LEGISLATIVE COUNCIL OF THE HONG KONG SPECIAL ADMINISTRATIVE REGION

Report of the Subcommittee to Study Issues Arising from Lehman Brothers-related Minibonds and Structured Financial Products

The minutes of evidence which comprise the verbatim transcripts, in their original language, of the public hearings are part of the Report and are available in CD-ROM only.

June 2012

TABLE OF CONTENTS

Page

Lists of written evidence/documents

Executive Summary

Introduction

On 15 September 2008, Lehman Brothers Holdings Inc. (LBHI), the fourth largest investment bank in the United States of America (US), filed a petition in the US Bankruptcy Court under Chapter 11 of the Bankruptcy Code. Here in Hong Kong, many investors holding outstanding Lehman Brothers (LB)-related structured financial products (LB structured products) suffered losses following the failure of LBHI and its group of companies. According to information of the Hong Kong Monetary Authority (HKMA), some HK$20.23 billion worth of LB structured products had been sold through banks to over 43 700 investors. Many of these investors complained that the bank staff who sold these products to them had not apprised them of the nature and risks of such products. They also queried whether the regulatory authorities, namely HKMA and the Securities and Futures Commission (SFC), and the Administration had exercised effective regulation over the sale of complex financial products by banks. HKMA received over 9 000 complaints shortly after the collapse of LB. The number rose to 19 699 by December 2008.

2. Given the magnitude of the problems and widespread public concerns, the House Committee of the Legislative Council (LegCo) held meetings on 10 and 13 October 2008 to follow up the matter. At the meeting on 13 October 2008, Members agreed that a subcommittee should be set up under the House Committee to study issues arising from LB-related Minibonds and structured financial products (the Subcommittee). At the House Committee meeting held on 17 October 2008, Members further decided to seek the approval of LegCo to authorize the Subcommittee to exercise the powers under section 9(1) of the Legislative Council (Powers and Privileges) Ordinance (Cap. 382) in performing its functions. A motion to this effect was passed by LegCo on 12 November 2008.

3. The Terms of Reference, membership, scope of study, work plan, practice and procedure of the Subcommittee are given in Chapter 1. The Subcommittee has decided to focus its study on the regulatory issues and the practice of retail banks in the distribution of LB structured products. In undertaking its work, the Subcommittee has abided by the overriding principle not to investigate into specific cases, corporations or individuals; nor to assist individual investors to pursue their complaints. During the period from February 2009 to May 2011, it held a total of 106 hearings (70 public hearings and 36 closed hearings) and took evidence from 62 witnesses from the Administration, regulators, six distributing banks of LB structured products and investors of such products. In addition, the Subcommittee also held 42 meetings to consider procedural and other matters related to its inquiry. It held a further 15 meetings to discuss the evidence obtained and deliberate on the report of its study.

Concluding observations of the Subcommittee

4. The Subcommittee has examined the legislative framework and regulatory arrangement governing the public offer and distribution of LB structured products by retail banks, the policy and regulatory roles of the Administration, HKMA and SFC, the systems and practices adopted by banks in relation to the distribution of these products, as well as related issues including the handling of investor complaints and investor protection. Based on the relevant findings and observations as set out in Chapters 2 to 7, the Subcommittee has come to a number of conclusions in Chapter 8 and a gist is given below:

<u>The regulatory arrangement</u>

(a) Under the existing arrangement, HKMA is the frontline regulator of banks overseeing their regulated activities (including the sale of investment products such as LB structured products) according to the standards and requirements set and applied by SFC to its licensed intermediaries. Unlike SFC which maintains a licensing regime for intermediaries, HKMA does not regulate

directly the relevant individuals (ReIs) employed by banks (which are registered institutions (RIs)) to carry out regulated activities, but relies on the bank management to ensure compliance of their ReIs with regulatory requirements. Prior to 2008, the ongoing regulatory process of HKMA had not detected and rectified at an early stage any serious problem of mis-selling. This was in sharp contrast to the large number of complaints after the collapse of LB. There had also been relatively few enforcement actions taken against ReIs. The Subcommittee considers that the current regulatory arrangement had not been conducive to early detection of mis-selling of structured financial products among RIs.

(b) SFC is the regulator of the securities and futures industry in Hong Kong. However, it does not have the power to oversee the regulated activities of banks on a day-to-day basis. HKMA is responsible for supervising banks, detecting and conducting initial investigation into non-compliance. The Monetary Authority (MA) does not have the power to impose disciplinary sanctions on RIs and their ReIs in respect of their regulated activities. Such power under the Securities and Futures Ordinance (Cap. 571)(SFO) is vested with SFC. The two regulators are also required to consult each other on specified regulatory matters. In the view of the Subcommittee, the division of regulatory powers between the two regulators has given rise to operational complexities which are not conducive to effective regulation of RIs and their ReIs.

<u>Policy role of the Government</u>

(c) The current regulatory arrangement has been in place since April 2003 upon the commencement of SFO and the Banking (Amendment) Ordinance. There were no lack of developments (such as the phenomenal growth in banks' securities business and concerns about whether banks and

securities brokers were subject to consistent regulation when conducting the same regulated activities) calling for regulatory attention. The Subcommittee has noted with grave concern that all along, the Administration had not taken the initiative to conduct a comprehensive review of the current regulatory arrangement. Many existing weaknesses have therefore been left to subsist for years and remained unaddressed.

The "disclosure-cum-conduct regulation" regime

(d) SFC was responsible for administering the disclosure regime with the objective to ensure sufficient disclosure of information in the product documentation in accordance with the requirements specified in the Third Schedule to the Companies Ordinance (Cap. 32)(CO). However, the Subcommittee has found that the disclosure requirements under CO, which were intended to cater for traditional debt capital-raising issues, provided little detailed guidance on disclosure specific to structured financial products. It is also concerned about the quality of disclosure as the prospectuses of LB structured products were often copious and not easy to understand, while the marketing materials of such products had not given due prominence to the risks associated with the products.

(e) The fact that quite a large number of LB structured products had been issued by making use of certain exemptions under CO (commonly known as offers by way of private placement) without requiring SFC authorization of their offer documentation was incongruent with the objective of the prevailing disclosure regime and undermined its usefulness.

(f) As far as RIs are concerned, conduct regulation at the point of sale is the responsibility of HKMA. As stated in paragraphs (a) and (b) above and on account of the Subcommittee's observations in paragraph (g) below on how RIs had conducted the sale of LB structured products, the Subcommittee considers that there might not have been sufficient conduct regulation at the point of sale.

Compliance of RIs with regulatory requirements in their distribution of LB structured products

(g) Having regard to the evidence given by witnesses from the management and frontline staff of six distributing banks and some investors, the Subcommittee has identified a number of deficiencies in compliance with regulatory requirements in the following key activities relating to the sale of LB structured products: product due diligence, provision of staff training and guidance, knowing your clients (KYC) and performing suitability assessment on customers, how the sales process was conducted by ReIs, the monitoring and internal controls put in place by RIs and their complaint-handling systems. For example, there were instances of inappropriate risk ratings being assigned to certain LB structured products. Some of the training materials used by the banks were found to contain misleading information. Some investors appearing before the Subcommittee could hardly be assessed as suitable for acquiring LB structured products but had been sold such products. This raised doubt over whether KYC and suitability assessment had been properly conducted in every transaction. Nevertheless, the Subcommittee has also found it equally important for investors to take responsibility in protecting their own interest when making investment decisions.

Resolution of LB-related complaints

(h) Since July 2009, five settlement agreements have been entered into by SFC, MA and the distributing banks pursuant to section 201 of SFO. On one hand, the Subcommittee considers these agreements instrumental in bringing about the resolution of the vast majority of over 21 000 LB-related complaints received by HKMA up to June 2009. On the other hand, the Subcommittee considers it unfair to exclude some investors from certain repurchase offers under the settlement agreements by arbitrarily designating them as "experienced investors" when no such designation is found in existing legislation.

Investor protection

(i) As revealed in the LB incident, the prevailing "disclosure-cum-conduct regulation" regime had not provided sufficient protection to investors. The disclosure requirements under CO were not specific to structured financial products. The Subcommittee is concerned that the information in the product documentation (i.e. prospectuses and marketing materials) was not disclosed in a manner which could effectively apprise the prospective investor of key product features and risks. As stated in paragraphs (a) and (b) above, there might not have been sufficient conduct regulation at the point of sale in RIs.

(j) Although SFC and HKMA have launched different investor education initiatives over the years, it does not appear that certain key messages, such as "investor should not invest in products they do not understand" and how investors can best protect themselves, have been effectively delivered to reach the investing public.

Recommendations of the Subcommittee

5. Arising from its study, the Subcommittee has put forward over 50 items of recommendations which are detailed in Chapter 8. The main recommendations are highlighted below:

<u>The disclosure regime for the offer of investment products</u>

(a) The legislative amendments effecting the transfer of the regulation of the offer of structured financial products from CO to SFO in May 2011 is an improvement over the previous regime which had relied on compliance with the disclosure requirements in CO. SFC will henceforth be able to issue product codes to prescribe structural requirements taking into account the nature of the product. SFC should keep the new arrangements (such as its new Code on Unlisted Structured Investment Products and the requirement that investment products should have concise Product Key Facts Statements) under regular reviews and proactively assess their effectiveness, having regard to innovation in financial products, market developments and regulatory experience.

(b) An issue arising from the LB incident is whether the disclosure regime should be retained or replaced by a product approval regime. The Subcommittee envisages that the latter regulatory approach may give rise to a number of problems, such as less financial innovation and substituting the regulator's judgement for that of the investors. It does not appear that such an approach is found in overseas jurisdictions. Nevertheless, the Subcommittee considers that the current disclosure regime should be beefed up by requiring due consideration be given to treating customers fairly throughout the product cycle, along the lines of the "Treating Customers Fairly" (TCF) initiative introduced by the Financial Services Authority (FSA) in the United

Kingdom. The product issuer should also be required to disclose which types of customers for whom the product is likely to be suitable, and how the product characteristics are suitable for that particular group of target customers.

Regulation of the conduct of RIs and their staff

(c) The supervision of RIs should be strengthened. The ongoing regulatory process, including both on-site examinations and off-site surveillance, should focus on the capability of the management controls and systems within the RIs to ensure compliance of regulatory requirements.

(d) To better assist RIs to fulfil their obligations, SFC and HKMA should consider the feasibility of setting benchmarks on certain key requirements (such as risk-rating of investment products, risk-profiling of customers etc.) to achieve consistency in standards of practice among RIs and better protection for investors.

(e) The regulators should consider raising the minimum academic qualifications of ReIs to better ensure that they can understand the financial products that may be sold to customers and discharge their duties to their clients properly.

(f) To minimize contention over whether it was investment information or investment advice that had been given to the customer in the sales process, the regulators should consider stipulating (by way of legislation or guidance/codes) that when providing investment information to their customers, RIs would be deemed to be also providing incidental investment advice, unless the RIs have proof to the contrary. Where the investor who has acquired an investment product remains a customer

of the RI, the duty of the RI to the investor should continue throughout the product tenor.

(g) To facilitate a structured sales process, the regulators should consider requiring RIs to take appropriate measures for ensuring that their ReIs complete all requisite steps for the transaction and that the customers in the transaction are fully aware of the completion or otherwise of such steps.

Complaint-handling and disputes resolution

(h) To reduce operational complexities and enhance the effectiveness of enforcement and handling of complaints, investigatory and disciplinary powers against RIs and their staff should rest with a single regulator, instead of being shared by HKMA and SFC as under the current arrangement.

(i) As far as permissible under the relevant legislation, there should be greater transparency in the progress of investigation of complaint cases by the regulator. This may be done through publication of information on investigation/enforcement outcomes and keeping the complainants informed of the progress of investigation.

(j) The Subcommittee sees no need to modify SFC's power under section 201 of SFO to enter into settlements with the regulated persons intended to be disciplined. However, it considers that when exercising such power, SFC should not agree to adopt any arbitrary and non-statutory threshold to exclude certain persons from the settlement offers.

(k) The regulator responsible for enforcement should be vested with appropriate statutory powers to order the payment of compensation where the findings so justify. Payment of compensation to aggrieved investors and consideration of disciplinary action (where required) by the regulator should proceed as parallel courses of action.

(l) HKMA should review the effectiveness of the LB-related Products Disputes Mediation and Arbitration Scheme set up in November 2008 so that the lessons learned can shed light on the future operation of the Financial Dispute Resolution Centre.

Investor protection

(m) In recognition that there are individuals who, due to their personal circumstances such as age or illiteracy, may not be capable of protecting themselves against mis-selling, the Administration and regulators should consider setting some tangible and objective criteria for determining the category of persons that are suitable for acquiring specified products (such as structured financial products), with the result that certain products can only be sold to the designated category of investors.

(n) In pursuing the recommendation in paragraph (m) above, reference should be made to relevant overseas practices such as the guidance issued by the National Association of Securities Dealers in US on the type of investors who could acquire structured financial products and the TCF initiative of FSA in the United Kingdom.

(o) To ensure better protection for investors, many of whom may obtain investment services from banks, the Subcommittee considers that investor protection should be explicitly stated as one of MA's statutory functions under the relevant provisions of the Banking Ordinance.

Investor education

(p) In carrying out investor education work, it is important for the Investor Education Council to reach out proactively to different sectors of the community. Greater use should be made of radio and TV as they are the main channels through which less educated and elderly persons obtain information. Banks should be required to make available to their customers the flyers or leaflets published by SFC to apprise prospective investors of the "dos" and "don'ts" in investment.

(q) Investor education initiatives must unequivocally convey the message that investors should exercise vigilance and due diligence and should not invest in products that they do not know or understand.

The way forward

(r) In the light of the LB incident, the Subcommittee has found the present regulatory structure under which the securities business of banks being regulated by both HKMA and SFC largely ineffective. The Administration and the regulators should examine the feasibility of placing the securities business conducted by banks under the regulation of SFC, which is the regulator for the securities and futures industry. This will better ensure that the regulated activities conducted by banks and securities brokers will be subject to consistent regulation.

(s) It is incumbent upon the Administration to play a proactive role to ensure that its policy objectives are met, and to provide the necessary policy steer. The Administration should keep the regulatory regime under regular reviews, identify and address issues of concern and shortcoming.

(t) The existing forums of the Council of Financial Regulators and Financial Stability Committee should be strengthened. The transparency of these two bodies should be enhanced by publishing or reporting to the Panel on Financial Affairs the main deliberations and decisions reached at their meetings.

(u) HKMA should continue its action on unresolved LB-related complaints and re-open unsubstantiated cases if more information is available.

(v) The Subcommittee's recommendations should be followed up by the Panel on Financial Affairs in due course.

Chapter 1 Introduction

Background

1.1 On 15 September 2008, Lehman Brothers Holdings Inc. (LBHI), the fourth largest investment bank in the United States of America (US), filed a petition in the US Bankruptcy Court under Chapter 11 of the Bankruptcy Code. This marked one of the worst failures of major financial institutions in US which gave rise to a series of adverse developments not only in US, but also in many other parts of the world. Locally, there was a public outcry as tens of thousands of investors feared substantial or total loss on the outstanding Lehman Brothers (LB)-related Minibonds and structured financial products held by them.

1.2 According to information of the Hong Kong Monetary Authority (HKMA), some HK$20.23 billion worth of various LB-related structured financial products (LB structured products) had been sold through banks to over 43 700 investors, including HK$11.2 billion in Minibonds held by about 33 600 investors[1]. HKMA alone received over 9 000 complaints[2] shortly after the collapse of LBHI. The number stood at 19 699 by December 2008[3]. Many aggrieved investors said that they were customers of the banks which sold them the LB structured products. However, they complained that when selling these products to them, the bank staff did not explain clearly or fully the risks to which they were exposed, but advised them that the products were safe and of low risk. These investors also queried whether the regulatory authorities, namely HKMA and the Securities and Futures Commission (SFC), as

[1] Table 1 of Report of the HKMA on Issues Concerning the Distribution of Structured Products Connected to Lehman Group Companies submitted to Financial Secretary in December 2008 (HKMA Review Report) and LC Paper No. CB(2)100/08-09(04) containing the written information provided by HKMA for the special meeting of the House Committee on 13 October 2008.

[2] As informed by Mr Joseph YAM, then Monetary Authority, at the special meeting of the House Committee on 13 October 2008. The verbatim transcript of the meeting is available on the Legislative Council's website at http://www.legco.gov.hk.

[3] Paragraph 1.10 of HKMA Review Report.

well as the Administration had exercised effective regulation over banks' sale of complex financial products to their customers. The investors voiced their predicament and urged the authorities concerned to follow up their complaints and assist them in recovering their losses.

1.3 Given the magnitude of the problems and the public concern over how the Administration, the regulatory authorities and the banking sector would deal with the huge number of complaints from investors, the House Committee considered a proposal at its meeting on 10 October 2008 to appoint a select committee[4] authorized to exercise the powers under section 9(1) of the Legislative Council (Powers and Privileges) Ordinance (Cap. 382) (LCPPO) to inquire into matters relating to the sale of LB-related Minibonds and structured financial products. While there was support for the proposal, reservation was also expressed on the immediate appointment of a select committee as there was concern that this might make the banks less prepared to resolve complaints with their customers on a voluntary basis. After deliberation, Members decided by a majority against the immediate appointment of a select committee[5].

1.4 Subsequently, the House Committee held a special meeting on 13 October 2008 with the Administration, the regulators and representatives of the distributors of LB structured products[6]. Members were deeply concerned about the policy and regulatory issues relating to the sale of LB structured products through retail banks in Hong Kong, as well as the protection available to investors under the prevailing regime. To follow up the matter, Members agreed that a subcommittee should be set up under the House Committee to study issues arising from LB-related Minibonds and structured financial products (the

[4] On the appointment and procedure of a select committee, please see Rules 78 and 79 of the Rules of Procedure of the Legislative Council which is available on the Council's website at http://www.legco.gov.hk.

[5] The verbatim transcript of the meeting of the House Committee on 10 October 2008 is available on the website of the Legislative Council at http://www.legco.gov.hk.

[6] Representatives from 19 retail banks and two securities brokers attended the special meeting of the House Committee. The meeting was also attended by the Commissioner of Insurance and representatives of Hong Kong and Shanghai Banking Corporation Limited.

Subcommittee)[7]. At the House Committee meeting on 17 October 2008, Members further decided that approval of the Legislative Council (LegCo) should be sought to authorize the Subcommittee to exercise the powers under section 9(1) of LCPPO in performing its functions[8]. A motion to this effect was passed by LegCo on 12 November 2008. The Subcommittee is the first subcommittee set up under the House Committee which has been authorized to exercise the summoning powers under LCPPO.

Terms of Reference

1.5 The Subcommittee's Terms of Reference, as endorsed by the House Committee pursuant to Rule 20(k)(i) of the House Rules, is as follows:

> "To study issues arising from Lehman Brothers-related Minibonds and structured financial products and to make recommendations where necessary."

Membership

1.6 After its formation in October 2008, membership of the Subcommittee was called in accordance with the established practice of inviting membership for subcommittees formed under the House Committee[9]. The membership list of the Subcommittee is at **Appendix 1(a)**.

[7] The verbatim transcript of the special meeting of the House Committee on 13 October 2008 is available on the Legislative Council's website at http://www.legco.gov.hk.

[8] The verbatim transcript of the meeting of the House Committee on 17 October 2008 is available on LegCo's website at http://www.legco.gov.hk.

[9] Under the existing practice, a subcommittee formed under the House Committee shall consist of not less than three members including the chairman.

1.7 Hon LEUNG Kwok-hung, a member of the Subcommittee, resigned from office as a LegCo Member with effect from 29 January 2010 and ceased to be a member of the Subcommittee from that date. He was re-elected in the by-election held on 16 May 2010 and after the commencement of his term of office, Mr LEUNG sought the House Committee's agreement for him to re-join the Subcommittee. In considering Mr LEUNG's request at the House Committee meeting held on 4 June 2010, some Members opined that as Mr LEUNG had been a member of the Subcommittee since it was first set up, he could keep abreast of the Subcommittee's work by studying the relevant documents and the transcripts of proceedings of those hearings not attended by him. Some Members supported Mr LEUNG's request on account of his active participation in the work of the Subcommittee. The House Committee raised no objection to Mr LEUNG's request to re-join the Subcommittee.

Scope of study and work plan

1.8 LB-related Minibonds and structured financial products were distributed by both retail banks and securities brokers in Hong Kong. They were however more widely sold through banks to a much larger number of customers, as reflected by the fact that most of the complaints received by the regulators were made against distributing banks[10]. The Subcommittee has therefore decided to focus on the distribution of LB-related Minibonds and structured financial products by retail banks when delineating the scope of its study.

