

**WRITTEN STATEMENT OF MR JOSEPH YAM CHI-KWONG, GBS, JP**  
**MONETARY AUTHORITY**

**GENERAL REMARKS**

**Introduction**

1. In response to the questions raised by the Subcommittee in the Clerk's letter dated 5 March 2009, I have prepared the following replies. I have sought assistance from my colleagues in the Hong Kong Monetary Authority (HKMA) in perusing relevant files and records of the HKMA and obtaining factual information from the Administration and the Securities and Futures Commission (SFC) in preparing the replies. I have in this statement responded to the questions raised by the Subcommittee to the best of my knowledge and belief.

2. The current global financial crisis has generated extreme and unexpected events, including the collapse of Lehman Brothers (LB), one of the world's largest and oldest investment banks. During the first three quarters in 2008, at least 19 prominent financial institutions were reported to have experienced financial difficulties. 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 by a government. Before LB filed for bankruptcy protection on 14 September 2008, the prevailing market expectation, as shown by market indicators such as the credit default swap spread, was that some form of rescue or bail-out would take place, as had taken place with Bear Stearns and subsequently with AIG. Unfortunately, this turned out not to be the case, and in consequence great harm was done to the world's financial system and, most regrettably, to the interests of ordinary investors, including many in Hong Kong.

**(a) The role of the HKMA in the overall policy and regulatory regime governing banks' undertaking of securities-related business**

3. According to the statement by the Chief Executive of the Hong Kong Special Administrative Region (Hong Kong SAR) on Responsibilities of the Financial Secretary and the Secretary for Financial Services and the Treasury issued on 27 June 2003 (a copy of this is enclosed as **Annex 1**), the Financial Secretary (FS) is 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 organisations as appropriate. The SFST also has a specific responsibility for the efficient functioning of our financial system. Where this requires regulation, the regulatory authorities shall exercise their powers and discharge their functions independently in accordance with the respective statutes. The SFST is expected to safeguard that independence. The Policy Objectives in Financial Affairs and Public Finance set out by the FS in his statement of 27 June 2003 (a copy of this is enclosed as **Annex 2**) state that the Government should formulate specific policies to promote the efficient functioning of the financial system, and that policies concerning the regulatory regime should provide a regulatory framework that promotes the stability of the financial system, provides an appropriate measure of protection of users of financial services and facilitates competition, and is consistent with the standards and practices of major international financial centres.

4. Paragraph 8 of the Exchange of Letters between the FS and the Monetary Authority (MA) of 25 June 2003 notes that the MA has a number of specific responsibilities in addition to his responsibilities for promoting the general stability and effective working of the banking system through the regulation of banking business and the business of taking deposits and the supervision of Authorized Institutions (AIs) as provided for in the Banking Ordinance (Cap. 155) (BO). The FS, assisted by the SFST, is responsible for policies for the maintenance of the stability and integrity of the financial system of Hong Kong. In support of those policies, the MA is responsible, among other things, for: (a) co-operating with other relevant authorities in the supervision of business conducted by AIs other than banking business or the business of taking deposits; and (b) developing the debt market in co-operation with other relevant authorities and organizations. A copy of the Exchange of Letters is enclosed as **Annex 3**.

5. As the HKMA understands it, the specific policy of the Government in providing an appropriate measure of protection to investors in Hong Kong prescribes, in line with international practice, a disclosure-based system with four key elements. First, sufficient information, including the nature and risks of the investment product being offered, is disclosed in the investment product documentation by the issuer. Secondly, suitability assessments are conducted by intermediaries selling those products to the general public to ensure that the products are suitable for the investors. Thirdly, through these two processes, the intention is to enable investors to make informed investment decisions. Finally, once the nature and relevant risks of the investment products have been properly disclosed and a suitability assessment properly conducted, investors take responsibility in an informed way for their investment decisions. The HKMA believes that the disclosure-based policy is appropriate for Hong Kong and should be retained.

**(b) The role of the HKMA in overseeing the sale of structured financial products by banks**

6. As one of the agencies responsible for putting policy into practice, the HKMA serves as the front-line regulator of the regulated activities conducted by banks. The role of the HKMA is to ensure that banks and their staff engaged in regulated activities conduct the sale of investment products, including structured financial products, in accordance with the regulatory requirements stipulated in the Securities and Futures Ordinance (Cap. 571) (SFO) and other regulatory documents promulgated by the SFC and the HKMA. According to the framework set out in the SFO and the BO, an AI as defined under the BO intending to conduct regulated activities has to apply to the SFC for a Registered Institution (RI) status. For each type of regulated activities to be carried out, the applicant needs to appoint at least two Executive Officers (EOs) responsible for directly supervising the activities concerned and such EOs must obtain the prior consent of the MA. Front-line staff engaged by RIs for carrying out regulated activities have to fulfil the “fit and proper” requirement promulgated by the SFC (e.g., the Fit and Proper Guidelines and the Guidelines on Competence issued by the SFC) and their names and details have to be included in a public register maintained by the HKMA.

7. The HKMA's regulatory approach regarding the regulated activities of RIs comprises two pillars: day-to-day regulation and enforcement. In its day-to-day regulation of RIs, the HKMA adopts the standards set by the SFC, supplemented by additional guidance or requirements promulgated by the HKMA from time to time taking into account regulatory experience and market conditions. In terms of methodology, the HKMA conducts on-site examinations and off-site reviews of RIs' securities-related business, the details of which will be explained further in the next section of this statement relating to the specific questions and issues raised by the Subcommittee. Where incidents involving possible misconduct or breach of the relevant statutory provisions or regulatory requirements are identified in the day-to-day regulatory work, such cases are referred to the HKMA's securities enforcement team for investigation: this may lead either to disciplinary proceedings by the HKMA or referral to the SFC for any action that it might consider appropriate. If sufficient evidence is found after investigation into those cases, the RI concerned and its staff are subject to the same range of disciplinary sanctions as would be the case of firms or individuals regulated directly by the SFC.

8. The growing securities business of RIs since 2004 has led to a greater focus on investor protection. The selling of investment products by RIs has become one of the HKMA's key supervisory priorities. As a result, more thematic examinations focusing on the sale of investment products have been conducted, and supplementary guidance or requirements have been issued. In the light of increasingly volatile market conditions, the HKMA conducted a survey from December 2007 to early 2008 to gather information about the sale by RIs of retail credit-linked notes with sub-prime mortgages as underlying collateral and credit-linked notes the collateral of which was, or might include, collateralised debt obligations (CDOs). To promote uniform and prudent treatment among RIs, the HKMA advised the RIs distributing retail credit-linked products without full principal protection to assign such products a "high" risk rating if they had not already done so. The HKMA also conducted thematic examinations of RIs' selling of retail credit-linked investment products in 2008.

9. In order to carry out its regulatory role effectively, the HKMA maintains close coordination and communication with the SFC to ensure consistency in interpretation and application of the SFC's regulatory standards. A revised Memorandum of Understanding (MoU) [*Paper No. provided by the HKMA to the Subcommittee – A-01(01)-HKMA(03)-E(O)*] was signed in December 2002 to further strengthen the co-operation. In addition to regular MoU meetings held between the two regulators, there are very frequent contacts at the working level to discuss issues of common regulatory interest.

10. Taking a wider perspective in its responsibility for investor protection, the HKMA actively monitors key trends and developments that may have implications for the stability of global and local financial markets and therefore for the investing public in Hong Kong. While, for reasons explained later in this statement, it is inappropriate for a regulator to give warnings about specific institutions or products, I have given numerous general warnings to the investing public, urging caution and careful risk management with regard to investments that may be affected by adverse developments in the global economies, in particular the effects of the sub-prime problem and ensuing credit crisis.

