory arrangements as pledged at LegCo to facilitate the smooth rollout of the SFO.

8.2 For example, at the Bills Committee on the Securities and Futures Bill in December 2000, SFC indicated that they were updating an MOU with HKMA with a view to aligning the regulatory standards applied in frontline supervision and enforcement. The updated MOU was subsequently signed on 12 December 2002; published on the internet 13 December 2002; and a copy of the MOU was submitted to LegCo on 17 January 2003.

8.3 During the above-said period, CFR noted with the passage of the Securities and Futures Bill and the related Banking (Amendment) Bill 2000 in March 2002, efforts were then devoted to preparing relevant subsidiary legislation. In doing so, the regulators closely engaged the market to remove any obsolete procedures and to ensure that the new rules would be user-friendly. Furthermore, CFR also noted that HKMA had been liaising with SFC in the implementation of the SFO before it came into operation.

(b) what discussion, if any, had been held by CFR in the five years following the implementation of the new regulatory framework since April 2003? Was the attention of CFR ever drawn to any issues of concern regarding the implementation of the new framework? If yes, please provide the particulars of the issues of concern.

8.4 Following the commencement of the SFO in 2003, regulation of securities business conducted by banks was reported and discussed at CFR meetings on a number of occasions.

8.5 At the CFR meeting on 10 October 2003, CFR noted that HKMA had been liaising with SFC on the implementation of the SFO and the BO. The regulation of the securities business conducted by banks was another area of joint efforts by the two regulators.

- 8.6 At the CFR meeting on 13 May 2004, HKMA reported that it would continue to work together with SFC on the regulation of the securities business conducted by banks.
- 8.7 At the CFR meeting on 3 December 2004, CFR noted that the cooperation between HKMA and SFC had been working well, and there had not been many concerns raised.
- 8.8 At the CFR meeting on 22 June 2006, CFR noted that there had been continued cooperation between HKMA and SFC on the regulation of securities business, and there were no other cross-sector regulatory issues which warranted the meeting's attention.
- 8.9 At the CFR meeting on 9 July 2007, CFR noted that the implementation of the revised MOU concerning the supervision of banks' securities activities between HKMA and SFC had helped enhance the effectiveness of the communication and cooperation on enforcement matters; and that the two regulators worked closely to review the policy on the imposition of disciplinary sanctions.
- 8.10 All in all, the Administration was not aware of any specific reports from the regulators or substantial discussions on issues relating to any gaps between SFC and HKMA in regulating banks' selling of structured financial products during CFR meetings.¹
9. ***When the incumbent FS took office in July 2007, the US sub-prime problem and the credit standing of some of the world's leading financial institutions were showing signs of deterioration. Did FS initiate any discussion at CFR on the implications of these external problems on Hong Kong's financial markets and***

¹ For the avoidance of doubt, the said references made to the various CFR and FSC meetings in this statement were made without prejudice to the claim for confidentiality previously made by the Administration in relation to the extracts of the agenda and minutes of these CFR and FSC meetings which were confidential in nature as discussions at these meetings might be sensitive and leakage of such information might not be conducive to the financial stability of Hong Kong, in respect of which the Subcommittee notified the Administration vide its letter dated 17.3.2009 that the Subcommittee decided by a majority that the above said materials would be handled in accordance with the paragraph 19 of the Subcommittee's Practice and Procedure.

on the investing public? If yes, please provide the particulars.

- 9.1 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 FSC and CFR (paragraph 2.5 above refers) 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.
- 9.2 During the period from June to mid-September 2008 (i.e. before the collapse of LB), I understood that regulators had been closely and actively monitoring the international developments which might have spillover effects to Hong Kong, thus affecting our financial stability and FSC also kept in view any overseas developments in this regard. For instance, at the FSC meeting on 29 May 2008, FSC noted that the market was by and large stable during the reporting period, although international financial institutes might present disappointing business figures. It was also noted that volatilities in the international financial markets might have an impact on Hong Kong, though no systemic problem was identified in the banking sector of Hong Kong.
- 9.3 At its meeting on 20 June 2008, FSC noted that Hong Kong was mainly influenced by a number of external factors at that moment, one being the credit crunch and instability in the US and Europe, which were caused by the US subprime turmoil and its repercussions. Many large financial institutions in the aforesaid jurisdictions were expected to report further losses in the second quarter of 2008. In general, financial institutions worldwide were facing pressure brought about by the negative outlook on asset qualities having regard to the continuing downward adjustment of the property market as well as the economic slowdown. Such pressure might increase to a magnitude that made these institutions withdraw or reduce their loans to new markets. Against this background, an outflow of capital from new markets and Hong

Kong was not impossible. It was noted that no systemic problem was observed in the Hong Kong financial markets but it was necessary to closely monitor the relevant developments.