1.9 The Subcommittee recognized that its study would straddle a wide spectrum of issues, mostly complex and controversial. Owing to the evolving developments of some of the issues arising from LB-related

[10] As reported by SFC in "Issues raised by the Lehmans Minibonds crisis – Report to the Financial Secretary" (SFC Review Report) published in December 2008, at the end of November 2008, SFC received 8 055 complaints related to LB, of which only 5.9% related to SFC's area of responsibility. 7 712 of these complaints were made against distributing banks.

Minibonds and structured financial products, the Subcommittee also agreed that certain flexibility should be exercised when dealing with the matters under study. With a view to understanding what had happened in connection with the distribution of LB structured products by retail banks in Hong Kong and to ascertain the efficacy or otherwise of the applicable regulatory regime, the Subcommittee has inquired into the following major areas:

(a) The legislative framework and regulatory arrangement governing the distribution of LB-related Minibonds and structured financial products by retail banks. This includes the policy-making role of the Government; how the securities business of banks were subject to regulation by HKMA and SFC; the regulatory regime (disclosure-based cum conduct-regulation at the point of sale) applicable to the sale of LB-related Minibonds and structured financial products by banks.

(b) The systems and practices adopted by banks in relation to their distribution of LB structured products; and what had commonly transpired during the selling process. This includes key activities such as product due diligence, training and guidance to staff, suitability assessment of products for customers, compliance with regulatory requirements in handling customers.

(c) The systemic issues arising from (a) and (b) above, including the efficacy or otherwise of the regulatory regime in regulating the sale of LB structured products by banks and in providing an appropriate measure of protection to investors.

1.10 The Subcommittee aims to find out the facts relating to the above areas of study. It has abided by the overriding principle not to investigate into specific cases, corporations or individuals; nor to assist individual investors to pursue their complaints and recoup their losses.

1.11 The Subcommittee commenced work in October 2008 and took forward its study in stages and by phases according to the following work plan :

(a) **Stage 1** for undertaking preparatory work. This included drawing up the Subcommittee's Practice and Procedure, obtaining background information from relevant parties for determining the scope of study and issues to be examined, drawing up the work plan and identifying the witnesses to be summoned in different phases.

(b) **Stage 2** for conducting hearings in four phases to receive evidence from the following groups of witnesses –

- the Administration and regulators (Phase I);
- the top/senior management of distributing banks of LB structured products (Phase II);
- the frontline bank staff involved in the sale of LB structured products (Phase III); and
- investors of LB structured products (Phase IV).

(c) **Stage 3** for considering the evidence obtained and preparing the report of the Subcommittee.

1.12 At its meeting held on 22 October 2010, the House Committee noted the progress report of the Subcommittee and gave approval for it to continue its work up to the end of the 2011-2012 session pursuant to Rule 26(c) of the House Rules.

1.13 Unlike past inquiries which mostly looked into past events, new developments arising from the LB incident had taken place while the Subcommittee's study was underway. Some notable examples were the settlement agreements announced by the regulators and certain distributing banks in July and December 2009, July 2010, March and July 2011, as well as the Minibonds collateral recovery agreement announced in March 2011. On whether the Subcommittee should follow up new developments, members were of the view that the Subcommittee should focus on the decided areas of study and not take up new issues as and when they arose. Members also agreed at the meeting held on 9 December 2008 that the Subcommittee should carry on its study in accordance with its work plan, while the Panel on Financial Affairs would be the forum for receiving briefings on new developments relating to the LB incident.

Witnesses

1.14 The Subcommittee decided that all witnesses should be summoned under section 9(1) of LCPPO to attend before the Subcommittee and be examined on oath.

The Administration and the regulators

1.15 For the purpose of studying the policy and the prevailing regulatory regime governing the sale of LB-related Minibonds and structured financial products by banks, the Subcommittee took evidence from the Secretary for Financial Services and the Treasury (SFST), the Financial Secretary (FS), the Monetary Authority (MA), the Deputy Chief Executive of HKMA (DCE/HKMA) responsible for banking-related matters, as well as the Chief Executive Officer of SFC (CEO/SFC) and the executive director (ED) of SFC responsible for overseeing the

authorization of product documentation. The Subcommittee also received evidence from Mr Harold KO, a former employee of SFC.

Banks which distributed LB-related Minibonds and structured financial products and investors of such products

1.16 To understand how LB-related Minibonds and structured financial products were distributed by retail banks, the Subcommittee decided to summon witnesses from the following groups:

(a) the top/senior management of distributing banks;

(b) frontline bank staff who had been personally involved in matters related to the sale of LB structured products; and

(c) investors of such products.

1.17 In deciding to summon witnesses from banks and investors as listed above, it is not the Subcommittee's intention to investigate into the performance of individual banks or their staff in specific cases, or to follow up the complaints of individual investors. Based on the information then available to the Subcommittee, no less than 19 retail banks were known to have distributed a wide range of LB structured products to tens of thousands of investors. The Subcommittee therefore decided that it should select a reasonable number of witnesses from each of the above groups to assist the Subcommittee.

Distributing banks

1.18 The Subcommittee took into consideration a combination of factors to identify the banks for the purpose of summoning witnesses. Members considered that the number of banks should be manageable and they should represent an appropriate mix of local and overseas banking

corporations of various sizes. On account of some of them being the major distributors of certain widely sold products (e.g. Minibonds, LB-related Constellation Notes (LB-CLNs) and LB-related equity-linked notes (LB-ELNs))[11], their volumes of sales, the number of investors and complaints involved, the following six banks were selected:

(a) DBS Bank (Hong Kong) Limited (DBSHK);

(b) Standard Chartered Bank (Hong Kong) Limited (SCBHK);

(c) Citibank (Hong Kong) Limited (CHKL);

(d) The Royal Bank of Scotland N.V. (RBS) (formerly known as ABN AMRO Bank N.V.);

(e) Bank of China (Hong Kong) Limited (BOCHK); and

(f) Dah Sing Bank, Limited (DSB).

Top and senior management of the six banks

1.19 The Subcommittee has decided to examine the policies and management systems adopted and implemented by the banks in distributing LB structured products. It considered that the chief executive officers and, where appropriate, their deputies and other senior executives in charge of retail banking services of the six banks would be in the best position to assist the Subcommittee. A total of 13 witnesses from the top and senior management of the six banks had been summoned to give evidence to the Subcommittee.

[11] For more details, please see Chapter 2.

Frontline bank staff

1.20 Given the large network of bank branches and the staffing structures of frontline staff with responsibilities related to the sale of LB structured products which varied among banks, the Subcommittee decided to summon a team of relevant frontline staff from the branch(es) of each of the six banks that had recorded the highest volume of transactions and the highest number of complaints in respect of their distribution of LB structured products. With a view to understanding the overall supervision exercised by the branch management over the sale of LB structured products, how training and guidance was provided to the sales staff and how the selling process was actually conducted, the Subcommittee had summoned teams of frontline staff comprising the branch managers (BMs), the training/investment consultants and the relationship managers (RMs) who had personally conducted the sale of LB structured products. Their evidence is needed in order to shed light on how the banks' policies and guidelines had been put into practice. A total of 26 frontline staff[12] had been summoned to testify to the Subcommittee. They included both former and existing employees of the six banks and had been selected mainly on account of their length of service during the period when their banks distributed LB structured products. The Subcommittee also agreed that the frontline bank staff should not be asked to testify on specific cases or complaints of individual customers.

1.21 On being notified in writing that they would be summoned, some frontline staff wrote to the Subcommittee and requested to testify in camera in order to protect their identity and relieve them of the pressure arising from giving evidence in public. A few of them also submitted reasons in writing and requested the Subcommittee to consider not to summon them. After thorough consideration of their requests and in

[12] Of the 26 witnesses, six were branch/district managers, four were investment/portfolio consultants and 16 were RMs or equivalent.

pursuit of its objective to obtain the necessary evidence, the Subcommittee decided to hold closed hearings to take evidence from all frontline bank staff. It also agreed that the identity of these 26 witnesses would not be disclosed.

Investors of LB structured products

1.22 The Subcommittee has decided to take evidence from investors of LB structured products in order to understand the entire selling process and what typically had transpired at the point of sale. In particular, members are concerned about how LB structured products could have been sold to bank customers who had no previous experience in investing in structured financial products, or to general depositors who used to place time deposits with the banks. They also consider it necessary to examine how banks had handled the sale of LB structured products to elderly and vulnerable customers.

1.23 It is not the Subcommittee's intention to conduct a general survey on the population of over 40 000 investors affected by the default of LB. The Subcommittee has specified a number of requirements in order to identify the profile of investors whose evidence is considered pertinent to the Subcommittee's study. For completeness of evidence, the Subcommittee has decided that the prospective witnesses from investors of LB structured products must be customers of the six selected banks whose top/senior management and frontline staff had testified to the Subcommittee; and they must have purchased one or more of the LB structured products specified by the Subcommittee. In addition, the prospective witnesses must also meet at least two of the three specified criteria relating to age, investment experience and whether the purchase had been made with proceeds of matured time deposits. Details of the eligibility criteria are at **Appendix 1(b)**.

1.24 To source eligible investors, the Subcommittee published a notice on the website of LegCo to invite investors who met the requisite criteria to indicate their interest in assisting the Subcommittee[13]. The Subcommittee was subsequently informed by some of the investors who had previously volunteered their assistance that they would no longer wish to testify to the Subcommittee. Finally, a total of 16 investors gave evidence to the Subcommittee.

1.25 In taking evidence from investors, the Subcommittee has adhered to the overriding principle not to investigate into specific cases, or to assist individual investors to seek compensation or redress their complaints.

Practice and Procedure

1.26 Being a subcommittee set up under the House Committee and authorized to exercise the powers under LCPPO, the Subcommittee has drawn up its practice and procedure with reference to the relevant provisions in the Rules of Procedure and the House Rules applicable to subcommittees of committees of LegCo. The Subcommittee's practice and procedure are also regulated by relevant provisions of LCPPO. In determining its practice and procedure, the Subcommittee has made reference to those adopted by select committees and given due regard to a number of principles including the following:

(a) the Subcommittee is not tasked to investigate into specific cases, or to assist individual persons to pursue their claims or complaints;

[13] The Subcommittee posted a notice on LegCo's website in November 2010 to invite investors who met the requisite criteria to indicate their interest in assisting the Subcommittee by responding to the invitation in writing for consideration by the Subcommittee. It also placed an advertisement in three local newspapers to draw readers' attention to the Subcommittee's invitation on the Internet.

(b) the Subcommittee's proceedings should be fair and seen to be fair; and

(c) the Subcommittee's practice and procedure should facilitate the ascertaining of facts relevant to and within its terms of reference, which do not include the adjudication of the legal liabilities of any parties or individuals.

The Subcommittee's Practice and Procedure was endorsed by the House Committee on 28 November 2008 in accordance with Rule 20(k)(i) of the House Rules, and is at **Appendix 1(c)**.

Hearings conducted by the Subcommittee

1.27 The Subcommittee has agreed that as a general rule, the taking of evidence should be conducted at open hearings. However, if any witness wished their evidence or any part thereof to be taken at closed hearings, they should submit their reasons in writing to the Subcommittee for decision. The Subcommittee might also decide to take evidence in camera where circumstances so warranted. In considering whether to conduct closed hearings, the Subcommittee would have due regard to the circumstances of each case, including the need to protect the identity of the witnesses, the impact on the well-being of a witness if the hearing was to be held in public, and the confidentiality of the evidence to be obtained.

1.28 Under its Stage 2 study from 20 February 2009 to 31 May 2011, the Subcommittee held 106 hearings which were attended by 62 witnesses, as follows:

(a) Phase I – 32 hearings, including 30 open hearings and two closed hearings[14], attended by seven witnesses from the Administration, HKMA, SFC and a former employee of SFC;

(b) Phase II – 32 hearings, including 24 open hearings and eight closed hearings[14], attended by 13 witnesses from the top/senior management of six selected banks which had distributed LB-related Minibonds and structured financial products;

(c) Phase III – 26 closed hearings[15] attended by 26 witnesses from the frontline staff of the six selected banks; and

(d) Phase IV – 16 open hearings attended by 16 witnesses who were customers of the six selected banks and had invested in LB structured products.

1.29 The total number of hearing hours under the four phases was 206 hours. A schedule of the hearings and the attending witnesses is at **Appendix 1(d)**.

1.30 The witnesses lawfully ordered to attend the hearings of the Subcommittee to give evidence or to produce documents are entitled, in respect of such evidence or documents, to the same right or privilege as before a court of law by virtue of section 14(1) of LCPPO.

1.31 The Subcommittee also agreed that a witness might request to be accompanied by up to two persons, one being a legal adviser and another person to assist the witness with documents. The accompanying

[14] These closed hearings were held as the Subcommittee considered that the witnesses should be ordered to produce certain written evidence to the Subcommittee in confidence.

[15] These closed hearings were held for the frontline bank staff to testify to the Subcommittee in confidence.

persons could not address the Subcommittee. To ensure fairness of proceedings, the witnesses were reminded that they must not engage in discussion with the accompanying persons, or receive any prompting, whether oral or in writing, from such persons. Most of the witnesses had requested to be accompanied by specified persons and the Subcommittee had acceded to all such requests.

Other meetings held by the Subcommittee

1.32 Between 27 October 2008 and mid February 2009, the Subcommittee held eight meetings (including three open and five closed meetings) totalling some 15 hours to undertake preparatory work for commencing its inquiry. In addition, about 24 hours were spent on preparation for the hearings and discussing follow-up action where required.

1.33 During Stage 2 of its study, the Subcommittee held closed meetings from time to time to consider legal and procedural matters, the progress of its work, the summoning of witnesses, requests from witnesses and logistical arrangements for hearings. A total of 34 closed meetings of some 48 hours were held for these purposes. The Subcommittee also held 15 closed meetings comprising 30 hours to discuss the evidence obtained and its report, as well as other matters relating to the inquiry.

1.34 In sum, during the three stages of its study, the Subcommittee held a total of 163 meetings, as follows:

Purpose of meetings	Number
(a) Hearings to receive evidence from witnesses	106 (70 open and 36 closed hearings)
(b) Meetings for the Subcommittee to deliberate on matters relating to its work	57 (3 open and 54 closed meetings)
Total	163

Verbatim transcripts of hearings

1.35 The minutes of evidence, in the form of verbatim transcripts made from the sound recordings of the proceedings of the hearings at which witnesses were examined, form part of the Subcommittee's report. In order that witnesses could have a fair and reasonable opportunity to consider whether their oral evidence had been accurately transcribed, the Subcommittee has sent to all witnesses the parts of the draft verbatim transcripts of their respective oral evidence so that they could have the opportunity to propose corrections, subject to their signing of an undertaking that they would not make any copy of the draft and would return it to the Subcommittee before a specified date. The Subcommittee accepted corrections proposed so long as they did not materially alter the general sense of the evidence so recorded.

1.36 The Subcommittee also agreed that copies of the transcripts of evidence taken in public could be provided to witnesses and prospective witnesses on request upon payment of a fee, subject to the unpublished and/or uncorrected status of the transcripts being stated clearly, and also subject to the conditions that the witnesses or prospective witnesses shall not make public use of the transcripts, or quote directly from the

transcripts, or use the transcripts in a manner prejudicial to the interest of the Subcommittee or other persons. Requests from other parties for the provision of transcripts were considered by the Subcommittee on a case by case basis; and a fee is also charged for such provision.

Handling of classified documents

1.37 For the purpose of its study, the Subcommittee had ordered witnesses from the Administration, HKMA, SFC and banks to produce specified papers, records and documents in their possession. Some witnesses from the Administration and the two regulators had requested the Subcommittee to treat certain documents produced by them as confidential, mainly on the grounds that the documents covered internal exchanges within high-level government; they might reveal information on enforcement methods; and might prejudice ongoing investigation, court proceedings or negotiations. The Subcommittee considered each of these requests on their merits and had not acceded to most of them as the Subcommittee considered that there were insufficient grounds to justify confidentiality. It decided that the documents could be used at open hearings and some of these documents were handled in accordance with Paragraph 19 of the Subcommittee's Practice and Procedure. At the same time, the Subcommittee made it clear to the witnesses that it would not make available such documents to the public before it publishes its report.

1.38 Some witnesses from the bank management considered that their written statements and other documents to be produced to the Subcommittee were private and confidential, on the grounds that disclosure of the information contained in these documents might prejudice their interests in various ways. The Subcommittee did not consider that there were sufficient grounds for confidential treatment, lest the purpose of the proceedings to take evidence at open hearings would be defeated. Nevertheless, the Subcommittee followed the established

practice as specified in Paragraph 37 of its Practice and Procedure that the written evidence/documents received from witnesses would not be published before the Subcommittee publishes its report[16].

Disclosure of interests

1.39 In addition to Rules 83A and 84 of the Rules of Procedure providing for the disclosure of pecuniary interest by Members, the Subcommittee also considered related arrangements to facilitate members in disclosing their interests. It was agreed that it would be for individual members to decide whether they should disclose an interest, pecuniary or non-pecuniary, that might give rise to any real or perceived conflict of interests. The Subcommittee also agreed that individual members who wished to declare an interest should do so in writing. At the start of the relevant hearings, the Chairman would report the declarations orally on behalf of the members who had declared their interests in writing.

1.40 A member declared that he was a non-executive director of SFC, and decided not to take part in the hearings involving witnesses from SFC. Written declarations were also received from some other Subcommittee members mainly in connection with their being customers of the banks summoned by the Subcommittee, or their acquaintance with some of the bank staff and investors testifying to the Subcommittee. The Subcommittee also noted that members' written declarations would be available for public inspection on request.

Claim of public interest immunity

1.41 For the purpose of its study, the Subcommittee ordered Mr Martin WHEATLEY, CEO/SFC, to produce two final draft Notices of

[16] As decided by the Subcommittee, copies of the written statements produced by witnesses at the Subcommittee's open hearings were made available to members of the public observing the hearings. This arrangement is for the sole purpose of assisting them to follow the proceedings of the Subcommittee. Please see paragraph 1.42 below.

Proposed Disciplinary Action (NPDAs). At the open hearing held on 3 July 2009, Mr WHEATLEY claimed public interest immunity against the production of the two documents under Paragraph 2 of Appendix I of the Subcommittee's Practice and Procedure. The relevant body, namely the Chairman and Deputy Chairman of the Subcommittee, dealt with the witness's claim in accordance with the procedures set out in the aforesaid Paragraph. The Chairman subsequently delivered his opinion that CEO/SFC's claim of public interest immunity was not justified. In compliance with the Subcommittee's order, the witness produced the two final draft NPDAs to the Subcommittee at a closed hearing. Pursuant to the Subcommittee's decision, the documents were handled in accordance with Paragraph 22 of its Practice and Procedure, which stipulates that "[a]ny information obtained by way of oral evidence or in the form of documents provided at closed hearings shall not be disclosed".

Transparency of the Subcommittee's work

1.42 So far as the circumstances allowed and where legally feasible, the Subcommittee has strived to achieve the greatest transparency possible in relation to its work. The Subcommittee usually conducted hearings in public, unless decided otherwise by the Subcommittee. The audio recordings of all open hearings are posted on LegCo's website, copies of which can be obtained upon payment of a fee. Members of the public accessing such audio recordings are reminded to seek legal advice on the proper use of the recordings. The Subcommittee also decided to make available copies of the written statements (exclusive of any appendices) produced by witnesses at the Subcommittee's open hearings for the sole purpose of assisting members of the public observing the hearings to follow the proceedings. They were reminded that the use of the contents of the written statements for other purposes was not protected under LCPPO and they should obtain legal advice before doing so.

1.43 To keep the media and the public informed of the work of the Subcommittee, the Chairman conducted briefings for the media after closed meetings. To enhance transparency, the Subcommittee took the initiative to publish a gist of the major decisions reached at closed meetings on its webpage.

Draft findings and observations

1.44 In accordance with the requirements under Paragraph 35 of its Practice and Procedure, the Subcommittee has provided relevant parts of the draft findings and observations of its report to parties/persons against whom adverse comments are intended to be made to give them an opportunity to comment on these parts. The comments received have been carefully considered by the Subcommittee before finalizing its report.