**(c) Regulatory concerns arising from the fallout of the sub-prime problem in the United States and the sale of LB-related Minibonds and structured financial products**

11. The principal regulatory concern revealed in the United States and other major economies by the sub-prime problem and its aftermath has been the lack of attention to prudential issues that might lead to serious systemic problems, which might in turn cause the failure of financial institutions and damage to the interests of depositors and investors. The current financial crisis has exposed a failure in some jurisdictions to understand that actions by the individual components of a financial system, which could well be optimal from their own narrow perspectives, may collectively be damaging for the system as a whole. The need for a macro-prudential approach to financial regulation and supervision has now been recognised by regulators and policy-makers in a number of jurisdictions and is one of the areas of focus of the discussion at G20 on how to reform the international financial

architecture. Such an approach would involve monitoring and addressing changes in markets or products, large or rapid increases in leverage or exposures – such as to sub-prime mortgages – across firms and markets, rather than only at the level of individual firms or sectors, and identifying possible regulatory gaps, including gaps in the protection of investors, that pose risks for the system as a whole. The HKMA has already made progress in developing forms of macro-prudential supervision, for example in the longstanding 70% loan-to-value ratio for residential mortgages, and in monitoring or giving guidance to banks on managing the risks associated with exposures to the fast-developing Mainland market or to the property market. This supplements the micro-level supervisory and regulatory work performed by the HKMA regarding the prudential standards of individual institutions and the conduct of RIs and their staff. The HKMA will continue to develop its work in this area, taking into account the proposals formulated by regulators in other jurisdictions and international bodies.

12. In the light of changing expectations among investors, particularly following the LB incident, the HKMA has reviewed aspects of the current regulatory framework and approach for the sale of investment products by RIs. The results of our review, including the 19 recommendations on further enhancing the protection of retail investors, are set out in the “Report of the Hong Kong Monetary Authority on Issues Concerning the Distribution of Structured Products Connected to Lehman Group Companies” (“the HKMA’s Review Report”) submitted to the FS on 31 December 2008. The HKMA has already asked RIs to implement a number of measures recommended in the HKMA’s Review Report that can be introduced immediately and will ensure that the remaining measures are properly discussed, and where appropriate, implemented as soon as possible. In addition, we will continue to work closely with the Administration, the other regulators and the financial services industry to consider and introduce further enhancements if necessary.

13. I shall now turn to the specific issues raised by the Subcommittee in its Clerk’s letter dated 5 March 2009.

## SPECIFIC REPLIES

### Overall policy and regulatory regime governing banks' undertaking of securities-related business

1. *It is noted that the letter dated 25 June 2003 from the Financial Secretary (FS) to the Monetary Authority (MA) (SC(1)-A16/English version, paragraph 8(e) on p.8) sets out the division of functions and responsibilities in monetary and financial affairs between FS and MA. As stipulated in paragraph 8(d) of the letter, MA is responsible for co-operating with other relevant authorities in the supervision of business conducted by Authorized Institutions (AIs) (other than banking business or the business of taking deposits).*
  - (a) *What are the views of the Hong Kong Monetary Authority (HKMA) on banks' active involvement in undertaking securities or other non-banking business? Was there any assessment of the implications of such activities on market development and investor protection?*
  - (b) *Regarding the growth in securities business conducted by banks from 2003 to 2007 and the increase in the number of banking staff engaged in securities business, please provide information on the growth in the sale of structured financial products and the number of banking personnel engaged in such business.*

#### Item (a)

- 1.1 Since 2004, demand from retail customers for financial planning and wealth management services increased. This may have been due to a benign investment and low interest rate environment during the period. In response to this demand, banks diversified their business into non-interest-income businesses, including securities business, in order to offer more investment services and choices to customers more conveniently (for example, by offering integrated systems for banking and investment services and branch network).

The increase in demand for retail structured financial products was not confined to Hong Kong but was also observed in overseas markets in recent years.

- 1.2 The HKMA believes that the development of banks' non-interest-income businesses, including securities business, is beneficial to Hong Kong's status as an international financial centre and the local economy, and is in the interests of banks' customers, who benefit from greater choice and easier access to investment services.
- 1.3 However, the HKMA recognises that the growing securities business of banks highlights the need to strengthen investor protection. The role of the HKMA, as the front-line regulator of banks' securities business, is to take all reasonable steps to ensure that the banks operate in a responsible, honest and business-like manner. The HKMA is also required to take all reasonable steps to ensure that such business is conducted with integrity, prudence and the appropriate degree of professional competence.
- 1.4 In discharging these functions, the HKMA continuously assesses whether investors are adequately protected, given the changing market conditions and increasing participation of banks in securities business. According to this assessment, the HKMA has, since 2005, stepped up its regulatory efforts with regard to banks' selling of financial products, including undertaking more thematic on-site examinations<sup>1</sup> of the sale of investment products by banks, issuing related circulars to the banking industry, and requiring large, complex or active RIs to conduct independent self-assessment of regulatory compliance. In the light of increasingly volatile market conditions in late 2007, the HKMA decided to conduct thematic examinations of RIs' selling of retail credit-linked investment products in 2008, as stated in the HKMA's Annual Report of 2007.<sup>2</sup>

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<sup>1</sup> Thematic on-site examinations involve reviewing a particular activity or function across a selection of institutions.

<sup>2</sup> Refer to the section "Supervision of securities and insurance businesses" of *Plans for 2008 and Beyond* under the chapter on *Banking Stability*. The chapter on Banking Stability in this Annual Report is the report on the working of the BO and the activities of the office of the MA during 2007 submitted by the MA to the FS in accordance with section 9 of the BO.



Item (b)

- 1.5 The aggregate notional value of structured financial products<sup>3</sup> sold by all of the current 101 RIs from 2003 to 2007 is summarised in Table 1 below:

Table 1

	2003	2004	2005	2006	2007
Notional value of structured financial products sold by the RIs during the year (in HK\$ billion)	406.7	697.1	746.0	1,123.9	2,529.6
% change from the preceding year	N.A.	+71%	+7%	+51%	+125%

- 1.6 Banking personnel engaged in regulated activities (including but not limited to the sale of structured financial products) must be registered as relevant individuals (ReIs). In addition, at least two EOs who are responsible for directly supervising the conduct of each regulated activity must be appointed by every RI. Please refer to Table 2 for the number of these ReIs from 2003 to 2007:

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<sup>3</sup> “Structured financial products” generally refer to products which, in addition to an exposure to the credit or default risk of the issuer (or guarantor where applicable), contain an exposure to an underlying asset, opportunity or risk that is usually unrelated to the issuer or the guarantor (adopting the definition of “structured products” in Consultation Conclusions on the Consultation Paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance published by the SFC in September 2006). The information in Table 1 above excludes transactions in structured financial products between RIs and other financial institutions and also excludes insurance products.

Table 2

	As at 31 December 2003	As at 31 December 2004	As at 31 December 2005	As at 31 December 2006	As at 31 December 2007
Total number of ReIs (including EOs) of RIs	19,527	20,791	22,570	24,887	27,269
% change from previous year-end	N.A.	+6.5%	+8.6%	+10.3%	+9.6%

2. *The regulation of dealings in securities by banks has two aspects: prudential regulation and conduct regulation. In the regulation of the sale of securities or structured financial products to customers, it is conduct regulation that is more relevant. In acting as the frontline supervisor of banks' securities business using the standards established by the Securities and Futures Commission (SFC), does HKMA have any difficulty in detecting non-compliance committed by banks as intermediaries, given that the standards per se were not developed by HKMA and that HKMA's supervisory focus is on prudential regulation of banks?*

2.1 Although banking supervision generally involves two aspects (prudential supervision and conduct regulation), the HKMA's focus in its regulation of securities business conducted by RIs is on conduct regulation. This includes investor protection, which, although not expressly stated in the BO, is a function of the HKMA that can be construed from the relevant provisions of the BO.