- 9.4 However, it is important to appreciate the mixed market messages before the collapse of LB. Prior to LB filing for bankruptcy protection in mid-September 2008, while there was widespread concern about the health of US financial institutions, including but not limited to LB, there were market views that some form of rescue or bail-out would take place, as had happened with Bear Sterns and as subsequently happened with the American International Group. It was extremely difficult, if not impossible, for anyone to predict whether any of these institutions would in fact fail or whether they would be taken over by another institution or rescued, which is squarely a policy decision of the relevant authorities outside Hong Kong.²

10. *It is noted that issues relating to the alleged mis-selling of “accumulators” had been brought up for discussion at meetings of CFR. Did the problems associated with “accumulators” prompt CFR to also consider paying attention to the prevalence and selling practices of other structured financial products (such as Minibonds) that were easily available to retail investors? If yes, what did CFR do?*

- 10.1 Following the commencement of the SFO in 2003, regulation of securities business conducted by banks was discussed at CFR meetings on a continuous basis, and it was reported in July 2007, after I assumed the office of FS, that the cooperation between HKMA and SFC had been working well.
- 10.2 Notwithstanding the above, the Administration and regulators have continued to stay in close touch and exchange views on issues related to the regulatory regime on an ongoing basis. The Administration has reminded investors of the implications of the subprime turmoil from time to time in general, while 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.

² Please refer to Footnote 1.

- 10.3 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.
- 10.4 In March and August 2008, regulators reported at CFR that a number of investors had lodged complaints about alleged mis-selling of accumulators including incomplete disclosure of risk. The CFR noted that the accumulators were sold directly to the high net-worth individuals mainly through private banking network.
- 10.5 I understand from the above CFR discussions that regulators had taken a series of action on suspected mis-selling cases related to the sale of accumulators, such as collecting further information on such products, actively looking into the complaints, keeping in touch with the complainants, as well as stepping up education on the importance of knowing and managing the investment risk.
- 10.6 Discussions and follow-up work regarding complaints related to accumulators were not confined to the forum of CFR. I should stress that our communication with the regulators are conducted on an ongoing basis as and when necessary.
- 10.7 At FSC, the Administration and regulators have henceforth reviewed the latest situation regarding allegations on mis-selling of accumulator contracts. I learnt that HKMA had received 12 complaints on accumulators up to mid-April 2008. The Administration also obtained figures on complaints relating to accumulators, derivative warrants and other derivative products received by HKMA, SFC and Consumer Council since 2006, details of which were subsequently set out in SFST’s written reply to Hon James To’s question asked at the LegCo sitting of 23 April 2008.
- 10.8 On 7 July 2008, I understand that FSTB together with HKMA and SFC discussed the regulation of sale of structured products or derivative products at a meeting of the FA Panel. In the Administration’s paper entitled “Regulation of Sale of Structured

Investment or Derivative Products”, it was pointed out that regardless of who the client was, the sale process for all securities and futures products offered by banks regulated by HKMA or non-bank intermediaries regulated by SFC were both governed by the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission. It was 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 regulators would continue to actively carry out investor education activities to enhance investors’ awareness of various investment products and the potential risks involved.

10.9 In the HKMA’s submission to the FA Panel, it pointed out, inter alia, that as the front-line supervisor of banks’ regulated activities, HKMA had a duty to ensure that banks comply with the requirements of the Code, and that this had been one of HKMA’s key supervisory priorities in the past few years in line with banks’ growing securities business. In the SFC’s submission, 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. I also understood that SFC undertook at the FA Panel meeting on 7 July 2008 to review the definition of “professional investors” in the SFO and SFC’s Code of Conduct in view of the market concerns.