Written submissions

1.45 A general notice inviting members of the public to give views on the matters under study by the Subcommittee was posted on the website of LegCo in January 2009. The Subcommittee had since received over 5 000 written submissions, most of which were from investors who had purchased LB structured products from banks and incurred losses. They recounted their own experience in subscribing for the products in question at individual banks and complained that the products had been mis-sold to them by bank staff without due regard to their investment needs and risk tolerance levels. While it is not the purpose of the Subcommittee's study to look into individual cases, members had taken into consideration some of the matters raised in the submissions when drawing up the line of inquiry.

Report

1.46 Under Rule 20(k)(iii) of the House Rules, a subcommittee formed under the House Committee should report to the House Committee as soon as it has completed work.

1.47 The Report of the Subcommittee consists of the main report, the lists of written evidence and relevant documents, the minutes of proceedings, as well as the minutes of evidence in the form of verbatim transcripts in the original language used at the open hearings. To economize on the use of paper, the minutes of evidence are available on CD-ROM only. This Report is also available on the website of LegCo at http://www.legco.gov.hk.

1.48 The main report consists of eight chapters. This chapter is mainly an introduction to the background leading to the formation of the Subcommittee, as well as important matters relating to the work of the Subcommittee. Chapter 2 describes the impact of the collapse of LB on retail investors in Hong Kong. Chapter 3 examines the regulatory roles and responsibilities of HKMA and SFC in regulating the securities business conducted by banks. Chapter 4 examines the disclosure-based cum conduct-regulation approach in regulating the distribution of LB structured products by banks. Chapter 5 provides a thematic analysis of issues relating to the sale of LB structured products to bank customers. Chapter 6 discusses how LB-related complaints were dealt with by the regulators. Chapter 7 examines the subject of investor protection. Chapter 8 sets out the Subcommittee's concluding observations and recommendations.

Chapter 2 Lehman Brothers-related Minibonds and structured financial products sold in Hong Kong

2.1 This chapter describes the impact of the collapse of LBHI and its group of companies (collectively referred to as LB) on retail investors in Hong Kong holding outstanding LB structured products.

The collapse of LB

2.2 The collapse of LB in September 2008 dealt a severe blow to the economic development and financial stability worldwide. The ensuing financial tsunami has often been described as a "once-in-a-century" crisis. In the first three quarters of 2008, some form of rescue or bail-out action had been taken out by the US government and other Wall Street institutions in respect of certain troubled financial institutions such as Bear Stearns and American International Group. However, such has not been the case for LB.

2.3 Founded in 1850, LBHI was the fourth largest investment bank in US. In June and July 2008, the credit ratings of LBHI were lowered by major credit-rating agencies. On 15 September 2008, LBHI filed for bankruptcy protection under Chapter 11 of US Bankruptcy Code. This also triggered insolvency proceedings against LB subsidiaries in other jurisdictions. Here in Hong Kong, eight LB companies were put into liquidation, including Lehman Brothers Asia Limited (LBAL) which was the arranger for a number of LB structured products sold in Hong Kong, including Minibonds.

Local investors' exposure to LB structured products

2.4 The Subcommittee has noted from the HKMA Review Report that local banks' direct exposure to LB was insignificant. The aftermath was mainly manifested in terms of individual investors' exposure to the credit risk of LB through their purchase of LB structured products distributed by banks and securities brokers[1]. According to the information in the HKMA Review Report, over HK$20.23 billion worth of outstanding LB structured products had been sold to more than 43 700 investors[2] in Hong Kong through retail banks. The banks which distributed LB structured products are at **Appendix 2(a)**. The major categories of LB structured products that remained outstanding at the collapse of LB and the number of affected investors are in **Appendix 2(b)**.

2.5 It is noted that among the LB structured products affected by the failure of LB, the Minibonds issued by Pacific International Finance Limited (PIFL), the credit-linked notes issued by Constellation Investment Limited and a wide range of other LB structured products distributed through private placement accounted for a significant number of affected investors and investment amount. For example, some HK$11.2 billion in value of Minibonds had been sold to over 33 000 investors. About HK$6.2 billion worth of various LB structured products distributed by way of private placement were held by customers in 6 130 bank accounts[3]. The major distributing banks of these products are at **Appendix 2(c)**.

[1] According to the information published by SFC, the following brokers also distributed LB-related structured financial products to their customers: Core Pacific-Yamaichi International (H.K.) Limited, Grand Cathay Securities (Hong Kong) Limited, Karl Thomson Investment Consultants Limited, KGI Asia Limited and Sun Hung Kai Investment Services Limited.

[2] Please see footnote 1 of Chapter 1.

[3] Please see footnote 1 of Chapter 1.

Minibonds

2.6 Minibonds was the name for over 30 series of credit-linked notes issued by PIFL[4] under its Secured Continuously Offered Note Programme and arranged by LBAL for distribution in Hong Kong. PIFL issued Minibonds Series 1 to 36[5] from 2002 to 2008. Sun Hung Kai Investment Services Limited (SHKIS) was the co-ordinating distributor for Minibonds in Hong Kong. Minibonds were distributed by 16 retail banks[6] and several securities brokers including SHKIS.

2.7 Minibonds were unrated structured debt instruments linked to the credit of a basket of six to eight reference entities, mostly well-known listed corporations. The proceeds from the sale of Minibonds would be used by the issuer to purchase collateral which would be held by a trustee for the benefit of the note-holders subject to the terms of the relevant notes. Such collateral must meet certain criteria as specified in the relevant prospectus, e.g. AAA-rated. At the time of subscription for the Minibonds, the particulars of the collateral were not known to the investors. The collateral held by a trustee was segregated for each series. For the earlier series (up to Series 9), the collateral comprised debt obligations of Lehman Brothers Treasury Co. B.V. (LBTC) while the collateral for later series (from Series 10 onwards) were AAA-rated collateralized debt obligations (CDO)[7]. For most series, the issuer also entered into swap arrangements with a swap counterparty, which was also

[4] PIFL was a special purpose vehicle set up for the sole purpose of issuing the series of credit-linked notes known as Minibonds.

[5] Series 4, 13, 14 and 24 were not offered for various reasons. At the time when LBHI filed for bankruptcy, Series 1, 2 and 3 had matured and Series 8 had been the subject of an early call by the issuer.

[6] Except CHKL, DBSHK and SCBHK, the remaining 16 banks listed in Appendix 2(a) distributed Minibonds.

[7] CDOs are a type of structured asset-backed security whose value and payments are derived from a portfolio of fixed–income underlying assets. CDOs are assigned different risk classes, or tranches, whereby "senior" tranches are considered the safest securities. Interest and principal payments are made in order of seniority, so that junior tranches offer higher coupon payments (and interest rates) or lower prices to compensate for additional default risk.

an LB entity, whose obligations were in turn guaranteed by LBHI. The swap arrangements included interest rate and/or currency swaps.

2.8 Note-holders would receive from the issuer periodic payments of interest and at maturity, the repayment of principal if no credit event or early redemption event had occurred during the tenor of the notes. Credit events normally included situations where an entity in the basket of reference entities became insolvent or unable to meet its specified obligations. Early redemption would occur where the swap arrangements were early terminated and in such event the collateral would be sold to effect early redemption payment. The interest payable varied from series to series but was generally above the HIBOR/LIBOR prevailing at the time of issue. This was made possible by means of a credit default swap (CDS)[8]. In effect, the holders of Minibonds were insuring the issuer against the likelihood of a credit event happening to the reference entities, in return for payment of coupon by the issuer.

2.9 In order to meet its obligations to note-holders, the issuer would have to rely on receiving from the swap counterparty money or securities due under the terms of the collaterals. Since the swap counterparty was an LB entity and the swap guarantor was LBHI, the insolvency of LB meant that the issuer would not receive what was due to it under the swap agreements and would in turn default in respect of its obligations to the note-holders.

2.10 The insolvency of LBHI constituted a termination event under the swap arrangements entitling the issuer to terminate the swaps and triggering early redemption of the Minibonds. In the event of an early

[8] A CDS is a swap designed to transfer the credit exposure between parties. As to the CDS arrangements of Minibonds, the issuer will pay to the swap counterparty a sum equal to the interest receivable by the issuer in respect of the collateral. The swap counterparty will pay the issuer an amount equal to the interest due on the Minibonds which the issuer uses to pay to the note-holders. Upon the occurrence of a credit event to a reference entity, the issuer will deliver the collateral to the swap counterparty and the swap counterparty will then pay the issuer an amount equal to the market value of debt obligations of the reference entity in respect of which the credit event was occurred.

redemption of the Minibonds, the recourse of the note-holders would be limited to the proceeds of realization of the collateral (net of costs and expenses) which could be less than the principal amount invested.

LB-related Constellation Notes

2.11 LB-CLNs were a series of credit-linked notes issued by Constellation Investment Limited under its Limited Recourse Secured Note Programme and arranged by DBS Bank Limited, in which LBHI was one of the reference entities. The failure of LBHI constituted a credit event under which each of the relevant series of LB-CLNs had to be redeemed at its credit event redemption amount. This was calculated by reference to, among others, the price of a specified reference obligation of the reference entity that had suffered the credit event. Considering the results of the Lehman Credit-Swap Auction in October 2008, which indicated a value in the region of eight to 10 cents on the dollar for LBHI debt, the value of any such reference obligations would likely be substantially less than the principal amount of the LB-CLNs.

LB structured products distributed through private placement

2.12 In addition to the above products which were distributed through "offers to the public", a variety of other LB structured products with an aggregate nominal value of HK$6.2 billion were distributed by banks through "private placement" to over 6 000 customers. The Subcommittee has examined the termsheets of some of these products which were more widely sold to investors[9]. Most of them were non-principal protected ELNs issued by LBTC under its Euro Medium

[9] For example, the Lehman Brothers 1 Year USD Daily Accrual Coupon Auto-call Note with Daily Knock-In – Series 10 linked to PetroChina (0857.HK) and China Life Insurance (2628.HK) distributed by CHKL, the Lehman Brothers 1-Year HKD All Weather Coupon Daily Callable ELN – Series 17 (390+1800) distributed by SCBHK, and LB 2-Year HKD Index Bonus Fixed Coupon PPN – Private Placement (LMP0017) – Mini PPN distributed by DSB.

Term Note (EMTN) Programme, and guaranteed by LBHI. They were unrated structured notes with a tenor usually not exceeding two years. Unlike Minibonds, these LB-ELNs were not secured by any distributable collateral.

2.13 The Subcommittee notes that the return on these notes was linked to the performance of a basket of exchange-traded shares. The interests payable usually consisted of a "fixed" interest for the first month of the tenor and a "variable" interest for the remaining months calculated with reference to the prices of the shares in the basket. It is not uncommon that a fixed interest exceeding 30% per annum was payable for the first month, while a relatively lower rate of variable interest was payable in subsequent months depending on the prices of the shares in the basket. Under specified circumstances, including the occurrence of a "Knock-In" Event[10], the note-holder would end up receiving the physical shares of the worst performing stock in the basket upon maturity of the LB-ELN, in addition to the coupon already received. The note-holder would incur a loss of the principal amount if the market price of the worst performing stock fell significantly.

2.14 It should be noted that the repayment of principal upon early redemption of the LB-ELN, or the delivery of the worst performing shares or the repayment of principal at maturity to the investors, was provided by the issuer/guarantor and therefore subject to their credit risk. In other words, investors had taken on the risk of the issuer/guarantor's failure to fulfil their obligations under the LB-ELN in question. In the event of insolvency of the issuer/guarantor, any amounts owed under the notes would become unsecured claims that would be paid, if at all, only after all secured claims had been settled in the amount allowed by the US bankruptcy law. In the circumstances, note-holders of such products would not be able to recover much of their investments upon the

[10] A "Knock-In" Event is deemed to have occurred if any one share in the reference basket closes at or below its lower barrier price (knock-in price) on any scheduled trading day from the issue date to the final valuation date.

insolvency of the issuer or guarantor. At the time of preparing this report, LBTC was in insolvency proceedings in the Netherlands[11]. LBHI, which had filed for bankruptcy protection in US in 2008, announced on 6 March 2012 that it had emerged from bankruptcy and would commence distributions to creditors on 17 April 2012[12].

2.15 The Subcommittee was aware that some principal-protected LB-related notes were linked to the performance of market indices such as the Hang Seng Index and the Nikkei 225 Stock Average Index. Similar to the non-principal protected ELNs, they were issued by LBTC under the EMTN Programme and guaranteed by LBHI. Investors had likewise assumed the risk of the default of the issuer/guarantor in respect of their obligations. It is noted that the description of "principal protection" mainly specifies the need for note-holders to hold the notes until maturity to benefit from full repayment of principal.

Other LB structured products

2.16 The Subcommittee has noted that in addition to the major types of products described above, the collapse of LBHI also resulted in the default of LB in respect of its obligations in respect of certain series of Pyxis Notes and ProFund Notes. It also constituted a credit event leading to the early termination of certain outstanding series of Retail-Aimed Callable Investment Notes and Octave Notes with LBHI as one of the reference entities.

[11] Information about the progress of the insolvency proceedings is published by the Bankruptcy Trustees of LBTC through public reports that are available on the website at http://www.lehmanbrotherstreasury.com.

[12] The LBHI's announcement dated 6 March 2012 is available on the website at http://www.lehman.com.

Offering documentation of LB structured products

2.17 The relevant prospectuses of Minibonds and other LB structured products expressly stated that these products were not suitable for all investors. For example, the issue prospectus of Minibonds Series 35 and LB-CLNs Series 34 stated respectively that the products were "not suitable for everyone" and "not suitable for inexperienced investors". They were suitable for investors who were looking for fixed rate quarterly interest income, as well as confident that none of the reference entities would be affected by a credit event, and who were willing to accept the risk that the notes were not principal protected, and that the credit event redemption amount or early redemption amount received by them could be significantly less than the principal amount of the notes. It was also stipulated in the terms and conditions of most LB-ELNs offered by way of private placement that investors should ensure that they had the knowledge, experience and expertise in financial and business matters necessary to enable them to understand and evaluate the risks associated with the products. Investors were also asked to consider carefully whether the products were suitable for themselves in the light of their experience, objectives, financial position and other relevant circumstances. The Subcommittee notes, for example, that according to the terms and conditions of a two-year LB-ELN distributed by RBS[13], the product was "not suitable for inexperienced purchasers". It is stated in the Base Prospectus of the EMTN Programme that "prospective investors should read the entire Base Prospectus" which comprises over 200 pages in English. Apparently, LB structured products including Minibonds were suitable for the more sophisticated investors with experience and knowledge in structured financial products, and who were able to tolerate the various risks associated with the products.

[13] Lehman Brothers 2-Year USD HK Basket (0857.HK+0883.HK+3328.HK) Daily Accrual Callable Equity Linked Note with Daily Knock-In Put

Observations

2.18 The Subcommittee is aware that structured financial products generally refer to products which, in addition 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. In effect, a person investing in structured financial products is relying on a pre-determined formula or occurrence of events described in the prospectus to be paid the return promised. The LB structured products described in the foregoing paragraphs are but some examples of structured financial products, which were offered to tens of thousands of retail investors in Hong Kong from about 2003 to 2008.

2.19 Taking the example of Minibonds and its product structure which had evolved over time, there is no doubt that retail investors needed to understand quite a number of matters, notably the collateral securing the product, special financial arrangements involving CDOs and synthetic CDOs, swap arrangements and CDS etc. The risk implications of various LB entities taking up the roles of arranger, swap counterparty and swap guarantor in the structure of the product and the consequences of any default in their respective obligations might also not be readily comprehensible. Some other LB structured products, though not involving any underlying collateral, were linked to the performance of various underlying assets. For example, the ELNs issued by LBTC and distributed by banks through private placement were linked to a basket of listed stocks. The investors would need to understand that the payout to them was to be determined with reference to certain price levels (e.g. strike price, call price, lower barrier price etc.) of the shares linked to the notes. The Subcommittee considers that retail investors who were not conversant with financial market products could hardly understand without investment advice the structure of Minibonds and other LB structured products and their related risks.

2.20 Although the relevant offer documents of the LB structured products expressly stated that they are not suitable for everyone and are only appropriate for the more experienced and knowledgeable investors, the Subcommittee has noted with concern that more than 43 000 investors in Hong Kong had invested over HK$20 billion in such products and incurred heavy losses as a result of the collapse of LB. The Subcommittee is also concerned that a large number of these investors, who had purchased the LB structured products through banks, alleged that they did not have the requisite experience with or knowledge of the products they had purchased, contrary to what was specified in the prospectuses and other offer documents.

Chapter 3 Regulation of the conduct of securities business by banks

3.1 Following the collapse of LB in September 2008, it became clear that here in Hong Kong, a wide range of LB structured products had been sold to a large number of investors, mainly through retail banks. This chapter examines how the securities business (the sale of structured financial products being one of such activities) conducted by banks are regulated, and sets out certain observations of the Subcommittee on the existing regime.

Overview of the regulatory structure

3.2 Under Hong Kong's regulatory regime, the legal status of an entity (for example, a bank, a securities broker or an insurance company) determines which regulator is responsible for overseeing both its prudential soundness and business conduct. The roles and responsibilities of the Administration and regulators under the existing regulatory structure are summarized in the ensuing paragraphs.

The Administration

3.3 FS and SFST are the principal officials of the Hong Kong Special Administrative Region Government charged with policy responsibilities in financial affairs. According to the "Responsibilities of the Financial Secretary and the Secretary for Financial Services and the Treasury" issued on 27 June 2003 by Mr TUNG Chee-hwa, then Chief Executive, FS is responsible for determining the policy objectives at a macro level in relation to the financial system, while SFST is responsible for formulating specific policies to achieve such objectives and overseeing their implementation through the regulatory authorities

and other organizations as appropriate. In addition, SFST has a specific responsibility for the efficient functioning of Hong Kong's 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 relevant legislation.

3.4 According to the "Policy Objectives in Financial Affairs and Public Finance" issued by Mr Antony LEUNG, then FS, on 27 June 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.

3.5 As regards the division of responsibilities between the Administration and the regulators, both Mr John TSANG, FS, and Prof CHAN Ka-keung, SFST[1], have stated in their respective testimony to the Subcommittee that the Administration is not involved in the day-to-day regulation of the industry, but makes 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. Furthermore, the Administration also seeks to provide various platforms for effective exchanges among regulators and between them and the Administration on the regulatory trends and development; ensure that appropriate checks and balances are put in place; and keep the regulatory systems under monitoring and review in collaboration with the regulators.

[1] Mr John TSANG and Prof CHAN Ka-keung were appointed FS and SFST respectively on 1 July 2007.

The Monetary Authority and the Hong Kong Monetary Authority

3.6 The Exchange Fund Ordinance (Cap. 66) was amended in 1992 to empower FS to appoint a person to be the MA and to specify his functions. MA is also the Chief Executive of HKMA, which is the office of MA and comprises persons appointed to assist MA[2]. Mr Joseph YAM was appointed MA and held office from 1 April 1993 to 30 September 2009. Mr Y K CHOI held the post of DCE/HKMA overseeing all banking-related matters during the period from September 2007 to December 2009.

3.7 The principal function of MA under the Banking Ordinance (Cap. 155) (BO)[3] is to promote the general stability and effective working of the banking system. In this respect, MA's role focuses on prudential regulation of banks. Nevertheless, MA does have a role in overseeing the general way in which banks conduct their business from the standpoint of prudence and integrity with a view to deterring improper conduct that might adversely affect their customers and risk loss of confidence in institutions or affect stability or inhibit the effective working of the banking system[4]. The BO also requires MA, amongst others, to promote and encourage proper standards of conduct and sound and prudent business practices among authorized institutions (AIs). Since April 2003, MA has taken on the added responsibility to take all reasonable steps to ensure that AIs' business (including securities business) is carried on with integrity, prudence and the appropriate degree of professional competence[5].

---

[2] Section 5A(3) of the Exchange Fund Ordinance (Cap. 66).

[3] Section 7(1) of BO.

[4] The Joint Forum of the Basel Committee on Banking Supervision, the International Organization of Securities Commissions and the International Association of Insurance Supervisors noted in its April 2008 report on "Customer suitability in the retail sale of financial products and services" that "[h]ow financial firms approach the sale of financial products and services is at the core of consumer confidence in financial markets and subsequently, has implications for firms' financial soundness and financial system stability as well as investor protection" and "concerns about the impact of mis-selling are arguably an area where concerns about system stability and investor protection meet". Please see Exhibit 2 of SFC Review Report.

[5] Section 7(2)(g) of BO.