2.2 Under the current regulatory regime, the SFC, which is responsible for the SFO and the related regulations, develops the standards and regulatory requirements

for regulated activities. Where the standards or regulatory requirements also apply to RIs in respect of their carrying out regulated activities, the SFC will consult the HKMA before making such standards or regulatory requirements. The HKMA is the front-line regulator of RIs in respect of their conduct of regulated activities and performs its regulatory functions according to standards that are consistent with those applied by the SFC to its licensed persons. A revised MoU was signed on 12 December 2002 to further strengthen co-operation between the SFC and the HKMA. The SFC consults the HKMA before making, publishing or amending any rules, codes or guidelines if they also apply to RIs. Where necessary, the HKMA issues circulars and additional guidelines to RIs to supplement the regulatory requirements and standards established by the SFC. To ensure consistency in interpretation of the SFC's standards, the HKMA also maintains close communication and co-ordination with the SFC. There has been reciprocal secondment of supervisory staff between the two regulators, and the HKMA's supervisory staff also attend the SFC's internal training. With the close communication and co-ordination between the two regulators, the division of regulatory responsibilities between the HKMA and the SFC has not posed any difficulty to the HKMA in performing its conduct regulation of regulated activities carried out by RIs.

- 2.3 The regime adopted for regulating RIs rests on two pillars: day-to-day regulation and enforcement. The HKMA carries out day-to-day regulation (including on-site examinations and off-site reviews) to help ensure that RIs conduct their regulated activities according to the legal and regulatory requirements. Where the day-to-day regulatory process or any complaint received reveals possible misconduct, the incident is referred to the HKMA's securities enforcement team for investigation and disciplinary proceedings or referral to the SFC as appropriate. It should however be emphasised that no regulatory system is able to prevent all incidents of non-compliance through day-to-day regulation alone. It is therefore important to have an enforcement element in the regulatory framework both to deal with regulatory breaches and as a deterrent against non-compliance.

3. *According to the Memorandum of Understanding (MOU) dated 12 December 2002 between SFC and HKMA (SC(1)-S1-Appendix 10, paragraphs 7.2.1 and 7.2.2), HKMA is the front-line regulator of banks' securities business and also serves the first point of contact for registered institutions (RIs). Section 7 of the Banking Ordinance specifies the functions of MA, which include:*

- (i) taking all reasonable steps to ensure that the principal places of business, local branches and local offices of all AIs are operated in a responsible, honest and business-like manner, and that any banking business or any other business conducted by AIs is carried on with integrity, prudence and the appropriate degree of professional competence and in a manner which is not detrimental, or likely to be detrimental, to the interests of depositors or potential depositors;*
- (ii) promoting and encouraging proper standards of conduct and sound and prudent business practices amongst AIs; and*
- (iii) suppressing or aiding in suppressing illegal, dishonourable or improper practices in relation to the business practices of AIs.*

*In this connection, please advise on:*

- (a) HKMA's understanding of its role and functions in relation to the conduct regulation of banks, particularly whether the conduct regulation of banks by HKMA has been done at the institutional level only;*
- (b) whether HKMA has relied on individual banks to supervise their front-line staff involved in the sale of investment products. If yes, does HKMA consider that such regulatory arrangement has placed banks in a conflict-of-interest situation where they have been both the seller of structured financial products and also the direct supervisor of the conduct of their front-line staff in selling such products; and*

*(c) measures (if any) taken by HKMA since April 2003 to suppress illegal, dishonourable or improper practices in relation to AIs' securities-related business.*

Item (a)

- 3.1 The HKMA's role and functions in the regulation of regulated activities of RIs are not restricted to the institutional level. The HKMA also regulates the conduct of RIs and EOs in their carrying on of regulated activities.
- 3.2 The HKMA considers every application of an AI to become a RI (which has been referred from the SFC), consults the SFC upon the merits of the application, and advises the SFC whether it is satisfied that the applicant is a fit and proper person to be registered for the regulated activities concerned.<sup>4</sup> No person shall become an EO of a RI without the HKMA's consent in writing.<sup>5</sup> In considering whether an applicant (i.e., an AI or an EO applicant) is fit and proper to be so registered, the HKMA takes into account, where appropriate, relevant provisions of the SFO and the BO and any relevant codes, guidelines or guidance made or published by the SFC and the HKMA.<sup>6</sup> Relevant factors relating to fitness and propriety include the applicant's financial status or solvency; educational or other qualifications or experience relevant to the proposed capacity; ability to carry on the regulated activity competently, honestly and fairly; and reputation, character, reliability and financial integrity. RIs have to fulfil the above "fit and proper" requirement and their names and details have to be included in a public register maintained by the HKMA.
- 3.3 The HKMA has powers under the BO and the SFO<sup>7</sup> to conduct inquiries into the regulated activities conducted by RIs and their staff for the purpose of

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<sup>4</sup> Section 119(2) and (3) of the SFO.

<sup>5</sup> Section 71C of the BO.

<sup>6</sup> These include section 129 of the SFO, section 71C(2)(a) of the BO, the SFC's Fit and Proper Guidelines and Guidelines on Competence and the HKMA's Supervisory Policy Manual module SB-1 "Supervision of Regulated Activities of SFC-Registered Authorized Institutions".

<sup>7</sup> Sections 55, 63 and 72A of the BO and section 180 of the SFO.

carrying out its statutory functions including exercising disciplinary powers against the EOs and ReIs of RIs and recommending the SFC to exercise its disciplinary powers against RIs, EOs and ReIs. The HKMA also has certain disciplinary powers over ReIs and EOs under the BO.<sup>8</sup>

- 3.4 The day-to-day regulatory process carried out by the HKMA also covers the fitness and propriety of ReIs and EOs. The SFC's Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission ("the Code of Conduct") applies to, among other persons, ReIs and EOs. The HKMA performs off-site reviews and on-site examinations to ensure RIs' compliance with the relevant legal and regulatory requirements, including the fitness and propriety of ReIs and EOs, and to test-check the effectiveness of the management supervision and internal control processes.

Item (b)

- 3.5 The HKMA's regulatory approach does not rely solely on RIs to ensure the proper conduct of their ReIs and EOs. However, RIs and their senior management (including EOs) have duties to supervise the conduct of their regulated activities, including the related conduct of business by their ReIs to ensure that they are fit and proper. These include:
- (a) the duty to ensure that in relation to a regulated activity, there is at least one EO of the RI who is available at all times to supervise the regulated activity of such RI and any individual whose name is entered in the HKMA's public register as engaged by such RI is fit and proper;<sup>9</sup>
  - (b) the duty of every RI to appoint not less than two EOs to be responsible for directly supervising the conduct of each regulated activity;<sup>10</sup> and

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<sup>8</sup> Sections 58A and 71C of the BO.

<sup>9</sup> Section 119(8) of the SFO.

<sup>10</sup> Section 71D of the BO.

(c) various duties imposed by the SFC in the Code of Conduct<sup>11</sup> and the Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the SFC,<sup>12</sup> which is enclosed respectively as Annex 4(A) and Annex 4(B).

3.6 In view of the above duties imposed on RIs and their senior management (including EOs), it is reasonable for the HKMA to expect them to take adequate measures to supervise RIs' front-line staff involved in the sale of investment products. At the same time, the HKMA performs day-to-day regulation over the conduct of RIs and EOs through on-site examinations and off-site reviews of RIs to ensure that the RIs and their senior management comply with the relevant legal and regulatory requirements and that the RIs have adequate internal controls. Where the regulatory process or any complaint received reveals possible misconduct, the incident is referred to the HKMA's securities enforcement team for investigation and disciplinary proceedings or referral to the SFC as appropriate.

3.7 The SFC's Code of Conduct requires RIs, RIs and EOs to properly address any actual or potential conflicts of interest that may be encountered in the sale of investment products and ensure fair treatment of clients. The relevant provisions include general principles GP1 (Honesty and fairness) and GP6 (Conflicts of interest), and paragraph 3.10 (Best interests of clients).

#### Item (c)

3.8 Since April 2003 the HKMA has adopted various regulatory measures to perform the statutory function of suppressing illegal, dishonourable or improper practices in relation to RIs' securities-related business. These involve issuing circulars, conducting regular on-site examinations (including thematic

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<sup>11</sup> For example, general principle GP9 (Responsibility of senior management) and paragraphs 4.1 (Fit and proper staff), 4.2 (Staff supervision) and 4.3 (Internal control, financial and operational resources).