10.10 In August 2008, I understand that SFST continued to keep in view with regulators on issues relating to accumulators. The Administration understood from HKMA that 33 complaints in relation to accumulators were received by HKMA. In this connection, I wish to highlight that, compared to the number of complaints relating to accumulators and derivative warrants, SFC and HKMA had only received one and two complaints respectively relating to Minibonds before the collapse of LB on 15 September 2008.³

Issues relating to investor protection

11. The global financial crisis leading to the collapse of Lehman Brothers Holdings Inc. caused losses to local investors who had

³ Please refer to Footnote 1.

bought retail structured financial products arranged by the company. Given that Hong Kong, being an open international financial centre, cannot be immune from turmoils in overseas markets, does FS consider that the Government or the regulators should have a duty to regularly assess the impact of trans-national financial problems on the investing public in Hong Kong, and to take appropriate measures (e.g. issuing some form of general forewarning) where necessary?

- 11.1 The regulators are equipped with the necessary experience, expertise and resources to actively monitor the development of the both the local and global financial markets on an ongoing basis. In discharging their duties, the regulators 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. From time to time, they also report to the Administration local and international developments with significant implications to our financial market.
- 11.2 Exchange platforms such as FSC and CFR have been established to allow the regulators to convey their observations among themselves and to the Administration from time to time and to monitor on a regular basis the functioning of the financial system of Hong Kong, including the banking, debt, equity, insurance and related markets; as well as to deliberate on events, issues and developments with possible cross market and systemic implications, and where appropriate, formulate and co-ordinate responses. These exchange platforms also serve as a cross-sectoral focal point to review international developments in financial sector regulation; 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.
- 11.3 As stated at paragraphs 1.5-1.6, the Administration also closely and constantly monitors the economic situation, including the subprime crisis in the US and its repercussions on the economy and financial markets of Hong Kong. In particular, the EABFU publishes quarterly 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 Administration has briefed 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.

- 11.4 While no one could have foreseen the outbreak of the global financial turmoil on such an unprecedented and disruptive scale, the Administration has repeatedly warned of the substantial downside risks in the global economy associated with the US subprime problem since late 2007. As early as October 2007, I 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, I further pointed out the risk that “the situation might deteriorate in the near future and the fallout may be prolonged”.
- 11.5 I also noted that regulators did give general warnings when financial markets experienced heightened volatility and increased risks through different channels, including briefings for the media and to the FA Panel as well as speeches given by senior management of the regulators, to urge caution with regard to developments in the global and local economies, in particular the contagious effects of the sub-prime problem and ensuing credit crisis and the need for investors to carefully manage risk.
- 11.6 I understand that regulators have explained their views to the Subcommittee on the inappropriateness for any regulator to issue public warnings related to individual institutions or specific products. Apart from forewarning the general public in general, the regulators have also stepped up their supervisory, regulatory, market surveillance and investor protection efforts in view of the evolving market changes as set out at the reply to Q.5 above.
12. *It is noted that after months of negotiation, SFC, HKMA and the 16 Minibonds distributing banks reached a repurchase agreement which was announced on 22 July 2009. What role, if any, did the Government play in the process of negotiation? Was there any high-level direction or advice given by the Administration to the regulators in their negotiation with the banks?*

- 12.1 The Administration had from the outset urged SFC to accord a high priority to handling the problems following the collapse of LB. Given that a large number of banks were involved in the sale of the Minibonds to the retail public, the Administration considered that an expeditious resolution of the matter to the satisfaction of the main stakeholders was crucial not only to investor protection, but also to the maintenance of Hong Kong's banking and financial stability.
- 12.2 The Administration had also considered that it would be highly desirable if the banks concerned could reach a broad-based settlement with the Minibond holders who deserved to have returned a fair portion of their investments without the need to go through a lengthy, costly, uncertain and anxious process of investigation and litigation on a case-by-case basis, provided that the terms of any such settlement must be fair and reasonable and, importantly, acceptable to the relevant supervisory authorities.
- 12.3 In view of the concerns of the investors concerned, the Administration had also encouraged SFC, in close consultation with HKMA, to use best endeavours to resolve the matter with the banks concerned as soon as practicable, which would serve a wider public interest and avoid lengthy and costly disciplinary and legal proceedings that may not bring about the necessary and timely relief to the Minibond holders.

Mr John C. Tsang, JP
Financial Secretary
November 2009