3.8 The commencement of the Securities and Futures Ordinance (Cap. 571) (SFO) and the Banking (Amendment) Ordinance 2002 (No. 6 of 2002) (BAO) brought the securities business of AIs under the regulatory regime of SFO. The arrangement is that HKMA is the frontline regulator of the securities business conducted by AIs. This is reflected in paragraph 8 of the letter dated 25 June 2003 issued by FS to MA[6] on "Functions and Responsibilities in Monetary and Financial Affairs", which specifies a number of responsibilities of MA, including that of co-operating with other relevant authorities in the supervision of business conducted by AIs other than their banking or deposit taking business, and developing the debt market in co-operation with other relevant authorities or organizations.

Securities and Futures Commission

3.9 The SFC was established on 1 May 1989 under the Securities and Futures Commission Ordinance (Cap. 24) which was repealed and consolidated into the SFO. SFC is the regulator of the securities and futures industry[7] in Hong Kong. The regulatory objectives of SFC as stated in SFO[8] include keeping the securities and futures industry fair, efficient, competitive, transparent and orderly; protecting the investing public; minimizing crime and misconduct in the markets; reducing systemic risks in the industry; and helping FS maintain financial stability in Hong Kong. In addition, when pursuing its regulatory objectives and performing its functions, SFC must have regard to the desirability of maintaining Hong Kong's status as a competitive international financial centre and of facilitating innovation in connection with financial products[9]. Mr Martin WHEATLEY was appointed CEO/SFC and held office from 23 June 2006 to 8 June 2011.

[6] The letter was acknowledged and agreed to by Mr Joseph YAM, then MA.
[7] "Securities and futures industry" has the meaning as given to the expression in Schedule 1 to SFO.
[8] Section 4 of SFO.
[9] Section 6(2)(a) and (b) of SFO.

3.10 SFC regulates intermediaries[10] which include brokers and investment advisers through a licensing regime. These intermediaries must satisfy SFC's requisite criteria before they can be granted a licence to deal in securities or futures or to give investment advice. Their business must also comply with financial resources obligations and standards of conduct specified by SFC. Most of the regulatory requirements relating to the sale of securities and futures products by intermediaries are set out in SFC's Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (the Code of Conduct)[11] made by SFC under section 169 of SFO. SFC also issued the Frequently Asked Questions and Answers on Suitability Obligations in May 2007 (Suitability FAQ) to provide practical guidance to the intermediaries[12].

Regulation of banks' securities business by the two regulators

3.11 Under the current regime as described above, HKMA is the frontline regulator of banks in respect of all their business activities, including regulated activities[13]. The sale of structured financial products by banks to their customers falls within regulated activity Type 1, while the provision of investment advice is regulated activity Type 4. In performing its functions as a regulator over banks' regulated activities,

[10] Where banks conduct securities and futures business, the banks must be registered with SFC as registered institutions. Their compliance with the rules and requirements of SFC are overseen by HKMA.

[11] First issued in February 1994 and revised from time to time, principally in April 2003 when the SFO came into effect. Further revisions to the Code of Conduct were made in June 2010 to give effect to measures to enhance investor protection. Please also see paragraph 4.27 of Chapter 4.

[12] Please see paragraphs 4.29 and 4.30 of Chapter 4.

[13] Prior to 1 June 2011, there were 9 types of regulated activity under SFO. Type 1: dealing in securities; Type 2: dealing in futures contracts; Type 3: leveraged foreign exchange trading; Type 4: advising on securities; Type 5: advising on futures contracts; Type 6: advising on corporate finance; Type 7: providing automated trading services; Type 8: securities margin financing; Type 9: asset management. The amendments to Schedule 5 to SFO, which came into force on 1 June 2011, added a new Type 10: providing credit-rating services.

HKMA follows the standards and requirements that are stipulated and applied by SFC to its licensed intermediaries[14].

Relevant legislation

3.12 The existing legislative framework, established by BAO and SFO, commenced operation on 1 April 2003. Prior to the enactment of these two Ordinances, banks, as AIs, were exempted from regulation by SFC in respect of their conduct of securities business. The relevant Bills were introduced with the objectives to develop a regulatory regime that provides adequate protection to investors, minimizes regulatory overlap and regulatory cost; and enforces a set of consistent regulatory standards between the then exempted AIs (i.e. the entities that were to become "registered institutions" (RIs)) and intermediaries licensed by SFC[15]. After their enactment, relevant provisions in BO and SFO empower MA to supervise the regulated activities of RIs according to the standards applied by SFC on its licensees, and subject banks to the sanctions for breaches of relevant rules and requirements as applicable to licensed intermediaries in the securities industry.

Regulatory functions of MA and SFC

3.13 When a bank intends to carry on regulated activities, it is required under section 119 of SFO to apply to SFC for registration. SFC will refer the application to HKMA for advice, and in deciding whether or not to register the bank, SFC must have regard to HKMA's advice on the fitness and properness of the bank, and may rely wholly or partly on such advice. The Subcommittee notes from the testimony of Mr Joseph YAM, then MA, that there had not been a case where HKMA and SFC had disagreed on the eligibility of an AI to be registered as an RI.

[14] An exception, for example, is the Securities and Futures (Financial Resources) Rules as banks are already subject to HKMA's Capital Adequacy Rules, which imposes more stringent requirements on financial adequacy.

[15] The LegCo Brief dated 10 November 2000 on the Banking (Amendment) Bill 2000 and the Securities and Futures Bill which is available on LegCo's website at http://www.legco.gov.hk.

3.14 Every RI must appoint at least two executive officers (EOs) for supervising each of its regulated activities[16]. The appointment of EOs is subject to the consent of MA on being satisfied that they are fit and proper and have sufficient authority in the institution[17]. Individuals engaged by RIs to carry out regulated activities (including the sales staff) are not required to be licensed by SFC, but as required by section 114 of SFO, must be registered with HKMA under section 20 of BO as relevant individuals (ReIs)[18]. HKMA does not license or approve ReIs as such, but requires the senior management of each RI to ensure that their ReIs meet the relevant requirements specified in SFC's Fit and Proper Guidelines, Guidelines on Competence and Guidelines on Continuous Professional Training. If MA considers that an EO or an ReI is no longer fit and proper, he may, after consultation with SFC under section 71C(4) or section 58A(1) of BO, withdraw or suspend consent to the appointment of the EO or remove or suspend the particulars of the ReI from the public register respectively. As a result of such disciplinary action, the person should cease to undertake any regulated activities on behalf of the RI.

3.15 In this connection, the Subcommittee has noted from the Guidelines on Competence issued by SFC in March 2003 that the minimum academic qualification requirement for ReIs is "passes in English or Chinese, and Mathematics in Hong Kong Certificate of Education Examination or equivalent". Some members enquired whether an ReI possessing only the minimum academic qualification would be competent enough to explain the product features and information in the prospectuses to customers. Mr Joseph YAM said that as there were also requirements on industry qualification and regulatory knowledge in addition to academic qualification, he considered the competence requirements on ReIs adequate and reasonable. Mr Martin

[16] Section 71D of BO.
[17] Section 71C(2) of BO.
[18] EOs and ReIs may be seen as the counterparts of "responsible officers" and "licensed representatives" in licensed corporations regulated by SFC.

WHEATLEY advised that the academic/industry qualifications and regulatory knowledge specified in the Guidelines are the minimum entry requirements. SFC would expect RIs to provide sufficient additional training to the ReIs to enable them to perform their duties.

3.16 MA is vested with the powers under section 180 of SFO and section 55 of BO to oversee the regulated activities of RIs. The ongoing supervisory activities of HKMA include on-site inspections, off-site review of information submitted by RIs and handling and investigation of complaints against RIs. Where investigation reveals suspected non-compliance with the Code of Conduct or other regulatory requirements, HKMA would refer the case to SFC for consideration of appropriate disciplinary sanctions under SFO, which include revoking/suspending the registration of the RI, issuance of prohibition orders, private or public reprimands and imposition of fines. SFC may only carry out an investigation into an RI where it has reason to inquire whether the RI is guilty of misconduct or is not fit and proper, and after consultation with MA under section 182(4) of SFO. Before exercising any disciplinary power against RIs and their staff, SFC has to consult MA under section 198(2) of SFO.

3.17 As stated by Mr Y K CHOI, then DCE/HKMA, HKMA had, since 2000, adopted the practice of holding prudential meetings[19] with the boards of directors of local banks once a year to the extent possible. The year 2000 also saw the de-regulation of interest rates rules[20]. The Subcommittee has noted from Mr CHOI that at the prudential meetings, HKMA might provide a peer group comparison to enable the bank concerned to understand its position in the market in terms of its financial position and sources of income. On whether these meetings might have in any way encouraged or exerted pressure on banks to become more aggressive in pursuing non-interest income, Mr Y K CHOI informed the

[19] In general, HKMA staff at the rank of Division Head, Executive Director or Deputy Chief Executive responsible for banking supervision would conduct the prudential meetings.

[20] The first phase of the de-regulation of interest rates rules took effect on 3 July 2000.

Subcommittee that while HKMA would draw the bank's attention to any potential risk of over-reliance on a particular source of income, it was for individual banks to decide on their business activities. Noting that from 2007 to 2008, HKMA had held 37 prudential meetings with local banks' senior management or board of directors, the Subcommittee sought clarification on whether these prudential meetings were only concerned with the banks' capital adequacy. As advised by Mr Y K CHOI, the prudential meetings also included various facets of the internal controls and operations of banks, including their conduct of securities business.

Memorandum of Understanding between SFC and HKMA

3.18 A revised Memorandum of Understanding (MoU) was signed between SFC and HKMA in December 2002[21] setting out their respective roles and responsibilities under each major functional aspect of regulating the securities business of banks, as well as the arrangements in relation to the exchange of relevant information and notification or referral matters. The regulatory objective is to ensure that all intermediaries, whether banks or securities brokers, carrying out the same regulated activities are subject to consistent regulatory measures. The division of responsibilities between SFC and HKMA as set out in the MoU is at **Appendix 3(a)**.

3.19 The Subcommittee notes that since the last revision of the MoU in 2002 to tie in with the enactment of the SFO and BAO, no major revision has been made, except that the side-letter to the MoU to streamline communication and co-operation on enforcement matters was revised in April 2007. According to Mr Joseph YAM and Mr Martin WHEATLEY, then CEO/SFC, regular MoU meetings were held between HKMA and SFC to discuss operational issues related to the regulated

[21] The revised MoU signed by the two regulators on 12 December 2002 replaced the previous one signed on 23 October 1995.

activities of RIs. During that period, both regulators did not see a need to revise the MoU.

Other high-level forum for exchange of views

3.20 The Council of Financial Regulators (CFR) and the Financial Stability Committee (FSC) were set up in 2000 to provide a high-level forum for financial regulators to consider and exchange views on systemic and cross-market issues.

3.21 Chaired by FS and comprising representatives from HKMA, SFC, Office of the Commissioner of Insurance (OCI), Mandatory Provident Fund Schemes Authority and the Financial Services and the Treasury Bureau (FSTB), the CFR is charged with the objective of contributing to the efficiency and effectiveness of regulation and supervision of financial institutions, the promotion and development of the financial markets and the maintenance of financial stability in Hong Kong[22]. According to Mr John TSANG, FS, from April 2003 to July 2007, the regulation of the securities business conducted by banks had been reported and discussed at CFR meetings on a number of occasions. For instance, CFR noted in October 2003 that HKMA had been liaising with SFC on the implementation of SFO and BAO. It also noted in July 2007 the implementation of the MoU between SFC and HKMA in supervising the regulated activities of banks.

3.22 The FSC, chaired by SFST, comprises representatives from HKMA, SFC and OCI. It is tasked to monitor the functioning of the financial system of Hong Kong, including the banking, debt, equity, insurance and related markets; deliberate on issues with possible cross-market and systemic implications, formulate and co-ordinate

[22] Please see the Terms of Reference of CFR which is available on FSTB's website at http://www.fstb.gov.hk .

responses; and reporting to FS as necessary[23]. The Subcommittee has noted that since August 2007, regulators had started to report the implications triggered by the US sub-prime problems on Hong Kong's financial market.

Growth in the securities business conducted by banks

3.23 The Subcommittee notes from the information of HKMA that the income from the securities business conducted by banks only amounted to some HK$8.35 billion, or 7% of their total income in 2003[24]. Subsequent years saw a significant growth in banks' securities business such that their securities-related income tripled from HK$13.964 billion in 2005 to HK$44.435 billion in 2007. Over the same period, the ratio of income from banks' securities business to their total income doubled from 9% to 18%[25]. According to the evidence of Mr Joseph YAM, the notional value of structured financial products sold by banks rose from HK$406.7 billion in 2003 to HK$746 billion in 2005, and reached HK$2,529.6 billion in 2007.

3.24 In explaining this phenomenal growth, Mr Joseph YAM informed the Subcommittee that the demand from retail customers for financial planning and wealth management services had increased since 2004, probably due to the prevailing benign investment and low interest rate environment. Banks responded to this demand by diversifying into non-interest business activities including securities business with a view to offering their customers greater choice and easier access to other investment options. In this connection, the Subcommittee notes that the Hong Kong dollar six-month time deposit rate was less than 1% during

[23] Please see the Terms of Reference of FSC which is available on FSTB's website at http://www.fstb.gov.hk.
[24] Paragraph 4.9 of HKMA Review Report.
[25] Paragraph 4.9 of HKMA Review Report.

January 2004 to May 2005; 1.12% to 2.92% during June 2005 to February 2008; and less than 1% from March 2008 onwards[26].

Observations

3.25 In considering the current regulatory structure, the Subcommittee has the following observations.

Perception of the crisis at the higher level of government

3.26 In examining the responses of the regulators and the Administration to the rapid deterioration in market conditions preceding the collapse of LB, the Subcommittee notes that there were discussions at FSC on the implications of the US sub-prime problems on the Hong Kong market. As indicated in the exchanges between MA and the Chairman of the Hong Kong Association of Banks (HKAB)[27] on 12 September 2008, the principal concern was on the impact of the market crisis on the soundness and stability of the local banking sector and financial system, as well as the banks' exposure to investment banks such as LBHI. The Subcommittee considers this justified and understandable from a prudential regulation point of view. However, it is concerned that during these high-level exchanges, it appears that very little attention had been given to the fact that a large number of retail investors in Hong Kong had assumed the credit risks of LB through their purchase of LB structured products. In fact, the Subcommittee has noted from the responses of Prof CHAN Ka-keung, SFST, at the hearings on 20 and 24 February 2009 that he only became aware of Minibonds after the collapse of LB in September 2008. The Subcommittee cannot but doubt whether

[26] HKMA Statistical Bulletin which is updated on a monthly basis and available on HKMA's website at http://www.hkma.gov.hk.

[27] HKMA sent an email to FS on 12 September 2008 providing a summary record of MA's bi-weekly meeting with the Chairman of HKAB on that day, which specifically discussed 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.

the authorities had a reasonable grasp of the predicament of the investing public in the event of the collapse of LB.

Regulatory foresight

3.27 The Subcommittee has sought to ascertain whether each of the two regulators had proactively looked at the possible implications of the increased exposure of local retail investors to structured products in the few years preceding the collapse of LB.

3.28 As informed by Mr Martin WHEATLEY, SFC has since 2005 warned investors on the increasing complexity of structured products available in the market and emphasized the need for professional advice relating to product suitability[28]. In March 2006, SFC published a document entitled "Regulatory Challenges and Responses" in which one of the challenges identified was the increased exposure of retail clients to complex and structured products[29]. The Subcommittee has noted from the Structured Product Investor Survey conducted by SFC in June 2006 that around half of those who purchased unlisted retail structured products did not fully understand the nature of these products, and that most investors (87.9%) bought these products through banks. SFC also conducted two rounds of themed inspections of selling practices of investment advisers in 2004 and 2006[30]. The second round was in parallel to HKMA's thematic examinations on the investment advisory activities of RIs.

[28] For example, in the July 2005 issue of Dr Wise, there was an article titled "Dr Wise – should you invest in structured notes?". In 2005, Dr Wise was a monthly column written by SFC and was available on the website of the SFC-operated Electronic Investor Resource Centre at http://www.eirc.hk. Dr Wise is now incorporated in the InvestEd Intelligence, a bi-monthly e-newsletter available at http://www.invested.hk.

[29] The paper "Regulatory Challenges and Responses" released on 29 March 2006 is available on SFC's website at http://www.sfc.hk.

[30] Further information on the two rounds of themed inspections conducted by SFC is given in Chapter 4.

3.29 Mr Joseph YAM has drawn the Subcommittee's attention to a survey conducted by HKMA from December 2007 to early 2008 to gather information on RIs' sale of retail credit-linked notes with sub-prime mortgages as underlying collateral, or with collateral that might include CDOs. Mr YAM has pointed out that although credit-linked notes only accounted for a small market share and the number of complaints about the sale of such products was low, HKMA had stepped up its regulatory effort on such products. To enhance uniform and prudent treatment among RIs, HKMA, through emails or telephone calls, advised eight RIs, which adopted a "medium" or "low" risk rating for retail credit-linked products without full principal protection, to rate such products as "high" risk. As a result, all except one RI (which had already decided not to sell such products by then) had revised the risk ratings for such products to "high" by February 2008. At the hearing on 20 February 2009, when being asked whether this course of action had exceeded MA's regulatory role under a disclosure-based system[31], Prof CHAN Ka-keung responded that in his view, MA's move had not exceeded his regulatory role under the policy of the Administration.

3.30 Some members of the Subcommittee questioned whether HKMA and SFC had considered issuing any forewarnings to alert investors of the possible failure of LB. In response, Mr Joseph YAM and Mr Martin WHEATLEY said that while HKMA and SFC had kept a close watch on the developments as the global financial crisis unfolded, it was neither appropriate nor possible for any regulator in Hong Kong to forewarn with precision whether a certain financial institution in US, such as LB, might or might not fail, as this was often the outcome of high-level policy considerations and decisions of US authorities. For example, when responding to members' questions at the hearings on 17 April, 8 and 15 May 2009, Mr Joseph YAM pointed out that the failure of LB could

[31] For discussion on the disclosure-based system, please see Chapter 4.

hardly be foreseen, given that some financial institutions such as Bear Stearns had been rescued by US authorities.

Regulation of brokers and banks conducting regulated activities

3.31 One of the key objectives of SFO and BAO is to provide consistency in regulatory standards for both the securities and banking sectors when they conduct the same regulated activities[32]. In this regard, the Subcommittee has examined whether securities brokers and RIs have been subject to a consistent extent of regulation by their respective regulator.

3.32 Unlike SFC which maintains a licensing regime for intermediaries engaged in securities business, HKMA regulates RIs and requires the bank management to ensure the fitness and properness of their ReIs before entering the latter's names in the public register maintained by HKMA. The Subcommittee is concerned that under the existing regime, HKMA does not regulate ReIs directly but relies on the management of individual banks to ensure that their ReIs comply with relevant requirements when conducting regulated activities. Given the keen competition for business, such as the sale of structured financial products, banks might not have exercised the necessary vigilance over their sales staff, also rendering it difficult for HKMA to detect at an early stage any non-compliance by bank staff.

3.33 The Subcommittee has noted that during the 65 months from April 2003 to September 2008 before the collapse of LB, HKMA handled 178 cases of suspected mis-selling of investment products by RIs. Among them, nine cases had been referred to SFC for appropriate action. SFC took enforcement actions in three of these cases[33]. MA suspended

[32] The LegCo Brief dated 10 November 2000 on the Banking (Amendment) Bill 2000 and the Securities and Futures Bill which is available on LegCo's website at http://www.legco.gov.hk.

[33] Please see the press releases issued by SFC on 10 April and 4 May 2007, 24 August 2007 and 4 August 2008 which are available on SFC's website at http://www.sfc.hk.

the registration of one ReI from the public register for one month for breaches of requirements under the Code of Conduct[34]. During the same five-year period, 430 licensed intermediaries were disciplined by SFC for breaches of the Code of Conduct following disciplinary inquiries. Of these, 23 intermediaries had their licences revoked, 164 had their licences suspended and 54 were prohibited from applying for a licence[35]. In total, 102 were fined and 188 were publicly reprimanded. The highest fine imposed was HK$38 million. The Subcommittee has noted with concern the relatively few enforcement actions taken against ReIs during these years. In the light of the large number of complaints alleging mis-selling of LB structured products, it is questionable whether the few enforcement actions were indicative of a high level of compliance, or a lack of effective enforcement actions in the past five years or so.