<sup>12</sup> For example, paragraph 1 of section I (Management and Supervision) and paragraph 1 of section III (Personnel and Training).

examinations), undertaking off-site reviews, and investigating alleged misconduct cases against RIs, ReIs and EOs and taking disciplinary actions as appropriate.

#### Circulars

- 3.9 The HKMA has issued circulars to provide practical guidance on the required standards and expected industry practices in the conduct of regulated activities (see Annex 5).

#### On-site examinations

- 3.10 The HKMA conducts regular on-site examinations of RIs. Between the commencement of the SFO in April 2003 and December 2008, the HKMA conducted 170 on-site examinations of RIs that included in whole or in part review of aspects of their securities business. The objectives of these examinations are to understand how regulated activities of RIs are being conducted, to ensure RIs' compliance with the relevant legal and regulatory requirements, and to perform sample checks and interviews of some of the relevant staff.

#### Off-site reviews

- 3.11 The HKMA's on-site examination activities are supplemented by off-site reviews by individual case teams. Each RI is assigned to the overall supervision of one case officer (or a team of officers for large institutions). Case officers are responsible for following up any deficiencies in the systems of the RIs under their supervision that are discovered in on-site examinations.
- 3.12 All RIs are required to submit semi-annually to the HKMA a "Return of Securities Related Activities". This return provides a general overview of the regulated activities carried out by each RI as well as the trends in the business to enable trend analysis to be conducted. The information collected is used as part of the input for determining the scope and focus of on-site examinations.



3.13 From 2005, an increasing number<sup>13</sup> (50 in 2008) of large, complex or active RIs (including all the active retail banks) have been required to commission annually an independent unit (for example, their compliance department) to review the RI's compliance with the regulatory requirements imposed by the SFC and the HKMA. The review reports are considered jointly by the RIs' case officers and the securities supervision team. Possible breaches of regulatory requirements identified in this process are reported to the HKMA's securities enforcement team for appropriate actions.

**4. *Does HKMA consider that the existing arrangement of relying on individual banks to ensure the proper conduct of their staff in selling investment products may be ineffective, given banks' keen competition for profit through the expansion of their non-interest-earning businesses? Does HKMA consider that under such an arrangement, it is difficult to detect at an early stage any non-compliance by banks?***

4.1 As explained in the response to items (a) and (b) of Question 3 above, the existing regulatory approach does not rely solely on banks to ensure the proper conduct of their staff in selling investment products.

4.2 The HKMA performs day-to-day regulation of the conduct of Rels and EOs through on-site examinations and off-site reviews of RIs to ensure that the duties of RIs and their senior management are properly performed and that the RIs have adequate internal controls to ensure that their Rels comply with the relevant regulatory requirements. While no regulatory regime can guarantee full compliance with regulatory requirements, where the day-to-day regulatory process or any complaint received reveals possible misconduct, the incident will be referred to the HKMA's securities enforcement team for investigation and disciplinary proceedings or referral to the SFC as appropriate.

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<sup>13</sup> The number of participating RIs was 30 in 2005, 40 in 2006 and 45 in 2007.

5. *According to MOU (paragraph 6.1.2), when an AI applies to become a RI, HKMA will advise SFC whether the AI is fit and proper to conduct the regulated activities under SFO for which it seeks registration. Please provide:*
- (a) details of HKMA's advice to SFC on the application of each distributing bank involved in the sale of Lehman Brothers-related structured financial products for becoming a RI;*
  - (b) details of HKMA's advice against any AI's application for becoming a RI since April 2003;*
  - (c) whether any RI was considered by HKMA as no longer fit or proper to carry on the regulated activities since April 2003; and*
  - (d) whether HKMA and SFC had different opinions on the eligibility of an AI for being a RI; and if yes, how to resolve such differences.*

Item (a)

- 5.1 As stated in the response to item 3(a) above, the SFC is required under the SFO to refer to the HKMA all applications by AIs to register as RIs, before deciding whether or not to approve such applications.
- 5.2 Upon receiving an application from the SFC, the HKMA will:
- (i) consider the application;
  - (ii) consult with the SFC on the merits of the application; and
  - (iii) advise the SFC whether it is satisfied that the AI is a fit and proper person to be registered for the relevant regulated activities.
- 5.3 With regard to the applications by the distributing banks which sold LB-related structured financial products to register as RIs, after taking into account all relevant information available at the time, the HKMA advised the SFC that the relevant banks were considered fit and proper by the HKMA to be registered

with the SFC for the regulated activities applied for. Nevertheless, the HKMA suggested the imposition of certain conditions on the registration of a number of RIs, to which the SFC had given due regard. After due consultation between the HKMA and the SFC on the terms of the proposed conditions and after taking into account the applicants' views, the SFC imposed conditions on the registration of some of the RIs. The particulars of such conditions<sup>14</sup> are recorded in the public register of licensed persons and RIs maintained by the SFC.

Item (b)

- 5.4 The HKMA has not provided any advice to the SFC against any of these banks' applications for becoming a RI since April 2003 up to the date of preparing this statement. However, during the processing of an application, the HKMA may require the institution to implement additional control procedures, submit further information, or resolve some particular issues before the HKMA forms a conclusion on the advice to the SFC.

Item (c)

- 5.5 Since April 2003, up to the date of preparing this statement, the HKMA has not considered any of these RIs to be no longer fit and proper to carry on regulated activities.

Item (d)

- 5.6 As noted under item 5(a) above, there is a considerable amount of consultation between the HKMA and the SFC during the processing of an application by an AI to be a RI. So far, there has been no case where the HKMA and the SFC have disagreed on the eligibility of an AI for being a RI.

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<sup>14</sup> Examples of such conditions include:

- "For Type 6 regulated activity, the person shall not advise on matters or transactions falling within the ambit of the Codes on Takeovers and Mergers and Share Repurchases issued by the Securities and Futures Commission."
- "For Type 9 regulated activity, the person shall not provide a service of managing a portfolio of futures contracts for another person."

6. **In the United Kingdom (UK), “fair treatment” of investors is a regulatory principle adopted by the Financial Services Authority. Investors of a financial product should be treated fairly throughout the product life-cycle (including design, marketing, sale, after-sale and complaint handling). Does HKMA consider that such a principle should be adopted under the present regulatory regime governing banks’ conduct of securities business in Hong Kong?**
- 6.1 The UK Financial Services Authority’s (FSA) “Treating Customers Fairly” (TCF) initiative is rooted in long-standing fundamental principles that require authorised firms under the supervision of the FSA to conduct their business with due skill, care and diligence; take reasonable care to organise and control their affairs responsibly and effectively, with adequate risk management systems; pay due regard to the interests of their customers and treat them fairly; and pay due regard to the information needs of their clients, and communicate information to them in a way which is clear, fair and not misleading. The TCF sets out the responsibilities of product providers and distributors for fair treatment of customers. The FSA’s TCF initiative was discussed in paragraphs 7.24 to 7.25 of the HKMA’s Review Report dated 31 December 2008.
- 6.2 In Hong Kong, the SFC’s Code of Conduct contains a list of general principles (GPs) considered to be fundamental to the undertaking of a licensed or registered person’s business. These GPs are in line with the fundamental principles underlying the TCF initiative in the UK.<sup>15</sup>

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<sup>15</sup> For example:

- GP1 (“Honesty and fairness”) states that “(i)n conducting its business activities, a licensed or registered person should act honestly, fairly, and in the best interests of its clients and the integrity of the market.”
- GP2 (“Diligence”) provides that “(i)n conducting its business activities, a licensed or registered person should act with due skill, care and diligence, in the best interests of its clients and the integrity of the market.”
- GP3 (“Capabilities”) states that “(a) licensed or registered person should have and employ effectively the resources and procedures which are needed for the proper performance of its business activities.”
- GP5 (“Information for clients”) provides that “(a) licensed or registered person should make adequate disclosure of relevant material information in its dealings with its clients.”