The exercise of regulatory powers by MA and SFC

3.34 The securities business of banks is currently regulated by HKMA and SFC in accordance with relevant provisions under SFO and BAO. The Subcommittee has noted the statutory powers vested with each regulator and the requirement that a regulator should consult the other on specified regulatory matters. In short, SFC does not oversee the regulated activities of RIs on a day-to-day basis, and must rely on MA to do it by exercising his powers under BO and SFO. MA is vested with the powers under BO to suspend or remove consent/registration for EOs and ReIs of RIs, but does not have the statutory power to impose disciplinary sanctions on them in respect of their conduct of regulated activities under SFO. This power is vested with SFC which may discipline RIs, their EOs and ReIs in accordance with the provisions under SFO. However, the regulators are required to consult each other before exercising disciplinary power over an RI, an EO or an ReI.

[34] Please see the press release issued by HKMA on 4 June 2007 which is available on HKMA's website at http://www.hkma.gov.hk.

[35] Some persons/companies had more than one sanction imposed on them by SFC.

Notwithstanding their powers to impose sanctions on RIs under the relevant legislation, neither MA nor SFC has the power to order RIs to compensate customers even if investigation shows that their complaints against the RIs are substantiated[36]. The Subcommittee considers that such division of regulatory powers between MA and SFC is not conducive to effective regulation of RIs, especially in enforcement matters.

Need for review of the regulatory arrangement

3.35 As the current regulatory arrangement has been in place since April 2003, the Subcommittee is of the view that a review should have been conducted to ascertain whether it has been effective and whether any improvement is required to meet changing needs. According to the evidence of Mr Martin WHEATLEY, he wrote to Mr Henry TANG, then FS, in February 2006 stating his views on the viability of putting the securities business of banks under the same regulator as brokers. In the same paper, he reflected the views of some securities brokers that banks had been favourably treated by HKMA as bank employees had rarely been disciplined by HKMA in carrying out regulated activities. The brokers also felt that the regulatory field was tilted against them as their representatives were required to be licensed while ReIs were not. The broad conclusion in Mr WHEATLEY's paper was that quite a number of hurdles would need to be overcome before any change of the current structure could be considered. There is no further evidence available to the Subcommittee of any discernible work done to critically examine the regulatory arrangement.

3.36 The Subcommittee considers that FS and SFST, being the principal officials with policy responsibility in financial affairs, should have closely monitored the implementation of the regulatory arrangement

[36] The absence of statutory power on the part of the regulators to order payment of compensation is discussed in Chapter 6.

for banks' securities business, and taken the lead in initiating a comprehensive review in a timely manner. The differences in enforcement outcomes as described in paragraph 3.33 above and the views submitted by Mr Martin WHEATLEY in February 2006 should have alerted the Administration of the need for a critical examination of the existing system to identify and address issues of concern. This did not appear to have taken place until after the collapse of LB in September 2008 when FS asked HKMA and SFC to submit reports to him on their observations and lessons learned from their investigation into LB-related complaints.

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

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

Disclosure-cum-conduct regulation

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

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

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

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

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

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

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

First pillar - Authorization of product documentation by SFC

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

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

[4] Paragraph 5.2 of the Code of Conduct.

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

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

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

Public offer of investment products

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Investment products offered by private placement

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

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

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

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

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

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

Observations on the CO prospectus regime

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

Name of the product

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

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

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

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

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

Information disclosed to investors

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

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

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

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

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

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

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

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

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

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

Regulatory requirements and standards

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

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

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

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

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

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

(a) Know their clients;

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

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

(d) Provide all relevant material information to clients;

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

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

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

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

HKMA's supervisory activities on RIs

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

Circulars

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

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

On-site examinations

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

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

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

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

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

Other measures

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

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

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

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

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

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

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

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

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

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

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

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

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

Off-site surveillance

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

Enforcement

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

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

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

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

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

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

Observations on the regulation of conduct of RIs

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Chapter 5 Distribution of Lehman Brothers-related Minibonds and structured financial products by retail banks to their customers

Introduction

5.1 This chapter examines the distribution of LB-related Minibonds and structured financial products by retail banks, having regard to the regulatory standards set out in the Code of Conduct[1], Internal Control Guidelines[2], Suitability FAQ[3] and other relevant guidelines. In examining issues related to the distribution of LB structured products by banks, the Subcommittee is not tasked to look into individual complaints, nor to adjudicate on the liability of any person or institution. The Subcommittee has adopted a theme-based approach to analyze the evidence given by 55 witnesses from (i) the top/senior management of six selected banks; (ii) the frontline staff of selected branches of these six banks; and (iii) customers who had purchased LB structured products through these six banks[4]. It is not the intention of the Subcommittee to obtain evidence from the three groups of witnesses in relation to particular cases or transactions, or to verify details of individual cases and transactions with the evidence obtained. The purpose of the thematic analysis of the evidence is to understand the policies and practices implemented by retail banks in distributing LB structured products, and to find out what had transpired in the process of the sale of the products to customers. The Subcommittee has also made some observations on the thematic issues under study.

[1] Please see paragraph 3.10 of Chapter 3 and paragraphs 4.27 and 4.30 of Chapter 4 about the Code of Conduct.

[2] Please see paragraph 4.28 of Chapter 4 about the Internal Control Guidelines.

[3] Please see paragraph 3.10 of Chapter 3 and paragraphs 4.29 to 4.30 of Chapter 4 about the Suitability FAQ issued by SFC in May 2007.

[4] Please see paragraphs 1.16 to 1.25 of Chapter 1 about the Subcommittee's selection of the six banks and the relevant witnesses.

Overview of the distribution of LB structured products by the six banks

5.2 The Subcommittee has noted from the evidence given by the management of the six banks that they distributed LB structured products during different periods between 2002 and 2008. The period during which LB structured products were distributed by the six banks ranged from the shortest duration of about 15 months (March 2007 to June 2008) to the longest of some 67 months (July 2002 to February 2008). It is noted that LB structured products were most widely distributed by the six banks between August 2006 and June 2008.

5.3 As explained in Chapter 2[5], among the six banks, one was the major distributor of Minibonds[6] and another was the major distributor of LB-CLNs[7]. Minibonds and LB-CLNs were the LB structured products most widely distributed by public offer. The other four banks mainly distributed LB structured products (mostly LB-ELNs) by way of private placement, accounting for a substantial portion of the total investment in such products that remained outstanding at the collapse of LB in September 2008. Most of the LB structured products were first introduced to the banks by the Product Team of LB. Some banks[8] were first introduced to Minibonds by the co-ordinating distributor[9] of the product. As informed by the major distributor of LB-CLNs, the product was first introduced to it by the arranger of the product[10]. According to the six banks, it was usually the issuer or the arranger that decided whether the LB structured products in question were to be distributed in Hong Kong by way of public offer or private placement.

---

[5] Please see Appendix 2(c) of Chapter 2 about the major distributing banks of certain outstanding LB structured products.
[6] BOCHK, accounting for 43 % of the value of outstanding Minibonds sold by banks.
[7] DBSHK, accounting for 59 % of the value of outstanding LB-CLNs sold by banks.
[8] DSB and RBS.
[9] Please see paragraph 2.6 of Chapter 2.
[10] Please see paragraph 2.11 of Chapter 2.

5.4 In response to the Subcommittee, the reasons given by the six banks for deciding to distribute LB structured products included the following:

(a) LBHI was highly rated by credit-rating agencies (e.g. it was rated A1 by Moody's until July 2008, and rated A+ by Standard & Poor's until June 2008). LBHI was one of the key suppliers in structured financial products in the region. The arranger, LBAL, was a well-known and active arranger of structured financial products.

(b) Distributing LB structured products was in response to customers' interest and to provide greater choices to customers in terms of product types and issuers. Customers would have more options to meet their demand for higher yield products when the prevailing interest rates were low.

(c) In deciding to act as distributors of LB structured products, the potential increase to non-interest income was only one of the factors considered by the banks. For example, some banks indicated that during the period when LB structured products were distributed, such products only accounted for about 0.9% to 3.8% of the total sales value of the investment products distributed by them.

5.5 The Subcommittee has noted from the evidence of the management of the six banks that the major distributing bank for LB-CLNs[11] ceased distributing the product in September 2007, some 19 months after it first distributed the product in February 2006. Four other

[11] DBSHK.

banks[12] ceased distributing LB structured products between March to June 2008. These banks ceased offering LB structured products mainly because of market volatilities, the downgrading of LB's credit ratings and the internal policy to avoid over-concentration on distributing the structured financial products issued by a single issuer. The remaining bank[13], which first distributed LB structured products in June 2003, continued to distribute these products until early September 2008, and only ceased distribution after it became aware of a negative watch warning issued by a credit-rating agency against LBHI, which implied that the credit rating of LBHI might be further downgraded.

Product due diligence

Regulatory requirements

5.6 According to GP2 of the Code of Conduct, intermediaries should act with due skill, care and diligence and in the best interests of customers when conducting their business activities. As elaborated under Question 3 of the Suitability FAQ issued by SFC in May 2007, intermediaries should develop a thorough understanding of the structure of investment products, including how they work, the nature of the underlying investments, the level of risks they bear and the liquidity of the products. Other factors which intermediaries need to consider include market and industry risks, economic and political environments and any other factors which may impact on the risk-return profiles of the investments. Where necessary, intermediaries should make their own enquiries and obtain explanation from the issuers about the products instead of relying on prospectuses and marketing materials only. Intermediaries should document in which aspects the products are considered suitable for different risk categories of investors.

[12] BOCHK, CHKL, RBS and SCBHK.
[13] DSB.

Intermediaries should also ensure that product due diligence is conducted on a continuous basis having regard to the nature, features and risks of investment products.

Relevant evidence

Approval of LB structured products for distribution

5.7 The Subcommittee notes from the evidence of the top/senior management of the six banks that internal approval was required for the distribution of new products including LB structured products. Most of the six banks[14] approved the products on a series-by-series basis. According to a bank that had distributed LB-ELNs by private placement[15], the distribution of investment products (including LB-structured products) required approval by the group wealth management of its banking group, and each series of the same product was reviewed and approved. The major distributor of Minibonds[16] informed the Subcommittee that since October 2006, an investment product steering committee under the retail banking department of the bank has been responsible for approving each series of LB structured products. According to the major distributor of LB-CLNs[17], the decision to distribute LB-CLNs as a product type was made by a resolution of its board of directors while the subsequent decision to distribute each series of the product was made by the bank management. However, the Subcommittee notes that one of the banks[18] only required approval of the distribution of new product types by its senior management. Distribution of individual series of the same product did not require separate or further approval.

[14] BOCHK, CHKL, DBSHK, RBS and SCBHK.
[15] SCBHK.
[16] BOCHK.
[17] DBSHK.
[18] DSB.

Conducting due diligence on LB structured products

5.8 According to the evidence of the management of the six banks, product due diligence for LB structured products was conducted as part of a bank's internal approval process to distribute these products to customers. The matters reviewed by the six banks in the process of conducting product due diligence included the following:

(a) Product features – the product tenor, coupon payment and early redemption scenarios, percentage of capital protection and the guarantor, fees and charges on customers, secondary market, and where applicable the reference entities (and their credit ratings), underlying assets and collaterals.

(b) Risks to customers – market risk, credit risk, interest rate risk, currency risk, liquidity risk, re-investment risk if the notes were redeemed by the issuer before maturity, issuer risk, settlement risk if the issuer or counterparty fails to settle the notes, concentration risk[19], sovereign risk and foreign exchange risk.

(c) Suitability for customers – client base (e.g. institutional, corporate or retail customers), customers' age, location, net worth, investment objectives and horizon, investment experience, risk appetite and their understanding of the product.

(d) Risks to the bank – market risk, legal and compliance risk, operational risk, counterparty risk, reputational risk, systems risk, procedural or fraud risk arising from

[19] Customers may face a concentration risk if a large portion of their funds is invested in financial products of the same issuer. They may face the risk of losing their investment should that specific issuer default.

mis-selling, documentation risk, and the concentration risk to the bank.

(e) Financial considerations for the bank – market analysis, commission receivable, revenue and expense projections, diversification of liability base or asset portfolio of the bank, capital requirements (e.g. system enhancement), accounting and tax implications.

(f) Legal/regulatory implications on the bank – compliance with the local laws and regulations, cross-border regulatory requirements, disclosure/reporting obligations.

(g) Requirements on the issuer or the counterparty – its credit rating, ability to price and launch structured products in the market, and provision of suitable offer documentation. For instance, one of the six banks[20] required that a product issuer should have a credit rating equal to or better than single A (or equivalent) by Standard & Poor's or Moody's, whereas another bank[21] stipulated that its counterparties must have a minimum credit rating of A- by Standard & Poor's or A3 by Moody's.

Individual banks might have taken into account all or some of the above factors when reviewing LB structured products.

5.9 The procedures in performing product due diligence varied among the six banks. For instance, for the bank which distributed LB-ELNs and LB market-linked notes (MLNs) by private placement[22], new product types distributed by the bank had to undergo a product due diligence process at the global, regional and local levels. The regional

[20] DSB.
[21] BOCHK.
[22] CHKL.

and global product committees of the banking group would assess the commercial viability and risks of new product types and their suitability for distribution to retail customers. In addition, the local product team of the bank would prepare a product programme to address regulatory, business, risks and operational issues relating to the distribution of the product in Hong Kong. According to the management of another bank which distributed LB-CLNs[23], its local product team would work with the product experts from the banking group in undertaking product due diligence for new product types and new series of the LB-CLNs. According to the major distributor of Minibonds[24], its local product teams/committees comprising qualified staff with extensive relevant market experience conducted product due diligence in accordance with the bank's product due diligence guidelines. This bank also informed the Subcommittee that its teams/committees would make enquiries with the product issuer/arranger/co-ordinating dealer or obtain information from independent sources to help evaluate the product structure and features.

5.10 The Subcommittee has examined some of the papers documenting the product due diligence conducted on LB structured products. It is noted that in seeking approval to distribute Minibonds Series 27, the product team of one bank[25] prepared a four-page summary in Chinese giving a very short description of the features and six major risks of the product. The summary also contained a statement that the product was not suitable for investors with low or medium risk tolerance levels and elderly or inexperienced investors. It also mentioned briefly the marketing strategy and the preparation of a VCD by the training centre of the bank. The product team of another bank which distributed LB-ELNs and LB-MLNs[26] prepared a 41-page product programme for seeking approval on the distribution of structured notes (which included

[23] DBSHK.
[24] BOCHK.
[25] BOCHK.
[26] CHKL.

LB structured products). The product programme gave an analysis of eight types of risks associated with structured notes to the customers and 12 types of risks to the bank. The Subcommittee has noted that one bank[27] had included only "liquidity risk" under the heading of "Product Risks to the Customer" in its product approval plan when reviewing and seeking approval to distribute a non-principal-protected LB-ELN.

Risk ratings of LB structured products

5.11 According to the evidence of the six banks, each of them had their own methodology for assigning risk ratings to investment products, including LB structured products. The practices and procedures were documented. In this connection, the Subcommittee notes that one of the banks[28] did not introduce a formal risk rating to the LB structured products it offered until August 2004, which was some two years after it first distributed LB structured products. Another bank[29] had distributed LB structured products since June 2003 but there was no quantitative risk classification for these products until October 2007.

5.12 The risk ratings adopted by the six banks ranged from three to seven tiers. For instance, one of the banks[30] adopted a three-tier scale to categorize the risks of its products as "Conservative", "Balanced" or "Growth". Another bank[31] classified its investment products into seven risk categories from "A" (lowest risk) to "F" (highest risk) and "P" for products with principal-protection at maturity. Some of the factors considered by the six banks in risk-rating investment products included the level and quality of principal protection of the product at maturity, the tenor of the product, and the quality of the underlying assets.

[27] DSB.
[28] BOCHK.
[29] DSB.
[30] RBS.
[31] SCBHK.

5.13 The Subcommittee notes that five of the six banks[32] had assigned a high-risk rating to non-principal-protected LB structured products such as Minibonds and LB-ELNs, taking into account their non-protection of principal, exposure to liquidity and credit risks, and where applicable, collateral asset risks, and volatility of the underlying stocks etc. It is noted that one bank[33] had assigned a "Level-2" rating (low to medium risk) to non-principal-protected LB-CLNs on its 5-level risk rating scale. The reasons as stated by the bank management were that the reference entities and collateral of the notes were all of high credit quality at the time of issue and the product risk was considered similar to the risk of a conventional corporate bond of investment grade. This bank had produced an expert opinion in support of its "Level-2" risk rating of the LB-CLNs[34]. However, it is noted that the same product distributed by another bank[35] was assigned a "Grade-4" risk rating, the highest on the bank's 4-grade risk rating scale.

Continuous assessment

5.14 As stated by the management of two of the six banks[36], they had conducted continuous assessment of the LB structured products by reviewing their mark-to-market prices or indicative bid prices, and reviewing the credit quality of the reference entities and collaterals or the credit rating of the product issuer. One other bank[37] however stated that it did not consider it necessary to undertake periodic product evaluation review for LB-ELNs as they were close-ended products with fixed tenors.

5.15 The Subcommittee notes that five of the six banks[38] had ceased distribution of LB structured products in or before June 2008.

[32] BOCHK, CHKL, DSB, RBS and SCBHK.
[33] DBSHK.
[34] The report of the expert opinion was dated 20 January 2010.
[35] BOCHK.
[36] CHKL and DBSHK.
[37] SCBHK.
[38] BOCHK, CHKL, DBSHK, RBS and SCBHK.

The remaining bank[39] had continued to distribute LB structured products until a negative watch warning was issued by Standard & Poor's against LBHI on or about 10 September 2008. When asked by the Subcommittee on the reasons for continuing to distribute LB structured products after June 2008, the top/senior management of this bank responded that this was because LBHI could still meet the bank's minimum requirement on the credit rating of an issuer.

5.16 Upon being asked by the Subcommittee whether they had alerted customers of LB structured products about LB's worsening financial situation in about mid 2008, the management of two of the six banks[40] said that information relating to the downgrading of LBHI's credit rating was already available in the public domain and reported by the media. According to most of the six banks[41], they had provided updates on the mark-to-market or indicative bid prices of the LB structured products, which could reflect the market value of these products, via monthly statements to the customers or on the websites of the banks. One of these banks[42] stated that upon receipt of information from the arranger about the change in the credit rating of collaterals for certain series of LB-CLNs, it had issued a notice to the relevant customers.

5.17 As stated by the six banks, before the collapse of LB, they had received and executed requests from their customers from time to time to dispose of the LB structured products before maturity. According to two of the banks[43], in response to such requests, they would quote the indicative bid price to customers for their consideration. One of the six banks[44] testified that out of the 604 requests for early redemption of Minibonds during the period from May 2003 to mid September 2008, it

[39] DSB.
[40] CHKL and SCBHK.
[41] BOCHK, CHKL, DBSHK, RBS and SCBHK.
[42] DBSHK.
[43] SCBHK and RBS.
[44] BOCHK.

had executed 595 such requests. The exit prices for different series of the Minibonds varied over time and most of them exceeded two-thirds of the original investment amount. Another bank[45] received and executed two requests for unwinding LB-ELNs in August and September 2008 at an exit price of about 77% of the principal.

Observations

5.18 The Subcommittee has found that all the six banks had put in place policies and procedures for conducting due diligence on LB structured products, and this was often done in connection with the seeking of approval to distribute the products. The practices and methodology of conducting the due diligence exercise, as well as the thoroughness of such exercise, varied among the six banks.

5.19 As it was often the case that product due diligence had been done by the six banks as part of its process of seeking approval to distribute the LB structured products, the Subcommittee has found from the relevant documentation that in reviewing the LB structured products, the banks had analyzed the risks, as well as the costs and benefits to the banks as a result of their distribution of such products. However, as described in paragraph 5.10 above, the documents examined by the Subcommittee did not clearly show in which aspects the products were considered suitable for different risk categories of investors, as required under the Suitability FAQ.

5.20 One of the banks[46] stated in the approval document for the distribution of Minibonds Series 27 that the product was not suitable for investors with low or medium risk tolerance levels and elderly or inexperienced investors. However, this statement was not found in the approval documents for some other series of the Minibonds[47] offered by

[45] SCBHK.
[46] BOCHK.
[47] Minibonds Series 9 to 12, 15 to 23 and 30 to 33.

this bank. In this connection, the Subcommittee notes that among the customers purchasing Minibonds from this bank, about 15% of them were aged 65 or above.