- 6.3 Drawing upon the GPs, paragraph 12.3 of the Code of Conduct requires a licensed or registered person to ensure that complaints from clients relating to its business are handled in a timely and appropriate manner; steps are taken to investigate and respond promptly to the complaints; and where a complaint is not remedied promptly, the client is advised of any further steps which may be available to the client under the regulatory system.
- 6.4 Thus the existing securities regulatory regime in Hong Kong already embodies substantial elements of the UK's TCF-related principles insofar as they relate to retail investors in securities products. It might, however, be noted that the TCF initiative has wider coverage in the sense that it extends to the design of a financial product,<sup>16</sup> which appears to go beyond the ambit of the Code of Conduct.
- 6.5 The HKMA sees potential merit in introducing a similar requirement on providers of structured investment products in Hong Kong. This would, however, require a policy review by the Government of the implications of such a requirement on different market practitioners (including licensed corporations) and in this regard the views of the regulators, the financial services industry, the Legislative Council and the public would have to be considered.

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<sup>16</sup> In 2007, the FSA issued a regulatory guide setting out the responsibilities of providers and distributors of financial products for the fair treatment of customers. The regulatory guide, among other things, requires providers of financial products to identify the target customers of their products and take steps to ensure that their products are suitable for these customers.

## Sale of structured financial products by banks

7. *As stated in paragraph 1.2.5 of HKMA's Supervisory Policy Manual, an AI needs to appoint at least two executive officers to directly supervise each regulated activity conducted by the RI. The executive officers must obtain the MA's written consent. As far as the sale of structured financial products is concerned, please advise on:*

*(a) whether such executive officers must have knowledge or experience in structured financial products; if yes, please provide the details; if no, the reasons; and*

*(b) whether HKMA has any information on the performance of the executive officers of RIs involved in the sale of Lehman Brothers-related Minibonds and/or structured financial products since April 2003.*

### Item (a)

7.1 In considering whether to grant consent to persons applying to become EOs, the HKMA will take into account the factors set out in section 129 of the SFO and the requirements stipulated by the SFC in the Fit and Proper Guidelines and the Guidelines on Competence, which also apply to responsible officers of licensed corporations. One of the key requirements is the ability to carry on the regulated activity competently. According to paragraph 5.1.1 of the SFC's Fit and Proper Guidelines, competence is assessed with reference to the person's academic and industry qualifications together with relevant experience, and the person should be equipped with the skills, knowledge and professionalism necessary to perform his or her duties, which include an understanding of the financial products he or she deals in or advises on and of the market in which the service is provided.

7.2 In addition, the SFC's Guidelines on Competence specify, among other things, that an EO should have at least 3 years' relevant industry experience over the 6 years immediately prior to the date of application. It should nevertheless be

noted that the academic or industry qualification requirements in the SFC's Guidelines on Competence depend on the type of regulated activity to be engaged in, rather than the specific products that the person is to deal in or advise upon.

Item (b)

- 7.3 The investigations of the complaints about the sale of LB-related Minibonds and/or structured financial products are still in progress. Where there is prima facie evidence of mis-selling of these products, the investigation will also look into the performance of the EOs concerned to see if they should be held accountable.
8. *Paragraph 4.6 of HKMA's Review Report mentions that bilateral meetings to discuss issues of interest are held regularly between HKMA and SFC. Given the growing popularity of structured financial products such as the Minibonds, was there any discussion on issues/problems relating to RIs' sale of such products and the division of responsibilities between HKMA and SFC in regulating such sale? If yes, please provide the details (including relevant minutes of the meetings, internal correspondence and any other related documents or records); if no, the reasons.*
- 8.1 Pursuant to the MoU (paragraph 12.7), the HKMA and the SFC hold regular meetings to discuss matters of common interest relating to the performance of their regulatory and supervisory functions ("MoU Meetings"). In addition, there are numerous discussions and exchanges on a day-to-day basis particularly at the working level between the HKMA and the SFC concerning supervisory and enforcement issues related to regulated activities conducted by the RIs and their RelS and issues in which the two regulators have a common interest.
- 8.2 During some of the MoU Meetings between 14 May 2003 and 4 November 2008 there were discussions between the parties on issues relating to the sale of

structured products by intermediaries including RIs and the division of responsibilities between the HKMA and the SFC in regulating such sale. A table setting out the dates of the MoU Meetings and summarising the relevant items discussed is attached (see **Part (A) of Annex 6**).

8.3 Also attached is a list summarising the correspondence between the SFC and the HKMA in connection with the above MoU Meetings relevant to the RIs' sale of structured financial products and the division of responsibilities between the HKMA and the SFC in regulating such sale (see **Part (B) of Annex 6**).

**9. The current regulatory regime adopts a disclosure-based approach, in common with many other jurisdictions such as the UK, other European Union countries, the United States, Australia and Singapore (HKMA's Review Report, paragraph 3.3). Please advise whether any of the measures as recommended in the HKMA's Review Report has been adopted by any of these jurisdictions before the Minibonds incident.**

9.1 In the course of preparing its Review Report, the HKMA undertook a brief desk-top review of the regulatory framework governing the sale of financial products to retail investors in some other financial centres including the UK, the US, Germany, the Netherlands, Australia and Singapore. Certain points of interest from the results of this desk-top review were set out in Chapter 7 of the HKMA's Review Report.

9.2 Among the nineteen recommendations in the HKMA's Review Report, five of them are related to local policy objectives and public education campaigns regarding these objectives, and therefore are not relevant for comparison with measures adopted by overseas jurisdictions. Six recommendations are the HKMA's own initiatives: we are not aware of any overseas regulators having similar regulatory requirements during our review. While the remaining eight recommendations were developed taking into account the existing practices or certain elements of the existing practices of other financial centres identified in the review, on two of these recommendations the HKMA has already



implemented certain parts of the regulatory requirements but plans to enhance the related measures.

9.3 Please refer to Annex 7 for details of our analysis.

**10. *Paragraph 8.33 of HKMA's Review Report mentions that in the Minibonds incident, complainants have claimed that they were sold products carrying a higher risk rating than warranted by their risk profile. In HKMA's view, should HKMA be empowered to disallow the sale of an investment product to certain groups of bank customers (such as retirees and illiterate persons) when the product is rated by the bank concerned as high-risk or not principal protected, and disclosure of such risks is not sufficient to help such customers to fully appreciate the risks involved?***

10.1 Under the current disclosure-based approach, the policy objective of providing a reasonable level of investor protection is effected through requiring disclosure of the nature and risks of the product and an assessment by regulated intermediaries of the suitability of the product for the investor, so as to enable the investor to make an informed decision and take responsibility for it. The HKMA does not have the power to prohibit outright the sale of specific investment products in Hong Kong.

10.2 Whether the HKMA should be empowered to disallow the sale of a particular investment product to certain groups of customers is a difficult issue. Such a prohibitive approach would effectively deprive a broad category of investors of otherwise legitimate investment opportunities. There may well be retail investors (including retirees or illiterate persons) who could, and would, take the steps necessary to understand the products, and a prohibitive approach would prevent such customers from investing in such products even if they intend to invest only a small portion of their net worth for higher returns purpose. More importantly, the prohibition would effectively substitute the regulatory authority's judgement for that of investors as to which products are suitable for them. In such a regime, if a given product is not prohibited, a

degree of moral hazard may arise, encouraging investors to invest without carefully considering the risks and the suitability of the product on the basis that it must be “safe” because it has not been banned by the regulators.

10.3 On a practical level, there would be difficulties in defining what should be prohibited for specific groups of customers. Therefore, the HKMA favours retention of the present disclosure-based system rather than a removal of freedom of choice of investment to such a degree as to ban certain products from sale to specific groups of customers. This would be in line with international standards. However, should there be any suggestion to introduce a policy to ban certain products from sale to specific groups of customers in departure from the disclosure-based system, this would be an important policy matter for the Government to consider, in consultation with relevant regulators, the financial services industry, the Legislative Council and the general public.

10.4 It should be added that for all types of clients and securities products, RIs and ReIs have the obligation to make adequate disclosure of the risks that the investment products bear to the customers concerned so that they can appreciate the risks involved. RIs and ReIs are required to act honestly, fairly and in the best interests of their clients. Therefore, if RIs and ReIs cannot assure themselves that a client understands the risks involved in an investment product, they should not recommend or solicit the client to invest in the product.

11. *Paragraph 8.30 of HKMA’s Review Report mentions that in conducting sales of investment products, a RI conducts an assessment of the investment product it proposes to sell in order to gauge its level of risk and recommends the product to a customer after an assessment of the customer’s risk profile. Please advise whether risk assessment of such products is subject to the review of HKMA or other regulators; and whether structured financial products should be categorized by their risk level and restricted in the sale to different groups of the investing public with different risk profiles.*

11.1 It is inappropriate for the HKMA to re-assess or approve the individual risk levels assigned by each RI to the products distributed as this would mean the regulator taking over the product due diligence function<sup>17</sup> of RIs and RelS. This would also create moral hazard in that RIs and RelS would be dependent on the HKMA's assessment when they should be conducting their own due diligence on such products. In fact, the HKMA is not aware of any overseas regulators which re-assess or approve the risk level assigned to each product by the institutions they regulate. Instead, the HKMA's supervisory approach is to have its examiners review RIs' systems of control for ensuring compliance with various regulatory requirements during the on-site examinations of RIs. The examiners also perform sample checks of the reasonableness of the risk assessments and the related process by reviewing the product analysis conducted by the RI. Where an assessment appears to be unreasonable or out of line compared with industry practice, the matter is raised with the relevant RI for discussion and necessary rectification.

11.2 While the HKMA does not re-assess or approve the risk level assigned to each product by RIs, from December 2007 to early 2008, in view of the significant changes in market conditions arising from the sub-prime crisis, the HKMA conducted a survey to gather information about the sale by RIs of retail credit-linked notes (i.e. credit-linked notes of which the issue prospectuses were authorized by the SFC) with sub-prime mortgages as underlying collateral and retail credit-linked notes the collateral of which was, or might consist of, CDOs. From the information collected, the HKMA noted that some RIs adopted a "high" risk rating classification for these products. In the light of the market conditions prevailing at that time and to promote uniform and prudent treatment among RIs, the HKMA advised the other RIs which distributed retail

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<sup>17</sup> In this context, these include the GP2 (Diligence), GP5 (Information for clients) of the SFC's Code of Conduct and, pursuant to the Questions and Answers on Suitability Obligations issued in May 2007 (which provides practical guidance to intermediaries engaged in financial planning and wealth management business activities), intermediaries are required to conduct their own product due diligence. Within RIs the assessment of a product's risk rating is made at the institutional level, generally through a system administered with the involvement of a risk management function independent of the sales function. Intermediaries may then only recommend the product and solicit orders from those customers for whom it is considered suitable.

credit-linked products without full principal protection to also adopt a “high” risk rating classification for these products.

11.3 In the circular entitled “Thematic Examinations on Investment Advisory Activities” issued by the HKMA in March 2007, it is recommended that a risk tolerance level be assigned to each client for matching against risk ratings of investment products to ensure product suitability. It should be noted that risk-matching is just one of the factors that need to be considered before a RI recommends a product to its client.

11.4 Client suitability assessments should take into account the relevant information and circumstances in each individual case. It is not appropriate simply to disallow the selling of a product of a particular risk level to a specified group of the investing public merely based on their risk tolerance level. Such a prohibitive approach would deprive those clients with low risk tolerance level of investment opportunities in some products which they may consider as suitable or acceptable for them in certain circumstances. For example, a customer with a low risk tolerance level may choose to invest a small portion of his net worth in a high risk product for higher returns. In these circumstances, special handling procedures, such as supervisor’s approval or declaration by client, are required. The RI should also provide and document the rationale for recommending the product to the client.

12. *A conflict of interests may arise when on the one hand, the staff of a RI may be paid commissions upon successfully selling structured financial products, and on the other hand, they are required to explain clearly and fully to the investors about the risks of the products being sold. In the face of growing popularity of such products over the past few years, what measures have been taken by HKMA to ensure that the staff of RIs have not compromised the investors’ interest?*

12.1 To ensure adequate protection of investors’ interest, the SFC and the HKMA have issued regulatory requirements to the industry to address possible conflicts

of interest arising from sale of investment products. These include:

- General Principles GP1 and GP6 and paragraph 3.10 of the SFC's Code of Conduct require that a licensed or registered person (including RIs) should act in the best interest of its clients in providing the services, try to avoid conflicts of interest, and when they cannot be avoided, should ensure that its clients are fairly treated.
- According to the SFC's Questions and Answers on Suitability Obligations issued in May 2007, senior management of investment advisers should review, assess, and be satisfied that investment advisers have adequate systems and controls to promptly identify issues and matters that may be detrimental to a client's interest (e.g. cases in which investment advice may have been given merely to meet sales targets or may be driven by financial or other incentives).
- The HKMA's Supervisory Policy Manual module SB-1 requires that RIs should have clearly defined systems for appraising the performance of Rels, and such systems should give due weight to compliance with internal guidelines and legal and regulatory requirements. The HKMA's Supervisory Policy Manual module OR-1 entitled "Operational Risk Management", which is generally applicable to all activities (i.e., including regulated activities) of AIs, also provides that an AI's remuneration policies and performance incentives should include consideration of risk management and it should not provide incentives to staff to operate contrary to the desired risk-management values. A copy of the HKMA's Supervisory Policy Manual module OR-1 is enclosed as **Annex 8** to this statement.

12.2 As part of its regulatory work, the HKMA seeks to ensure that RIs observe the above requirements through on-site examinations and off-site reviews. The HKMA supervisory staff pay special attention to any situations that pose questions of potential or actual conflicts of interest, such as recommending products that bring higher income for the RI but are not in the client's best

interests.

- 12.3 Subsequent to the LB incident, the HKMA has further strengthened the guidance on incentive schemes adopted by RIs. In a circular letter entitled “Selling of investment products to retail customers” issued by the HKMA on 23 October 2008 [SC Paper No. M6], RIs are requested to critically review any sales target and the appropriateness of any incentive schemes associated with such sales target. It is emphasised that incentive schemes should not be linked solely to sales volume and should take into account staff’s compliance with statutory and regulatory requirements. If the RI is acting as an agent, it should disclose the amount of commission earned in the relevant contract note. Alternatively, it should disclose in the contract note the fact that it is acting as principal in the transaction.

*Regulatory concerns arising from the fallout of the subprime problem in the United States and the sale of Lehman Brothers-related Minibonds and structured financial products*

13. *As shown in HKMA’s Review Report (p.5), between June and July 2008, credit-rating agencies lowered the credit ratings of Lehman Brothers. Lehman shares also dropped substantially during September 2008. As a regulator overseeing the soundness of Hong Kong’s financial system, did HKMA report to the Administration, or have any discussion with the Administration and other regulators, on the possible impact of the financial difficulties of Lehman Brothers on the market of structured financial products in Hong Kong? Did HKMA conduct any assessment in this regard? If yes, please provide the details (including all the relevant internal correspondences, minutes, documents and records); if no, the reasons.*

- 13.1 The HKMA actively monitors developments overseas that may have implications for the stability of global financial markets and therefore for Hong

Kong. While this monitoring covers mainly developments in global financial markets and public policy actions in a general way, it also includes developments relating to individual institutions if they may have wider implications.

13.2 In this monitoring work, the market concerns about the financial health of a number of overseas financial institutions, including LB, were covered and reflected to the Administration through channels including those described below. But there was no explicit or specific reference, as stated in the question, to “the possible impact of the financial difficulties of LB on the market of structured financial products in Hong Kong” before the collapse of LB. In this connection, it is important to remember that, before LB filed for bankruptcy protection on 14 September 2008, while there was widespread concern about the health of US financial institutions, including LB but also others, the widely held market view was that some form of rescue or bail-out would take place, as had happened with Bear Stearns and as subsequently happened with AIG. As late as 12 September 2008, the HKMA daily market report, which is distributed both internally and to the Administration, noted that Asian markets edged up on reports that LB had put itself up for sale, suggesting a smaller risk of a Wall Street meltdown. While the HKMA was alert to the possibility that a major financial institution might fail, and the likely consequences for financial markets globally and in Hong Kong, it was not possible to predict whether an institution would in fact fail or, if so, which one. This was particularly so because the issue was largely driven by high-level policies and decisions of the authorities in the US, of which the HKMA had no advance knowledge.