5.21 The Subcommittee has noted that it was up to individual banks to assign risk ratings to LB structured products after performing their own product due diligence. However, as described in paragraph 5.13 above, it is difficult to justify the different ratings of the same non-principal-protected LB-CLNs by different banks. The Subcommittee is of the view that LB-CLNs, which were non-principal-protected and linked to underlying assets, should not be rated as a product of low or medium risk. Inconsistency in risk rating by different banks of the same products would disadvantage investors in that an investor with a relatively conservative risk tolerance level might not be able to acquire the LB-CLN at one bank, but could do so at another bank which had set a lower risk rating on the same product. This undermined the effectiveness of product risk rating as an aid in determining the suitability of a product for investors, and weakened suitability assessment as a cornerstone of investor protection. Given the importance of product risk rating as an important link in investor protection, the Subcommittee is of the view that the regulators should consider introducing some form of benchmarking to achieve broad consistency.

5.22 As described in paragraph 5.6 above, intermediaries are required under the Suitability FAQ to conduct product due diligence on a continuous basis. Hence, the Subcommittee considers that distributing banks should perform product due diligence in respect of each series of a product because there could be considerable variation in product structure and risks between individual series, such as the different series of Minibonds issued after 2002 and before 15 September 2008[48]. As changes in market conditions might have a significant impact on various

[48] Please see paragraphs 2.7 to 2.10 of Chapter 2 about the product structure and risks of Minibonds.

investment products, banks should perform continuous review of the risk ratings assigned to the products offered to customers, and where appropriate, take action to inform the affected customers[49].

Staff training and guidance

Regulatory requirements

5.23 As stipulated in Section III of the Internal Control Guidelines, intermediaries should establish appropriate personnel recruitment and training policies to ensure that their staff are fit and proper to perform the relevant duties and comply with the applicable regulatory requirements. The sales staff should be provided with adequate training to, amongst others, enable them to properly understand the products that may be sold to customers and to assess the suitability of the products for the customers. The management of intermediaries should also ensure that suitable training is provided both initially and on an ongoing basis.

5.24 As stipulated in the Guidelines on Competence issued by SFC in March 2003, the minimum academic and industry qualifications of an ReI are passes in English/Chinese and Mathematics in the Hong Kong Certificate of Education Examination or its equivalent, and a pass in one of the recognized industry qualifications[50]. These qualifications can be compensated by a university degree or other internationally recognized

[49] According to the letter issued by HKMA to a number of RIs on 23 October 2008 after the collapse of LB, RIs should perform continuous review of the risk ratings assigned to investment products offered to customers. Where a higher risk rating is assigned to an investment product as a result of the review, the RIs should, as a matter of good practice, take appropriate action to alert the affected customers to such changes in a timely manner. This letter was brought to the attention of other RIs as an enclosure to a circular issued by HKMA on 11 December 2008. The circular is available on HKMA's website at http://www.hkma.gov.hk.

[50] The recognized industry qualification requirements vary with the types of regulated activities. According to Appendix C of the Guidelines on Competence issued by SFC in March 2003, for example, for Type 1 regulated activity, an ReI should pass one of the following examinations of the Hong Kong Securities Institute (HKSI): Diploma Programme Examination (DPE) Papers 1 and 3, Licensing Examination (LE) for Securities and Futures Intermediaries Papers 7 and 8, or Foundation Programme Examination (FPE) Paper 2.

professional qualifications in the specified fields (e.g. law, accounting or finance) or by the specified duration of relevant industry experience. In addition, an ReI is required to pass one of the recognized local regulatory framework papers[51].

Relevant evidence

5.25 As testified by the management of the six banks, all their sales staff engaged in the sale of investment products, including LB structured products, were ReIs registered with HKMA. At the time of giving evidence, all the investment consultants (ICs) and sales staff[52] (usually RMs) who had testified to the Subcommittee were ReIs qualified to undertake Type 1 regulated activity (dealing in securities). The majority of them were also qualified to undertake Type 4 regulated activity (advising on securities).

Product-specific training

5.26 According to the management of the six banks, it was mandatory for sales staff to attend both general and product-specific training. Information on LB structured products was provided to sales staff through product-specific training arranged by the product team or other designated teams of the banks and/or ICs whose responsibilities included the provision of training and coaching. All the six banks indicated that they would invite the issuer/arranger/co-ordinating distributor of the LB structured products to conduct initial training sessions on the new product type/structures to the ICs and/or the sales

[51] The local regulatory framework paper required to be passed by an ReI varies with the types of regulated activities. According to Appendix C of the Guidelines on Competence issued by SFC in March 2003, for example, for Type 1 regulated activity, an ReI has to pass one of the following HKSI examinations: DPE Paper 2, FPE Paper 1, LE Paper 1 or Financial Market Principal Programme Examination Paper 1.

[52] The titles of the sales staff who were directly involved in the sale of LB structured products and who had testified to the Subcommittee varied among the six banks (e.g. relationship manager, customer services manager). Their job responsibilities included the sale of banking products and services, providing customer services, building relationship with customers and answering their enquiries.

staff. One of the banks[53] stated that it adopted a "train-the-trainer" approach. Its product managers and representatives of the product provider would first brief the ICs on new product structures. The ICs would then conduct face-to-face training and ongoing coaching for the sales staff.

5.27 As testified by the management of one of the six banks[54], it had organized product-specific training in the form of workshops when an LB structured product and each subsequent series was launched. After attending the workshops, the sales staff had to complete and pass a quiz before they were allowed to conduct the sale of LB structured products to customers. For instance, the quiz used by this bank for Minibonds Series 35 comprised 10 multiple-choice questions covering the basic aspects of the offering of the product, such as the tenor, coupon payment, offer period, the reference entities and their credit ratings. None of the questions was related to the risks of the Minibonds series in question. According to this bank, it would also assess the sales staff's knowledge of the LB structured product by way of role-playing. Nevertheless, as the Subcommittee has noted in paragraph 5.10 above, according to what was proposed in the document seeking approval for distribution of Minibonds Series 27, the training to be arranged for the sales staff was the preparation of a VCD by the training centre of this bank.

5.28 The Subcommittee notes from the evidence of the management of most other banks[55] that they conducted product-specific training sessions mainly in respect of new product types. For subsequent series of the product, the banks provided product information on the specific series to the sales staff through briefings at the regular branch or district-level meetings and/or through emails before each series was launched. For instance, according to the bank which distributed

[53] SCBHK.
[54] BOCHK.
[55] CHKL, DBSHK, DSB, RBS and SCBHK.

LB-CLNs[56], the initial training covered the structure and risk factors of CLNs. There were interactive modules at the end of these sessions in which sales staff were encouraged to ask questions. After the sessions, sales staff were required to complete a quiz to assess their understanding of the product. According to the specimen provided by the bank to the Subcommittee, the quiz consisted of seven questions on a few aspects of the nature of LB-CLNs and on "credit event". Each time a new series of LB-CLNs was launched, the bank would disseminate the series-specific information to the sales staff through interactive briefings, and provided them with sales aid materials[57], prospectuses and marketing materials (where applicable).

5.29 In this connection, the Subcommittee has noted that one of the six banks[58] had launched eight series of an LB-ELN (sold by private placement) from 14 to 26 August 2008. When asked by the Subcommittee whether the sales staff had been given adequate training within such a short time to enable them to understand the products, the management of this bank responded that as the eight series of the LB-ELN in question were similar in nature and features, the training arranged before the launch of each series and the relevant product information (e.g. product termsheets) that had been provided to sales staff by "launch email" was considered adequate. It is noted that in the same period, the sales staff had to sell other financial and investment products in addition to LB structured products.

5.30 Most of the RMs who had testified to the Subcommittee confirmed that they had received product-specific training in relation to LB structured products. Some RMs informed the Subcommittee that the training provided by their banks focused on new product type/asset class (e.g. ELNs) or new product structure and was not issuer-specific.

[56] DBSHK.

[57] According to the bank, the sales aid materials included a summary fact sheet and FAQs about the key features of the product, sales scripts, and sales kits prepared by the product arranger which contained an in-depth explanation of the key features and risks of the product.

[58] DSB.

Briefings for each series of an LB structured product were usually arranged a few days or a week prior to product launch, and focused on the main differences between the new series and earlier series of the same structures. Some RMs indicated that the briefing sessions organized by their banks provided an interactive forum for them to ask questions about the products. According to two ICs, one-on-one training sessions or "sales clinics" would be organized upon request by the sales staff or for the less experienced sales staff nominated by the BMs.

5.31 In reply to the Subcommittee, the RMs were able to explain the structure and risks of Minibonds. When asked by the Subcommittee about the possible impact if a credit event occurred to one or more of the reference entities in Minibonds, one RM showed a correct understanding of the "first-to-default" nature of such products. Another RM also indicated that the extent of investment loss was not pro-rata to the number of defaulting reference entities.

Training materials for LB structured products

5.32 The management of the six banks and some ICs testified to the Subcommittee that the training materials usually comprised materials prepared by the issuer/arranger/co-ordinating distributor such as the offer documentation, powerpoint presentations, marketing and sales aid materials. According to the management of five of the six banks[59], the training materials were reviewed by their product teams or other designated teams of the banks in consultation with their legal/compliance teams. The management of the other bank[60] said that the bank did not vet the training materials received from the issuer and arranger.

[59] BOCHK, CHKL, DBSHK, DSB and SCBHK.
[60] RBS.

5.33 Two of the six banks[61] had made available copies of the training materials on Minibonds. According to their management, these training materials produced by them were prepared and supplied to them by the co-ordinating distributor of the product (as so specified in the training materials). The Subcommittee has noted that in these training materials, Minibonds was described as a product "authorized by SFC" (產品"得到證監會認可") or "authorized by SFC for offer to ordinary investors" (產品"得到證監會認可，向普遍投資者銷售"). However, as explained in Chapter 4, SFC only authorized the Minibonds documentation for registration under CO, not the product itself or its suitability for offer to any investors.

5.34 The Subcommittee has asked some witnesses from the management of the three banks[62] that had distributed Minibonds by public offer how they had understood the expression "SFC authorization" in relation to Minibonds. The Subcommittee has found that not all of them had precisely replied that SFC authorized only the product documentation but not the product. Some of them said that according to their understanding, for products such as Minibonds which were sold by public offer, SFC authorized the product for distribution to the public as well as its offer documentation. The Subcommittee also asked the sales and training staff of these banks about their understanding of the expression "SFC authorization" in relation to Minibonds. While some RMs had shown a correct understanding of SFC's role in authorizing product documentation only, the replies given by the other witnesses were:

(a) the product was authorized by SFC for offer to the public;

(b) the product had been reviewed by SFC;

[61] BOCHK and RBS.
[62] BOCHK, DSB and RBS.

(c) the accuracy of the contents of the marketing materials and prospectuses of the product had been verified by SFC; and

(d) the product issuer had fulfilled certain requirements stipulated by SFC in terms of its capital, financial reporting and the product structures.

General training

5.35 As testified by the management of the six banks, the general training provided to their sales staff focused on generic market and product knowledge, regulatory and compliance requirements (such as the Code of Conduct, KYC requirements, suitability obligations) applicable to the sale of investment products. Such training was provided in the form of induction training for new staff, E-learning training modules, compliance-related briefings, tutorials, workshops and seminars, issuance of circulars/newsletters to sales staff on compliance matters. The six banks also provided the sales staff with manuals and guidelines on conducting regulated activities. The RMs who had testified to the Subcommittee indicated that they had received training on regulatory and compliance matters. Most of the RMs also recalled that their management had drawn their attention to the Suitability FAQ issued by SFC.

5.36 Some of the ICs who had testified to the Subcommittee indicated that it was part of their responsibilities to provide market updates to sales staff. As to whether the sales staff had been briefed on the market volatilities in 2008 including the deteriorating financial position of LB, one IC stated that in early 2008, the product team of the bank had invited LB representatives to attend a meeting with the ICs to report on LB's financial status. The report from LB then was still positive and this was shared with the sales staff in the weekly briefings at

the branch. Another IC stated that most of his information about LB's deteriorating financial condition came from the media. One of the ICs indicated that he had not received any instruction requiring him to inform the sales staff about LB's worsening financial position.

Observations

5.37 The Subcommittee considers that the minimum academic qualification to be met for ReIs stated in paragraph 5.24 above is inadequate in the face of financial innovation, given that ReIs need to understand and explain the features and risks of products properly to prospective investors. The Subcommittee takes the view that the regulators should consider raising the minimum academic qualification of ReIs.

5.38 There is no doubt that continuous on-the-job training and coaching is important for ReIs to maintain their competence. The Subcommittee notes that all the six banks had made arrangement to provide general and product-specific training to their sales staff regarding the sale of investment products (including LB structured products) and the relevant regulatory requirements. The Subcommittee however is concerned about the quality of the training provided. For instance, as consecutive series of Minibonds varied considerably in design and structure, it would not suffice to conduct one-off training on the product type. Series-specific training should be provided to enable the sales staff to understand the features and risks specific to each Minibonds series. Where a post-training quiz was used as one of the tools to test the understanding of the sales staff on LB structured products, the Subcommittee considers that the questions stated in the quiz should give sufficient coverage to the structure of the products and the various risks involved.

5.39 The Subcommittee considers that the descriptions of Minibonds as a product "authorized by SFC" or "authorized by SFC for offer to ordinary investors" (as appeared in the training materials submitted to the Subcommittee by the management of some of the six banks[63]) were misleading, as SFC did not approve Minibonds or its suitability for offer to any investors. Having considered the evidence of the witnesses from the banks which had distributed Minibonds by public offer as summarized in paragraph 5.34 above, the Subcommittee is of the view that some of the staff did not have a correct understanding of the expression "SFC authorization". In particular, the Subcommittee is concerned that as some of the sales staff could not give an accurate explanation on the nature of "SFC authorization", they could have conveyed incorrect information to their customers. Individual sales staff might think that Minibonds, having been authorized by the regulator, was a sound and safe product. They could become less concerned about the inherent risks of the product and the need to ensure suitability for individual customers. The customers in turn might have decided to acquire the Minibonds on the wrong understanding that it was a product authorized by SFC.

5.40 The Subcommittee considers it incumbent upon banks to ensure that the contents of the training materials used by their staff were accurate and presented a balanced view of the features, risks and returns of the investment product, as the information was likely relied upon by the sales staff in understanding the products. Banks should not solely rely on the training materials provided by an external party (i.e. the issuer, arranger or co-ordinating distributor). To fulfil their obligation as intermediaries, banks should conduct their own independent scrutiny or reviews of such materials to ensure that they were in order.

[63] BOCHK and RBS.

"Know your client" requirements

Regulatory requirements

5.41 GP4 and Paragraph 5.1 of the Code of Conduct require intermediaries to seek adequate information from their customers about their financial situation, investment experience and objectives relevant to the services to be provided. Where derivative products are involved, Paragraph 5.3 of the Code requires intermediaries to ensure, amongst others, that their customers have sufficient net worth to be able to assume the risks and bear the potential losses of trading in the products. As stipulated under Question 2 of the Suitability FAQ, the information collected from customers should be fully documented and updated by the intermediaries on a continuous basis.

Relevant evidence

Seeking information from customers

5.42 The Subcommittee notes that according to the management of each of the six banks, in addition to obtaining the customers' general information at the time of account opening, the banks also required their staff to seek from their customers information about the latter's financial situation, investment knowledge, investment horizon, risk tolerance etc. All the banks had special handling procedures for obtaining information from customers aged 65 or above in the KYC process.

5.43 According to the branch operational manual of one bank[64], if a customer approached the bank and showed interest in its wealth management services, the relevant staff must check the customer's age, net worth and risk assessment record, if any, in the bank's system. The manual also set out the workflow of risk assessment and financial

[64] DSB.

analysis, and the scoring methodology for asset allocation portfolio and product matching. There were also separate guidelines for collecting additional information (e.g. more detailed information on the customer's net worth and investment horizon) from customers aged 65 or above and other vulnerable customers. Another bank[65] required its sales staff to collect information from the customers through a personal investment analysis, as part of the account opening process. The sales staff were also required to confirm with the customers if there were subsequent changes in their personal particulars. On handling customers aged 65 or above, there were separate guidelines requiring the responsible staff to ascertain, amongst others, the customers' physical and mental conditions and their English literacy through interview before opening an investment account for them.

5.44 The Subcommittee also notes that some of the six banks[66] provided checklists for the sales staff to follow when seeking or confirming information from/with the customers. All the six banks informed the Subcommittee that they provided compliance training to their sales staff, which included KYC requirements. The management of one of the six banks[67] indicated that sales staff who had served the bank's customers for a long period of time would be familiar with the latter's financial needs and circumstances.

5.45 The Subcommittee had asked some of the RMs how they had collected information from their customers to understand their investment needs. In reply, they indicated that they had acted in accordance with the relevant policies and practices on the KYC requirements. For instance, one of the RMs said that when a customer indicated interest in certain LB structured products, she would first check the customer's risk profiling records, if any, or whether the customer had experience in investing in the same product. Another RM told the Subcommittee that

[65] RBS.
[66] BOCHK, DSB and RBS.
[67] CHKL.

he would also gather information on the customers' personal circumstances, such as their occupations and investment preferences, through his ongoing contacts with them.

Profiles of some investors of LB structured products

5.46 Most of the investors who had testified to the Subcommittee stated that they had been customers of the banks (which sold them the LB structured products) for a long time ranging from five to 50 years. Most of them indicated that they trusted the banks and the staff serving them. Some of them said that they had received very little education or were illiterate, and had no regular income. They also had no knowledge about LB or the LB structured products they had purchased. Nevertheless, they had been sold various LB structured products. For instance, one of these investors was a housewife without any formal education or investment experience in any equity or credit-linked notes. As she was over 65 years of age when she purchased Minibonds Series 35, she had expressed concern to the bank staff handling her transaction that the three-year tenor of the product was considerably longer than the term of fixed deposits she used to place. She ended up investing nearly half of her available funds in Minibonds Series 35. Another investor said that he had told his RM that he would rely on the regular interest income from the investment to support his retirement life and had expressed concern about the possibility of investment loss. He ended up using 60% of his funds to purchase a non-principal-protected LB-ELN.

Observations

5.47 The Subcommittee notes that as some investors had been long-time customers of the six banks, their RMs should have no difficulty in knowing the personal circumstances and financial needs of their customers through the information obtained from the latter at the time of account opening and subsequent ongoing contacts. However, having

regard to the profile of investors described in paragraph 5.46 above, the Subcommittee has doubt on whether the banks had properly taken into account the relevant information (e.g. age, financial needs) of these customers when introducing LB structured products to them. The Subcommittee considers that the guidelines and procedures put in place by the banks might not have ensured that their staff fulfilled their KYC obligations in all cases.

Suitability assessment

Regulatory requirements

5.48 GP2 of the Code of Conduct requires that intermediaries should act in the best interests of the customers. As required under Paragraph 5.2 of the Code of Conduct, intermediaries should ensure the suitability of the recommendation or solicitation they make for the customer is reasonable in all the circumstances. In dealing with derivative products, Paragraph 5.3 requires intermediaries to ensure, amongst others, that the clients understand the nature and risks of the products. According to the guidance given under Question 1 of the Suitability FAQ, intermediaries should provide reasonably suitable recommendations to customers by matching the risk return profile of each investment product with the personal circumstances of the customers. Intermediaries are also reminded under Question 4 of the Suitability FAQ to take extra care in handling elderly or unsophisticated customers who are likely to rely on them for investment advice.

Relevant evidence

Risk/investment profiling of customers

5.49 According to the evidence of the six banks, when a customer intended to subscribe for any LB structured product, the handling RM must first ensure that the customer had a valid risk/investment profiling[68]. Risk profiling was usually conducted by way of a questionnaire which included questions on the customers' age, income, investment experience, risk appetite and investment horizon. Based on the result of the risk profiling, the customer's risk tolerance level would be established and he could subscribe for investment products whose risk ratings were commensurate with his risk tolerance level. The risk tolerance levels of customers ranged from the most conservative tier to the highest risk-taking tier. For instance, one bank[69] classified its customers into six risk tolerance levels according to the result of the risk profiling exercise: "Level 1" (Risk averse), "Level 2" (Income), "Level 3" (Conservative), "Level 4" (Balanced), "Level 5" (Growth) and "Level 6" (Enhanced growth). Another bank[70] classified customers into three tiers of risk tolerance, i.e. "Conservative", "Balanced" and "Growth". The Subcommittee notes that instead of ascribing a risk tolerance level to individual customers, one of the six banks[71] asked its customers to indicate, during the investment profiling exercise, their risk tolerance level in terms of a percentage of investment loss[72] they could bear in an investment year. Based on the results of the questionnaire, a list of investment products at the asset class level would be generated for the customers' reference.