13.3 The HKMA shared its observations through its monitoring work with the Administration through various channels. As mentioned above, the HKMA produces a daily market report, which is distributed both internally and to the Administration. The report covered market news and developments in Hong Kong and Asia, as well as developments relating to a number of troubled financial institutions in the US, including LB, between June and September 2008. I also provided regular updates on the turmoil in global financial markets and the risks and implications for monetary and financial stability in

Hong Kong at the Financial Stability Committee and the Council of Financial Regulators meetings and at my monthly meetings with the FS between September 2007 and September 2008. These updates related mainly to macro-prudential surveillance, but also covered on some occasions the financial problems experienced by individual financial institutions, including, for example, Fannie Mae and Freddie Mac, although the specific angle of the “possible impact of the financial difficulties of LB on the market of structured financial products in Hong Kong”, as referred to in this question, was not covered.

13.4 Similar discussions about the situation in the US and their implications for Hong Kong were made in the regular bi-weekly meetings I hold with the Chairman of the Hong Kong Association of Banks. A summary record was sent by email to the FS for information after each meeting. On 12 September 2008, the meeting specifically discussed the banks’ exposure to investment banks such as LB in terms of both credit risk and their dealings with LB in the over-the-counter markets. In relation to the latter, it was noted that banks’ main dealings with them were mainly to distribute the structured products originated by LB. I emphasised the need to keep a close watch on the vulnerabilities of the banking system in Hong Kong as the credit crisis and its impact on US financial institutions continued to unfold.

14. *At the special meeting of the House Committee on 13 October 2008, MA informed members that before the outbreak of the US subprime crisis in the third quarter of 2007, HKMA had, in March, May and June 2007, issued additional guidelines to banks. As stated in paragraph 4.14 of HKMA’s Review Report, in early 2008, HKMA advised RIs to adopt a “high” risk rating classification for credit-linked products without full principal protection, including those with CDOs as underlying collateral. What measures had been taken by HKMA to follow up RI’s compliance of such guidelines and “advice”? In HKMA’s view, were the banks sufficiently aware of the risks to which the structured financial products being sold by them were exposed?*



- 14.1 In ensuring compliance of RIs with the relevant legal and regulatory requirements, the HKMA performs regular securities-related on-site examinations of RIs, which include reviews of the RIs' management supervision and internal controls to ensure compliance with the relevant legal and regulatory requirements, and test-checks to assess the effectiveness of the management supervision and internal controls. In 2007 and 2008 the HKMA conducted a total of 78 securities-related on-site examinations to test-check compliance with the relevant legal and regulatory requirements.
- 14.2 With regard to those RIs that were advised by the HKMA in early 2008 to revise the product risk rating to "high" for retail credit-linked products without full principal protection, including those with CDOs as underlying collateral, the HKMA took separate follow-up actions and obtained their written confirmation on their action taken in response to the HKMA's advice to revise the product risk rating. According to the HKMA's follow-up actions, all except one RI (which had already decided not to sell such products by then) had revised the product risk rating to "high" by February 2008.
- 14.3 Apart from the above follow-up actions, in 2008 the HKMA performed thematic examinations to examine the dealings and advisory activities of selected RIs for retail credit-linked investment products. These examinations included reviews of, among other things, the product due diligence process and related controls of the examined institutions.
- 14.4 With regard to RIs' awareness of product risks, as mentioned in the response to Question 11 above, the HKMA expects RIs to comply with the regulatory standards on product due diligence. During the securities-related on-site examinations, the HKMA reviews the systems of control of RIs for ensuring compliance with these requirements. Where an examination reveals that the system of control requires improvement, the HKMA follows up with the management of the RI to ensure that appropriate remedial actions are taken to address the deficiencies identified.

14.5 According to the HKMA's understanding, compliance with the regulatory standards on product due diligence is one of the areas possibly covered by the SFC's current investigations in relation to some of the distributing banks of LB-related structured financial products. It is not appropriate for the HKMA to draw any conclusion in this area until the completion of these investigations.

15. *If MA was wary of the adverse impact of the US subprime crisis on the global market, was HKMA mindful of the consequential risks faced by investors who had bought a considerable number of structured financial products through banks? If yes, what measures had been taken, by HKMA alone or in conjunction with other authorities, to forewarn or safeguard small investors in this respect? Should regulators have the duty to assess the impact of cross-national financial problems on the investing public?*

15.1 The HKMA was indeed mindful that Hong Kong investors might be exposed to risks arising from the US sub-prime crisis and its knock-on effects. For a number of reasons, it would be inappropriate for any regulator to issue public warnings related to individual institutions or specific products. First, such warnings might turn out to be incorrect. Secondly, such a practice would introduce moral hazard by encouraging investors to rely on official warnings in place of their own due diligence and independent judgement based on information available in the market. Thirdly, it could actually trigger problems that might otherwise be avoided (e.g. it might lead to a run on the institution in question). Fourthly, it would be impossible for such warnings to be issued in a consistent way for every institution or product that might conceivably be at risk. Finally, to do so could risk contravening legal restrictions on the use of supervisory information (e.g. under section 120 of the BO).

15.2 Regulators can, however, give general warnings when financial markets are experiencing heightened volatility. I took the opportunity of my regular briefings to the Legislative Council Panel on Financial Affairs in November 2007 and January and April 2008 to give general warnings and urge caution with regard to developments in the global and local economies, in particular the

effects of the sub-prime problem and ensuing credit crisis. I also made similar comments in my answers to questions from Members, including the need for investors to carefully manage risk.

- 15.3 I also gave warnings in several of my weekly Viewpoint articles, which are published on the HKMA website and generally reproduced in full in several local newspapers and reported by others, and are therefore widely available to the public. I drew attention to possible risks to financial stability from interest-rate carry trades in July and August 2007 and, on 16 August of that year, to the fact that innovative financial products, including Mortgage-Backed Securities and CDOs related to the sub-prime mortgage market in the US, might have eroded credit-underwriting standards and were making it harder to identify and manage risk. I wrote about the sub-prime issue again on 6 September 2007, calling on market participants to watch developments closely. On 28 February 2008, I wrote again about the risks arising from financial innovation and warned specifically that “Investors could find themselves holding assets whose risk-return profile turns out to be different from what they believed.” On 27 March 2008, I wrote about inadequacies in the advice given by credit rating agencies and the risks of over-relying on the advice of counterparties and experts, warning that “investors should be aware that ratings are there only to help them to make independent judgements about the risks and not to replace investor due diligence.”.
- 15.4 I also urged caution with regard to developments in the global economy and markets in a number of comments to the media between August 2007 and September 2008.
- 15.5 Relevant extracts from my speaking notes and the record of the Financial Affairs Panel, extracts from my Viewpoint articles, and transcripts of comments to the media are contained in a table (see [Annex 9](#)).

16. *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 measures (if any) taken by HKMA to address IMF’s concern; and*

*(b) from 2007 till September 2008, whether HKMA detected any early signs of stress relating to the market risks of structured financial products (such as Minibonds) in Hong Kong. If no, please provide the reasons; if yes, whether HKMA alerted the Administration or other regulators of the possible market risks associated with the rapid development of banks’ sale of structured financial products to investors in Hong Kong.*

16.1 The quotation from the International Monetary Fund (IMF) is from its Preliminary Conclusions following discussions relating to regular consultations under article IV of the IMF’s Articles of Agreement. The relevant paragraph reads in full:

**“The competitiveness of the Hong Kong financial center also depends on continued enhancement of its strong reputation for supervision and governance.** The financial center remains robust, with banks profitable and well capitalized. Partly reflecting this and Hong Kong SAR’s strong supervision, exposures to subprime and other structured securities appear to be low across the banking and asset management industries. Continued monitoring of exposures and valuation of these products is important as global fallout from the subprime turmoil could endure. Further regulatory enhancements have also taken place, such as the introduction of the regulatory framework

for all the three-pillars of the Basel II capital standards and the smooth implementation of the standardized approaches under the framework and the strengthening of cross-border regulatory cooperation. The rapid rise in valuation and turnover of equities, related structured products and derivatives, and margin financing, calls for *continued close monitoring* [emphasis added] of cross-market risks, especially given global financial market uncertainties. In this regard, the *increased coordination* [emphasis added] among Hong Kong regulators should help to detect early signs of stress. ”

- 16.2 It is clear from this that the reference to the increased co-ordination among Hong Kong regulators is referring to what had already taken place at the time of the discussions, rather than a recommendation by the IMF that such co-ordination should be increased subsequently. In fact, the issue of rapid rises in valuation and turnover of equities, related structured products and derivatives, and margin financing, and the need for continued close monitoring of cross-market risks was raised by the HKMA in the discussions with the IMF.
- 16.3 Another point that should be noted is that the IMF’s concern centred on equities, related structured products and derivatives, rather than credit-linked products (like Minibonds). The concern was raised in the context of heightened stock market activity in Hong Kong, including record initial public offerings (IPOs).

Item (a)

- 16.4 It is the HKMA’s general practice to monitor market development and incorporate relevant changes in its banking supervisory initiatives where appropriate. After the sub-prime crisis started in the US in mid-2007, the HKMA further enhanced its supervisory stress testing programme in October 2007 by introducing additional stress scenarios to assess the possible impact of stock market corrections (covering the stress impact on IPO margin lending, non-IPO margin lending, and other loans for the purchase of shares and investments in listed shareholdings) and AIs’ direct and indirect exposures to the US sub-prime market on their profitability and capital positions. The stress-testing results indicated that despite the severity of the stress scenarios,

the banking sector would be able to withstand the stress, although the financial impact on some AIs might be more significant. Based on the results of these integrated stress tests, the HKMA stepped up its monitoring and discussion with the management of banks that were identified to be relatively more vulnerable under the new stress scenarios.

- 16.5 Following intensification of the global financial crisis and, in anticipation of the potential effects on the local economy and AIs' credit quality and profitability, the HKMA increased the scope and severity of its stress-testing scenarios in the second half of 2008 to ensure that they remain up to date and appropriate. For example, stress assumptions relating to rates of decline in property and stock prices and the profitability impact on AIs were tightened. The results showed that despite the more severe scenarios, the banking sector generally would be able to withstand the stress, although some AIs might experience a more significant impact. The HKMA will continue to monitor AIs' capital levels to ensure the adequacy of their capital buffers to withstand a possible worsening of the financial crisis.

Item (b)

- 16.6 During the period from December 2007 to early 2008, in view of the significant changes in market conditions arising from the sub-prime crisis, the HKMA conducted a survey to gather information about the sale by RIs of retail credit-linked notes with sub-prime mortgages as underlying collateral and credit-linked notes the collateral of which was, or might consist of, CDOs. For details of the survey, please refer to the response to Question 11 above and for the follow-up actions undertaken, please refer to the response to Question 14 above.
- 16.7 The HKMA also indicated in the chapter on Banking Stability in its Annual Report of 2007 that, with the recent volatile market conditions, it planned to conduct thematic examinations of RIs' selling of retail credit-linked investment products in 2008. This chapter of the Annual Report was prepared in accordance with section 9 of the BO, and was submitted to the Banking Advisory Committee (BAC) and the Deposit-Taking Companies Advisory

Committee (DTCAC) in that context, and to the Exchange Fund Advisory Committee as part of the HKMA's Annual Report.

- 16.8 With regard to the sale of structured financial products, the HKMA has also communicated with the Administration on the issues identified on various occasions. During the meetings of March and June 2008, the HKMA updated the members of BAC and DTCAC on RIs' selling practices of structured products and the HKMA's handling of complaints related to stock accumulators. The HKMA also briefed the members of the Council of Financial Regulators on the handling of complaints relating to stock accumulators during the meetings of March and August 2008.
- 16.9 As mentioned in my response to Question 8, RIs' selling practices of investment products has also been a regular discussion item at the MoU Meetings with the SFC.

## **ANNEXES TO WRITTEN STATEMENT OF MR JOSEPH YAM CHI-KWONG, GBS, JP Monetary Authority**

### **Annex   Particulars**

- 1 Statement by the Chief Executive of the Hong Kong Special Administrative Region on "Responsibilities of the Financial Secretary and the Secretary for Financial Services and the Treasury" issued on 27 June 2003
- 2 "Policy Objectives in Financial Affairs and Public Finance" issued by the FS on 27 June 2003
- 3 Exchange of Letters between the FS and the Monetary Authority of 25 June 2003
- 4 (A) "Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission " dated May 2006  
  
(B) "Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the SFC" dated April 2003
- 5 A list of circulars issued by the HKMA in relation to the conduct of regulated activities
- 6 (A) A list of the MoU Meetings between the HKMA and the SFC where issues relating to the sale of structured products by intermediaries were discussed  
  
(B) A summary of the correspondence between the HKMA and the SFC related to the Annex 6 (A) MoU Meetings
- 7 Comparison of recommendations made in the HKMA's Review Report and practices of overseas regulators
- 8 HKMA's Supervisory Policy Manual module OR-1 dated 28 November 2005
- 9 Relevant extracts (in Chinese) from MA's speaking notes and the record of the Financial Affairs Panel, MA's Viewpoint articles, and transcripts of comments to the media
- 10 "New securities supervisory regime – register to be maintained by the HKMA and specific guidance in relation to relevant individuals" dated 27 February 2003
- 11 "New publications of the Securities and Futures Commission (SFC) and the HKMA" dated 21 August 2003
- 12 "SFC Guidelines for Addressing Analyst Conflicts of Interest" dated 8 November 2004
- 13 "Register of relevant individuals under section 20(1)(ea) of the Banking Ordinance (BO)" dated 21 February 2005
- 14 "SFC press release - Extracts and Advertisements Concerning Prospectuses under the Companies Ordinance" dated 31 March 2005
- 15 "Controls to ensure the fitness and propriety of staff of authorized institutions" dated 28 September 2006
- 16 "Controls to ensure compliance with section 114(3) of the Securities and Futures Ordinance (SFO) and section 20(4) of the Banking Ordinance (BO)" dated 13 June 2007



## **ANNEXES TO WRITTEN STATEMENT OF MR JOSEPH YAM CHI-KWONG, GBS, JP Monetary Authority**

### **Annex   Particulars**

- 17      "Thematic examinations on controls to ensure fitness and propriety of relevant individuals" dated 12 March 2008
- 18      "Access to recordings of telephone conversation and Lehman Minibonds collaterals information" dated 5 November 2008
- 19      "Despatch of information to investors of retail investment product" dated 10 December 2008
- 20      "Circular Issued by the Securities and Futures Commission (SFC) on the Revised Advertising Guidelines Relating to SFC-authorized Collective Investment Schemes" dated 2 January 2009
- 21      "Report of the HKMA on Issues Concerning the Distribution of Structured Products Connected to Lehman Group Companies" dated 9 January 2009
- 22      "Circular Issued by the Securities and Futures Commission (SFC) Regarding Self-Examination of Controls and Procedures on Suitability Obligations" dated 26 February 2009
- 23      "Fair and reasonable arrangements for settling complaints related to the selling of investment products" dated 5 March 2009
- 24      "Circular Issued by the Securities and Futures Commission (SFC) on Suspension of the Closing Auction Session" dated 20 March 2009
- 25      "Implementation of recommendations in the HKMA's Report on Issues Concerning the Distribution of Structured Products Connected to Lehman Brothers (the HKMA's Report)" dated 25 March 2009