[68] For each of the six banks, the risk/investment profiling for individual customers was valid for 12 months. If, at the time of product subscription, 12 months or more had passed since the last risk profiling, a fresh risk profiling had to be conducted on the customer.

[69] CHKL.

[70] RBS.

[71] SCBHK.

[72] The options of the percentage of investment loss provided in the investment profiling questionnaire were "about 2%", "about 5%", "about 8%", "about 10%", "about 13%" and "about 15% or worse".

5.50 Each of the six banks had their own standardized risk/investment profiling questionnaire for assessing customers' risk tolerance levels or financial profiles. The Subcommittee notes that one of the banks [73] additionally required customers to complete a product-specific suitability questionnaire with the RM's guidance when they intended to purchase an investment product. For example, the product-specific suitability questionnaire used by this bank for Minibonds Series 35 contained 17 questions to seek the customer's confirmation that he had understood the product structure and was willing to accept the various risks associated with the notes including the credit risks of the reference entities and other risk factors listed in the prospectus. If the customer's response to any of the questions was in the negative, the subscription process should not continue. According to an RM who had testified to the Subcommittee, one of his customers had decided not to purchase an LB structured product after responding to some questions in the product-specific questionnaire which alerted the customer of the non-principal-protected nature of the product.

Suitability of LB structured products for investors

5.51 According to the relevant prospectuses and termsheets, LB structured products such as Minibonds and LB-ELNs were not suitable for everyone and were not suitable for inexperienced investors. Investors of these products should ensure that they understood the nature of and the risks associated with these products. They should be willing to accept the risk that they might lose their investment as the notes were not principal-protected. They should also consider whether the products were suitable for themselves in the light of their investment experience, objectives, financial position and other relevant circumstances[74].

[73] RBS.
[74] Please see paragraph 2.17 of Chapter 2.

5.52 The Subcommittee notes that some investors of Minibonds and LB-ELNs who had given evidence were retirees or housewives with little or no formal education. They had not invested in ELNs or credit-linked notes before. What they were looking for was safe and principal-protected investments that could bring them a stable level of interest income which was more favourable than the prevailing interest rates on time deposits. These investors indicated that they could neither understand nor accept investment risks. Without earnings, these investors had used their savings to purchase the LB structured products in question. Some of them stated that they relied on the interest from their investments to pay their medical and other expenses.

5.53 The Subcommittee is aware that some persons may be regarded as capable of taking on investment risks and having sufficient net worth to bear investment losses. However, such persons may not necessarily be willing to assume such investment risks. For instance, the personal profile of one of the investors was that she was of secondary education level, about 40 years of age, in employment with stable income and of relatively high net worth. She told the Subcommittee that she was resistant to investment in equities, bonds, investment funds, not to mention any structured financial products. However, she purchased an LB-ELN as she had been assessed as suitable to invest in such product.

5.54 The Subcommittee has also noted that there were circumstances that rendered suitability assessment all the more important at the point of sale. An example was the change introduced by one of the six banks[75] in around August 2008 to adopt the so-called "50-person" exemption[76] so that each series of LB-ELN would be offered to not more than 50 investors. This was different from the practice adopted by two

[75] DSB.

[76] This was one of the "safe harbour" provisions in the Seventeenth Schedule to CO in respect of the offer of financial products by private placement. Please refer to paragraph 4.16 of Chapter 4 for further details.

other banks[77] which adopted only the "minimum subscription of HK$500,000" exemption in offering LB-ELNs through private placement. The Subcommittee notes that as a result, the bank in question lowered the minimum subscription amount to HK$100,000 for each transaction. As revealed in the internal document seeking approval, there were comments made by certain senior staff of the bank that lowering the minimum subscription amount could enlarge the customer base that might include inexperienced investors. It was pointed out that training and additional guidelines should be provided to the sales staff on suitability assessment so as to avoid the risk of mis-selling. According to the bank management, prior to the distribution of the LB-ELNs in question, it had organized specific training to the sales staff on the features and risks of the product and on the relevant sales procedures, including checking with the customers whether they had previous investment experience in ELNs or equity-linked deposits. Sales staff were also required to follow the bank's guidelines for conducting customer risk profiling.

Conducting risk profiling on customers

5.55 The evidence given by the top/senior management of the six banks showed that these banks had put in place guidelines on how risk/investment profiling should be conducted. These guidelines included designating the staff for conducting risk profiling on customers, the forms to be used, the steps for completing the relevant risk/investment profiling form, and/or the chart for matching the product type with the customer's risk profile, etc. The guidelines issued by some of the banks[78] explicitly required the sales staff to explain the purpose of the risk profiling exercise, go through all the questions in the questionnaire with the customer and inform the customer about the results of the risk profiling. When testifying to the Subcommittee, the RMs stated that

[77] CHKL and SCBHK.
[78] BOCHK, DSB and RBS.

they had conducted the requisite risk profiling on their customers before selling the LB structured products to them.

5.56 Most of the investors giving evidence to the Subcommittee said that they were not aware of any risk/investment profiling being conducted on them by the RMs handling their transactions. Some investors recalled that a questionnaire was completed by the bank staff without seeking their answers to the questions and telling them that the risk/investment profiling was merely a formality. One investor recalled having answered a few questions put by the bank staff, but did not have sight of the completed questionnaire which the bank staff processed on the computer. Another investor told the Subcommittee that the risk profiling questionnaire was conducted after the transaction. Almost all the investors who had testified to the Subcommittee indicated that they had not been advised by the bank staff of their risk tolerance level before the transactions were completed. Some of these investors, who had obtained a hardcopy of the risk/investment profiling questionnaire after the collapse of LB, said that certain information filled in by the bank staff (e.g. age, investment experience, acceptable level of capital loss) was factually incorrect.

Risk mismatch

5.57 The Subcommittee notes that according to the management of the six banks, each bank had its own policies and measures for dealing with risk mismatch cases, i.e. transactions in which the risk rating of an investment product exceeded the customer's risk tolerance level. Sales staff were required to advise customers if the relevant products were not suitable for them based on the results of suitability assessment. If the customers insisted on subscribing for the product of risk mismatch, additional safeguards were implemented to ensure that the customers understood the product risks. The banks usually required the customers to sign a certain declaration form to the effect that they decided to make

the investment despite being informed of the risk mismatch. Most of the six banks[79] would require the additional approval of a more senior officer for the mismatched transaction. One of the banks[80] did not permit a transaction if the mismatch between the product risk and the customer risk profile exceeded two levels. For example, customers with a risk tolerance level "1" could not purchase investment products with a risk level "4".

"Golden age customers"

5.58 According to the evidence of the management and frontline staff of the six banks, additional steps were taken in handling "golden age customers" (i.e. customers of 65 years of age or above). These included the requirements of conducting additional suitability assessment, arranging a second ReI and/or inviting the customer to bring along a family member to witness the transaction. One of the banks[81] explicitly instructed its sales staff to pay due regard that products with long tenor were not suitable for "golden age customers" having regard to their liquidity needs. When taking evidence from investors, the Subcommittee tried to find out how transactions involving "golden age customers" had been handled. As stated by those investors who were over 65 years of age at the time of their purchase of the LB structured products, the bank staff who handled their transactions had not taken or arranged to take the abovementioned additional steps in the sales process.

Observations

5.59 The Subcommittee has found that the evidence given by the management and frontline staff of the six banks and the testimonies of the investors differed considerably on whether and how suitability assessment had been conducted in practice. On the one hand, the

[79] CHKL, DBSHK, RBS and SCBHK.
[80] DSB.
[81] BOCHK.

Subcommittee has noted from the oral and written evidence of the six banks and their staff that policies and procedures were in place for conducting suitability assessment on customers. On the other hand, members have found that many of the investors who had appeared before the Subcommittee should not have been sold LB structured products. The Subcommittee has found it hard to justify why these investors could have been assessed as suitable for purchasing such products. It does not appear that the intermediaries had fulfilled their obligations to ascertain that the LB structured products were suitable for these customers. Given the importance of suitability assessment in investor protection, the Subcommittee considers that further safeguards should be put in place to ensure that suitability assessment will be conducted properly in all transactions.

5.60 In view of the divergence in the evidence given by the banks and by the investors as stated in paragraphs 5.55, 5.56 and 5.58 above, the Subcommittee is concerned that despite the documented guidelines and procedures of the banks, the relevant requirements might not have been properly followed by individual sales staff in all cases. This was also indicative of a lack of effective internal controls and supervision on the part of the management of some banks to ensure proper compliance by frontline staff.

5.61 As noted in paragraph 5.54 above, the senior management of the bank[82] in question was concerned about the strong need for proper suitability assessment in anticipation of an enlarged customer base following the bank's adoption of the "50-person" exemption in offering LB-ELNs at a lower minimum subscription amount. The bank had also implemented certain measures to provide additional guidance and training to its sales staff. However, the critical question is whether the steps taken by the senior management had been effectively implemented so that their valid concerns about proper suitability assessment had been

[82] DSB.

communicated to and followed up by frontline staff. The Subcommittee is concerned that if conflict occurred between securing additional customers for selling LB structured products on the one hand, and strict adherence to all necessary requirements in conducting the sales on the other hand, the efforts to conduct proper suitability assessment of customers might not have been maintained in all cases.

5.62 As described in paragraph 5.57 above, there were circumstances under which LB structured products could be sold to customers whose risk profiles did not match the product risk ratings. However, if the customers did not know that there had been a risk mismatch, or if the sales staff had not explained properly the risk mismatch and the purpose of the documents requiring the customer's signature, the written declaration/acknowledgement given by the customers would serve no meaningful purpose. Noting that in the case of one of the six banks[83], about 11% of its customers who had invested in LB structured products were involved in transactions with a risk mismatch, the Subcommittee has found it necessary for the regulators to consider certain thresholds for permitting these transactions to ensure that the purpose of conducting suitability assessment would not be defeated.

5.63 Where risk profiling tools are concerned, the Subcommittee sees merits in the use of a product-specific suitability questionnaire as described in paragraph 5.50 above which, if properly explained and administered by the RM, should have been useful in apprising prospective investors of the key risks of LB structured products. The critical issue is whether in practice, the questions had been properly explained by the RM and well understood by the investor in giving his response.

[83] SCBHK.

5.64 As shown in the example in paragraph 5.53 above, a person who is capable of accepting investment risks and bearing potential investment losses may not necessarily be willing to take on these risks. The age, education level, income, net worth and investment horizon of a customer can reflect the customer's ability to assume investment risk, but not necessarily his willingness to take risk. Regardless of the methodology for risk profiling, the Subcommittee considers it important that risk profiling should give sufficient weighting to the "preparedness" or "willingness", not just the ability, of a person to assume risks.

The sales process

Regulatory requirements

5.65 As stated under Question 5 of the Suitability FAQ, it is the duty of intermediaries to help customers make informed decisions by explaining the nature of and risks associated with the investment products, and give them sufficient time to consider the information provided by the intermediaries. GP5 and Paragraph 5.3 of the Code of Conduct also require intermediaries to make adequate disclosure of relevant information to the customers and ensure that they understand the products.

5.66 HKMA issued a circular to all RIs on 13 January 2003 to provide specific guidance on the restrictions on unsolicited calls[84]. Pursuant to the requirements under SFO, the dealing in securities is Type 1, and advising on securities is Type 4 regulated activity. As set out in the FAQ dated 22 June 2009 on "Incidental Exemption" issued by SFC[85],

[84] The circular is available on HKMA's website at http://www.hkma.gov.hk.

[85] SFC has issued a number of FAQs on various licensing-related topics (e.g. competence, licensing conditions, provisional licence). One set of these FAQs is on "Incidental Exemption" (dated 22 June 2009) which gives information on the exemptions whereby corporations licensed for Type 1 regulated activity can carry on other regulated activities. The FAQ is also applicable to RIs and is available on SFC's website at http://www.sfc.hk.

intermediaries licensed for Type 1 regulated activity may give investment advice to clients to the extent that such activity is carried out wholly incidental, and subordinate or ancillary to the securities dealing business.

Relevant evidence

Target customers for LB structured products

5.67 Some investors giving evidence to the Subcommittee stated that they had not heard about LB or its products, but had been proactively approached and persuaded, mostly by the RMs handling their accounts, to invest available funds (e.g. matured time deposits) in Minibonds and other LB structured products. These investors alleged that at that juncture, they did not have the slightest intention to make an investment. Their RMs, however, had presented LB structured products such as Minibonds to them as safe products comparable to time deposits.

5.68 According to the evidence of the management and frontline staff of most of the six banks[86], they had not specified any target customers for LB structured products. In reply to the Subcommittee, three banks[87] stated that they did not designate any of its retail banking customers as professional investors. None of the investors who had testified to the Subcommittee said that they had been categorized by the banks as professional investors.

5.69 Some of the witnesses from the top/senior management and frontline staff of the banks stated that individual customers might become aware of LB structured products through advertisements and/or marketing materials or similar offers from other distributing banks. The RMs told the Subcommittee that they would provide information on LB structured products to the customers in response to the latter's enquiry or expression

[86] BOCHK, CHKL, DSB, RBS and SCBHK.
[87] CHKL, DSB and SCBHK.

of interest in such products during ongoing customer contacts, or upon referral by other staff (e.g. counter staff who were not ReIs) or by existing customers. When asked by the Subcommittee, the management of one bank[88] said that if a customer was referred to the RM by the counter staff, the bank would take the view that it was the customer who had indicated interest in purchasing a product and approached the bank on his own volition.

Issues related to recommendation and solicitation

5.70 According to the bank management and RMs, they only provided investment information, not investment advice or recommendation, to their customers. As testified by the investors, they had never heard about LB structured products before their RMs introduced the products to them. They had been told about the rate of coupon payment, the tenor of the product and what they would receive at the maturity of the notes. According to the investors, their RMs also highlighted the advantages of purchasing the LB structured products, and urged them to invest available funds in the products which were of low risks but could yield much higher returns. Apparently, the investors had not merely been given product information, but had been persuaded that it was in their interest to invest in LB structured products.

5.71 The Subcommittee has noticed that instead of responding to customer demands on a reactive basis, individual banks had taken measures to promote the LB structured products being offered and to encourage the customers to subscribe for the products. For example, one bank[89] displayed posters and marketing leaflets of Minibonds at its branches. This marketing strategy was clearly documented in the internal form seeking approval to distribute the Minibonds. The marketing brochures for certain series of LB-CLNs offered by another

[88] CHKL.
[89] BOCHK.

bank[90] informed the customers that "the Notes were offered for a limited period only" and that customers should "seize the investment opportunity" and "contact their designated distributors for details" ("本債券認購期有限。把握投資機會，請立即聯絡指定分銷商了解詳情。"). Some RMs informed the Subcommittee that in their regular contacts with the customers, they would inform the customers who had previously invested in LB structured products of the offer of a new series of the product, or new LB structured products.

Provision of offer documentation to customers

5.72 According to the policies and guidelines of the six banks, before completion of the transaction, a customer should be provided with the relevant offer documentation for LB structured products[91] and be explained the key product features and risks, so that the customer could make an informed investment decision[92]. One of the banks[93] had set a minimum standard of product explanation to customers, which included explaining the product nature, name of the issuer and its credit rating, market scenarios, investment returns, transaction details and fees and commission. As stated by the RMs testifying to the Subcommittee, they did make available to their customers the relevant offer documentation specified by their banks and explained the product features and risks with reference to the prospectuses, termsheets or marketing materials (where applicable). Two RMs informed the Subcommittee that hardcopies of the prospectuses of LB structured products were received by the branch before the product was offered for sale to customers but they could not confirm how many copies were in the stock. Another RM said that the

[90] DBSHK.

[91] The offer documentation would typically include the relevant prospectuses and marketing materials for LB structured products sold by public offer; and the termsheet and/or base prospectus for LB structured products distributed through private placement.

[92] As stated under Question 5 of the Suitability FAQ, the mere provision of documentation is not enough. The sales staff are obliged to help each client make informed decisions by giving the client proper explanations of why recommended investment products are suitable for the client and the nature and extent of risks the investment products bear.

[93] CHKL.

sales staff could download and print the base prospectus of LB structured products from the Intranet of the bank.

Explanation on LB structured products

5.73 According to an investor of Minibonds and another investor of LB-CLNs testifying to the Subcommittee, the bank staff handling their transactions had told them that these products were safe as they were linked to a number of large and reputable corporations which would unlikely fail. Even in the unlikely event that one of the entities failed, they would only sustain a pro-rata loss on their investment. Some other investors told the Subcommittee that they were under the impression that the LB-ELNs they had purchased were issued by the distributing bank or that the high coupon payable was a special offer. An investor said that she was not aware that an LB-related entity was the product issuer, nor did she know, until after the transaction, that the LB-ELN in question was linked to the shares of listed corporations. Another investor thought that LB was the name given to the product. According to most of the LB-ELN investors who had testified to the Subcommittee, the bank staff had told them that the worst scenario was receipt of the physical shares of the worst-performing stock at the pre-determined price. One other investor thought that it was the distributing bank that guaranteed the principal protection of the LB structured product she had purchased.

5.74 According to the evidence of the management of the six banks, the banks did not specify any minimum time that sales staff must take to explain an LB structured product to a customer. The top/senior management of one of the six banks[94] indicated that it usually took some 30 to 60 minutes to complete a transaction of an investment product, depending on the investment experience of the customers and their understanding of the product in question. Another bank[95] indicated that

[94] SCBHK.
[95] CHKL.

the time spent on explaining an investment product to customers was about one hour on average. Only one of the banks[96] indicated that it had provided sales scripts to the sales staff in conducting the sale of these products. As stated by some investors, the entire transaction took some 15 to 30 minutes to complete, including a short explanation by their RMs on the product, but without informing them clearly or fully of the risks involved. One investor told the Subcommittee that she met her RM at a security counter in a shopping mall and on being urged by her RM to complete the subscription process, signed the transaction documents there hastily without understanding their contents.

Declaration/acknowledgement by customers

5.75 The Subcommittee notes that to complete a transaction, it was a common practice of the six banks to require the customer to sign a form to confirm/acknowledge that he/she had gone through the risk/investment profiling exercise, read the offer documentation, understood the product risks, and decided to invest in the LB structured products based on his/her own judgement, not as a result of any advice given by the banks. For instance, one of the six banks[97] required the investor to sign on the suitability assessment questionnaire to confirm, amongst others, that he had received, read and understood the programme prospectus of the LB structured product, and understood the nature and risks of the investment. There was also a "disclaimer" made by the bank at the end of the form (not part of the declaration signed by the customer) which stated, inter alia, that the bank did not make any representations or warranties as to the accuracy or completeness of the information in the offering documents. However, according to some of the investors who had testified to the Subcommittee, they did not have any idea of the contents or purpose of the documents they had signed as the sales staff had not explained the subject matters to them. Two investors told the Subcommittee that at the

[96] DBSHK.
[97] RBS.

request of the sales staff processing their transactions, they had signed on blank forms.

Decision to purchase LB structured products

5.76 The Subcommittee had asked the investors why they had decided to subscribe for LB structured products which were unfamiliar to them. In response, most of the investors said that they trusted the banks due to their reputation and their RMs whom they considered professional or with whom they had a long history of dealing. It also appears to the Subcommittee that during the sales process, the investors had not asked why the LB structured products they had purchased could give them a much higher return than the prevailing interests on the time deposits. For example, subject to there being no early call by the issuer or early termination event, investors of Minibonds Series 35 could receive a return on their principal at the rate of 5.6% per annum. Around the time when Minibonds Series 35 was offered to the public in February 2008, the prevailing Hong Kong dollar six-month time deposit rate was not more than 1% per annum[98]. Some investors who had used about HK$500,000 to purchase an LB-ELN[99] in February 2008 offered by private placement told the Subcommittee that they had received some HK$20,000 to $30,000 as coupon payment during the first five months of the tenor of the product before the collapse of LB.

Observations

5.77 The Subcommittee has noted that one of the reasons commonly given by the six banks for deciding to distribute LB structured products was to provide greater choice to customers in terms of product issuers and investment products. Hence, it was unlikely that individual

[98] Please see paragraph 3.24 of Chapter 3.

[99] Series 17 (390+1800) or Series 18 (390+1800+2800) of Lehman Brothers 1-Year HKD All Weather Coupon Daily Callable ELN.

banks would passively wait for indication of interest from customers instead of proactively approaching existing customers who might provide a ready pool of potential investors for LB structured products. The Subcommittee also considers that banks enjoyed proximity to their customers, and there were ample opportunities for sales staff to promote LB structured products in their ongoing contacts with customers, such as when the latter approached the bank for general banking services.

5.78 As described in paragraph 5.67 above, some individuals did not have any intention to make an investment when they approached the banks for general banking services. To the customers, the fact that the same RMs servicing their accounts had introduced LB structured products to them in the course of handling their deposits had blurred the demarcation between banking and investment activities. If the customers were not aware that they were making an investment, they would not be alert to the nature and potential risks of the investment products.

5.79 The Subcommittee has observed that the banks claimed that they only provided investment information, not investment advice. It is noted that intermediaries have a higher duty to fulfil in providing advice than in providing information. However, as described in paragraph 5.70 above, it might not be easy to distinguish whether certain remarks made by the sales staff were purely investment information or advice incidental to the sale of the LB structured products in question. To the customers, they might reasonably believe that they had been advised by their RMs to purchase a product which, as presented by the RMs, would bring them stable and favourable returns. The Subcommittee considers that suitable measures should be taken to minimize any possible contention over whether the customers had been given "information" or "incidental advice" in respect of their purchase of investment products.

5.80 The evidence from most of the investors testifying to the Subcommittee did not indicate that all the steps of providing offer documentation and product explanation had been taken by their RMs prior to completion of their transactions. As described in paragraph 5.73 above, the lack of understanding of the LB structured products as revealed by most of the investors testifying to the Subcommittee raised serious doubt on whether there had been adequate and proper explanation by the sales staff who handled their transactions, and whether these investors had been given reasonable time to read and understand the offer documentation, if provided, and ask questions. If only some 15 to 30 minutes had been taken to complete a transaction of LB structured products, as alleged by some of the investors, the Subcommittee does not consider that sufficient explanation could have been provided to a prospective investor who was not familiar with the nature of LB structured products to make an informed decision.

5.81 The Subcommittee has found that the banks had relied heavily on the signed written declarations as proof of the customers' understanding of the LB structured products and the suitability of the products for them. It should be noted that the signing of forms could not necessarily demonstrate that the product had been properly explained by the bank staff and understood by the customer. Each case had to be examined on its facts. However, the Subcommittee considers that in order to protect their own interest, investors should not sign on transaction documents if they did not understand the contents or purpose of such documents. Trust in the banks or their RMs was no substitute for healthy scepticism and vigilance on the part of the investors.

Sales targets and incentives

Regulatory requirements

5.82 According to GP1, GP2 and GP6 of the Code of Conduct, intermediaries should treat their clients honestly and fairly. They should act in the best interests of their clients and avoid any conflicts of interest. In the SFC's Report on Selling Practices of Licensed Investment Advisers, which was brought to the attention of all RIs by a circular issued by HKMA on 1 March 2005, SFC had raised the regulatory concern that the way the intermediaries were remunerated might give rise to potential conflicts of interest with the customers. HKMA issued a letter to a number of retail banks on 23 October 2008[100], reminding them that any incentive schemes for their staff should not be linked solely to sales volume and should take into account the relevant staff's compliance with the applicable statutory and regulatory requirements.

Relevant evidence

Sales targets

5.83 The Subcommittee has examined whether the six banks had set any sales targets for the distribution of LB structured products. As testified by both the management and frontline staff of these banks, there were sales targets to be met by sales staff in respect of different financial and investment products[101]. However, there were no sales targets specific to LB structured products. Most of the RMs told the Subcommittee that LB structured products was only one of the many products handled by them. In response to the Subcommittee's questions on the highest number of transactions in LB structured products

[100] The letter was also brought to the attention of other RIs as an enclosure to a circular issued by HKMA on 11 December 2008. The circular is available on HKMA's website at http://www.hkma.gov.hk.

[101] These products included insurance products, bonds, credit cards, deposits, mutual funds, structured financial products, mortgages, loans, etc.

concluded by them in a single month, the figures provided by some of the RMs ranged from two to 14. As informed by some RMs, the sale of LB structured products accounted for only some 0.67% to 4.9% of their respective total monthly sales of financial and investment products.

5.84 All the RMs stated that they did not recall having received any specific instructions from the bank management to gear up their sales efforts specifically on LB structured products. They also said that they had not been under pressure to boost the sale of LB structured products. One of the RMs recalled that during the period when the bank offered various series of Minibonds, his supervisor had advised the sales staff that each of them should preferably accomplish at least one transaction in Minibonds. However, he also said that the same advice was issued in respect of other investment products being offered. One IC recalled having received feedbacks from sales staff that they had difficulty in achieving the overall sales target as it was raised by the bank each year. Another RM indicated that he had managed to cope with the pressure arising from the need to meet the overall sales targets.

Performance appraisal of sales staff

5.85 According to the management of the six banks, the performance of their sales staff was evaluated against a number of performance indicators, which included sales achievement. One bank[102] adopted three key performance indicators to appraise its staff, i.e. "sales achievement", "customer services" and "control and compliance", with a respective weighting of 50%, 20% and 30%. Another bank[103] evaluated staff performance in four aspects, namely "adherence to the bank's guidelines", "KYC or account opening", "sales/regulated activities" and "compliance/operations/service standard", each of which carried equal weighting.

[102] DBSHK.
[103] RBS.

5.86 According to the top/senior management of the six banks, due regard was given to all aspects of staff performance, or as one bank[104] put it, a "holistic staff performance framework". The Subcommittee has examined some specimens of the performance scorecards of the six banks, and notes that sales achievement (or the revenue generated for the banks) was one of the factors in assessing staff performance. As informed by one of the banks[105], it lowered the weighting of "sales achievement" in staff appraisal from 60% to 50% in 2006. Another bank[106] stated that the entitlement of its sales staff to incentives was subject to proper compliance with the regulatory requirements. Non-compliance would lead to disciplinary action and an incentive discount of 30% to 100% depending on the severity of the misconduct.

5.87 When asked by members about the arrangements, if any, for dealing with sales staff's failure to meet requisite sales targets, most of the BMs stated that they would usually discuss with the staff concerned to find out the reasons for the under-performance. Suitable coaching and training would be provided where necessary. One BM said that she would work out an action plan for improvement with the staff. Some RMs told the Subcommittee that if their sales performance lagged substantially behind that of their peers, their supervisors (mostly BMs) would usually discuss with them with a view to assisting them to overcome difficulties and make improvements.

5.88 The BMs and most of the RMs testifying to the Subcommittee did not recall any case in which the sales staff had been dismissed or penalized solely for failure to meet sales targets or achieve the requisite level of revenue for the bank. Some RMs said that it was the practice of their management to compare the sales performance of staff. Some other RMs stated that they were provided with information from time to time on the sales performance of their peers. However, none of the RMs

[104] SCBHK.
[105] DBSHK.
[106] RBS.

testifying to the Subcommittee indicated that they had any hard feeling towards such practices.

Sales incentives

5.89 As testified by the top/senior management of some of the banks[107], the distribution fee payable by the issuer to the banks for the distribution of Minibonds or LB-CLNs was in the range of about 2% to 3% of the purchase amount. Another bank[108] told the Subcommittee that the commission it received for the sale of LB-ELNs was 2.64% on average, which was broadly comparable to those payable for other investment products. Both the management and frontline staff of the six banks stated that there was no incentive scheme specific to LB structured products, although there were product-level incentives for product categories such as unit trust funds, insurance, deposits and structured notes.

5.90 The Subcommittee has noted from the evidence of the top/senior management and the frontline staff of the six banks that the remuneration of sales staff (mostly RMs) was made up of a fixed basic salary and a variable pay. The latter was linked to the sales staff's overall performance, the total revenue earned by the staff for the bank from sale of different products (usually calculated on a quarterly basis), and/or the product-level incentives. Some of the banks[109] specifically required that compliance of the regulatory requirements was an overriding factor for the release of incentives. In reply to the Subcommittee's questions on the amount of incentives that the sales staff could earn, one RM recalled that the incentives derived from his sale of financial and investment products in a quarter could amount to five times his basic monthly salary. However, another RM said that during his one year or so of employment with the bank, he had only received the basic

[107] BOCHK, DBSHK, DSB and RBS.
[108] CHKL.
[109] BOCHK, CHKL, DBSHK and RBS.

monthly salary as he had not achieved the requisite quarterly sales volume to earn any incentives. Another RM told the Subcommittee that his incentives were also linked to the overall sales performance of the branch.

Observations

5.91 The Subcommittee has found that the six banks did set overall sales targets to be met by sales staff. The sale of LB structured products would contribute to the achievement of the sales targets. However, there was no evidence to suggest that sales staff had to concentrate or rely heavily on the sale of LB structured products in order to meet their sales targets, as they could conduct sales on other financial and investment products. In fact, one of the RMs told the Subcommittee that it was not easy to sell LB-ELNs to his customers. Although the Subcommittee had not received any evidence that staff who could not achieve good sales performance would be penalized, the Subcommittee has found that sales achievement was a very important aspect in the evaluation of the performance of sales staff. As described in paragraph 5.84 above, the need to meet the overall sales targets would inevitably have exerted pressure on sales staff to boost their sales effort. In this connection, the Subcommittee considers it necessary for banks to strike a proper balance between "sales performance" and "due compliance" in their remuneration/incentive structures.

5.92 The Subcommittee also notes that sales incentives were an important part of the remuneration package of frontline sales staff such as RMs. The Subcommittee considers that individual banks and their staff were aware of the importance of maintaining a proper standard of conduct while striving to maximize profits and earnings. However, in view of the large number of complaints alleging mis-selling of LB structured products, it could not be ruled out that in some cases, the sales staff might

have sought to achieve sales at the expense of observing a proper standard of conduct.

Internal controls and monitoring of the sales process

Regulatory requirements

5.93 As stipulated in the Code of Conduct and the Internal Control Guidelines, RIs are required to put in place internal control systems to ensure that their business is conducted in an orderly and efficient manner that complies with the relevant legal and regulatory requirements, and safeguard their customers from financial loss arising from professional misconduct or omissions. The RIs should also have adequate resources to supervise their staff diligently and maintain proper records of their business. The senior management of the RIs bears the primary responsibility to establish effective internal control systems, with clearly defined policies and reporting lines, for ensuring the maintenance of appropriate standards of conduct and adherence to proper procedures by the staff, and timely detection of non-compliance of the relevant requirements.

Relevant evidence

5.94 The Subcommittee notes that the six banks had put in place policies and procedures with a view to ascertaining that their staff had complied with the relevant requirements in conducting sales. It was a common practice among the six banks to conduct reviews of transaction documents to check whether they were complete and in order. According to one bank [110], routine checking of all investment documentation was conducted by the branch service managers on a daily basis to ensure that the transactions completed at the branches were in

[110] SCBHK.

compliance with the relevant requirements and procedures. Another bank [111] posted independent checkers at all branches to conduct inspection of all transaction documents, including the risk profiling questionnaires, subscription forms and the self-assessment checklists completed by the sales staff confirming that all necessary steps of the sales process had been taken. The transactions could only be executed when the checkers confirmed satisfaction with the documentation. With the exceptions of those transactions executed over the phone, none of the six banks had adopted the practice of audio recording the sales conducted face-to-face with the customers[112].

5.95 Some other measures adopted by the six banks to monitor sales included:

(a) studying and monitoring complaint trends by the relevant business department of the bank with the BMs to consider whether any enhancement in supervision was needed;

(b) reviewing reports on transactions with risk mismatch by the branch service managers;

(c) conducting regular sample checking by the risk and compliance officers of the bank on the frontline staff's knowledge of compliance procedures by interviewing the staff and asking them related questions;

(d) reviewing samples of recorded telephone conversations between sales staff and customers by a designated team of the bank to determine whether the staff in question had

[111] BOCHK.

[112] After the LB incident and following the review by HKMA, RIs were required to implement, amongst others, audio-recording of the risk assessment and sales process. The relevant circular issued by HKMA on 9 January 2009 is available on HKMA's website at http://www.hkma.gov.hk.

discussed the product features and risks with the customers during the sales process; and

(e) conducting compliance reviews by the legal and compliance division of the bank on the sales practices and procedures adopted by the branches.

5.96 According to the BMs testifying to the Subcommittee, they usually monitored the sales process conducted by sales staff by walking around the branch and observing the discussions between the staff and the customers. Sample second-checking of transaction documentation was also performed to ascertain that the relevant internal policies and procedures had been followed during the sales process. In response to some members, the BMs said that they usually did not observe the entire sales process from beginning to end.

5.97 Five of the six banks[113] informed the Subcommittee that they conducted mystery shopper exercises[114] to evaluate whether the sales activities conducted at the branches were in compliance with the bank's internal policies and the regulatory requirements. In the light of the findings of the mystery shopper exercises, one bank[115] enhanced its internal policies and prepared additional operation manuals and guidelines on the completion and explanation of the risk profiling questionnaire. Another bank[116] introduced standardized techniques for analyzing the risk profiles of customers.

5.98 According to most of the six banks[117], they conducted internal audits from time to time on different aspects of the sales process of

[113] BOCHK, CHKL, DBSHK, DSB and SCBHK.
[114] In these mystery shopper exercises, the usual practice was that staff from the bank's internal audit department or an external consultant engaged by the bank were designated to be mystery customers. They role-played customers and approached the bank staff to seek investment information or advice.
[115] DBSHK.
[116] DSB.
[117] BOCHK, DBSHK, DSB, RBS and SCBHK.

investment products. One of these banks[118] detected in one of its audit exercises that there were deficiencies in tracking the expiry date of risk profiling questionnaire and the previous transaction record of existing customers for re-profiling. The bank subsequently enhanced its computer system for checking the validity of risk profiling and reminding the sales staff to review the customers' risk profiles.

Observations

5.99 The Subcommittee appreciates that it was not practicable for the bank management to physically supervise each and every sale of investment products, including LB structured products, by their sales staff. Effective governance and supervisory measures should therefore be implemented to ensure compliance with regulatory requirements. The Subcommittee considers that initiatives such as mystery shopper exercises were useful in strengthening on-site surveillance of sales activities.

5.100 In the light of the LB incident, the Subcommittee has also noticed that banks might have relied too much on reviewing transaction documents as a means to ascertain whether all relevant steps of the sales process had been duly completed. In the view of the Subcommittee, it is highly questionable whether and how far the completeness of the documentation could fully reflect what had actually taken place in a sales process, such as how the sales staff had conducted the risk profiling with the customers or explained the investment products to them. If the transaction documents were not prepared as a true record of what had been done but only to give an appearance of it, these documents could not be relied upon for detecting non-compliance, or ascertaining whether all the necessary steps had been taken before a transaction was completed.

[118] RBS.

Handling of complaints

Regulatory requirements

5.101 Paragraph 12.3 of the Code of Conduct and paragraph 5 under Section V of the Internal Control Guidelines require intermediaries to establish, maintain and enforce policies and procedures to ensure that complaints from customers relating to the intermediaries' business are handled in an appropriate, timely and independent manner. RIs also have to follow the guidance set out in HKMA's SPM on Complaint Handling Procedures[119].

Relevant evidence

5.102 As stated by the top/senior management of the six distributing banks, they had received very few complaints (not exceeding five) on alleged mis-selling of LB structured products prior to the collapse of LB. Two of the banks[120] said that they had not received any such complaint.

Complaint-handling procedures

5.103 The six banks stated that in accordance with the regulatory requirements of HKMA and SFC, they had put in place policies and procedures for handling customer complaints. The Subcommittee also notes that some of the banks[121] had made some adjustments to their respective complaint-handling process to deal with the large volume of complaints received after the collapse of LB. For example, two banks[122] each set up a designated team comprising more than 100 staff from the

[119] Module IC-4 of HKMA's SPM.
[120] DSB and RBS.
[121] DBSHK, DSB and SCBHK.
[122] DBSHK and SCBHK.

compliance, internal audit and risk management departments, which were independent of the sales teams, to investigate into the complaint cases.

5.104 Having examined the complaint-handling procedures of the six banks, the Subcommittee has found that only two of the six banks[123] had expressly required that complainants should be interviewed during the investigation process. According to the majority of investors of LB structured products who had testified to the Subcommittee, they had not been invited to attend meetings with the banks in connection with their complaints, and were dissatisfied that they had not been given an opportunity to be heard, nor kept informed of the progress of investigation of their complaints. Some investors said that they had encountered difficulty in obtaining from the banks copies of documents related to their purchase of LB structured products. For instance, an investor stated that she could only obtain a copy of her investment risk profiling form after repeated requests.

5.105 As stated by two of the investors, their complaints had been rejected on the grounds that they had signed relevant documents confirming their understanding of the risks of the products. Another investor who had settled her case with the bank indicated that although she was not satisfied with the terms of settlement, she had accepted it as she was worried that she might not receive anything if she rejected the offer. Based on the evidence provided by this investor, she was required, under the settlement offer, to withdraw her complaint from the bank and any other parties (including the regulators) in respect of her purchase of the LB structured product.

Banks' investigation into LB-related complaints

5.106 According to the top/senior management of the six banks, they would conduct internal investigations into their distribution of LB

[123] DBSHK and RBS.

structured products upon receipt of customer complaints. In this connection, the Subcommittee has noted that according to one bank[124] which had entered into the Minibonds repurchase agreement with SFC and MA, up to October 2010, its investigation of the 8 983 complaints received did not reveal any evidence of non-compliance.

5.107 The six banks stated that they generally took into account a number of factors in deciding whether or not settlement should be reached with individual customers. These factors included:

(a) whether the transaction documents had been properly completed and were in order;

(b) whether the bank's internal guidelines and relevant regulatory requirements had been complied with by the relevant staff; and

(c) the customers' personal circumstances, such as investment experience, literacy, etc.

Unresolved LB-related complaints

5.108 The hearings to receive evidence from the top/senior management of the six banks took place between April to November 2010, over 20 months after the collapse of LB in September 2008. However, the Subcommittee has noted that for those banks which had not entered into any agreement with MA and SFC pursuant to section 201 of SFO, a substantial number of their customer complaints remained unresolved[125]. The major distributor of LB-CLNs[126] had resolved not

[124] BOCHK.

[125] Please refer to paragraphs 6.23 and 6.31 and Appendix 6(a) of Chapter 6 about the agreements reached by SFC and MA with banks pursuant to section 201 of SFO in respect of LB structured products, and paragraphs 6.38 to 6.41 for discussion on the disputes resolution mechanism for LB-related complaints and agreements pursuant to section 201 of SFO.

[126] DBSHK.

more than 24% of the complaints when its management appeared before the Subcommittee in April 2010. When the witnesses from the top/senior management of two banks which mainly distributed LB-ELNs through private placement[127] gave evidence in May and June 2010, the Subcommittee found that each of the banks had resolved less than 13% of their complaint cases.

Agreements pursuant to section 201 of SFO

5.109 Since July 2009, MA and SFC had reached agreements with each of the six distributing banks pursuant to section 201 of SFO to, amongst others, repurchase LB structured products from their customers. In addition, a Minibonds collateral recovery agreement was announced in March 2011. The Subcommittee has found that quite a large number of complaints were resolved on a collective basis under these agreements. For example, at the time when its management gave evidence to the Subcommittee, the major distributor of Minibonds[128] had settled nearly 85% of the complaints under the Minibonds repurchase agreement announced on 22 July 2009. Another bank[129] settled about 64% of the complaints under the same agreement.

Enhanced complaint-handling procedures

5.110 Pursuant to most repurchase agreements, the distributing banks were required to implement enhanced complaint-handling procedures (ECHP) to resolve, in a fair and reasonable manner, all outstanding complaints in relation to the distribution of LB structured products that could not be resolved by the agreements pursuant to section 201 of SFO. The major requirements under the ECHP were at **Appendix 5(a)**. The Subcommittee notes that under the ECHP, it is mandatory for banks to interview the complainant in the investigation process. The investigation

[127] CHKL and SCBHK.
[128] BOCHK.
[129] DSB.

had to include an assessment of whether the conduct of the relevant staff and the bank was in compliance with the Code of Conduct and other relevant regulatory requirements. According to the top/senior management of the three banks[130] which had distributed Minibonds and reached an agreement with MA and SFC pursuant to section 201 of SFO, one bank[131] had settled about 90% of its outstanding complaint cases through ECHP; while the other two banks[132] had resolved over 20% of their outstanding cases through ECHP.

Arbitration and mediation

5.111 According to the evidence given by the top/senior management of the six banks, none of these banks had participated in arbitration. Two banks[133] had made use of the mediation service under the Lehman Brothers-related Products Disputes Mediation and Arbitration Scheme[134] launched by HKMA in November 2008. At the time when the investors of LB structured products gave evidence to the Subcommittee, only two of them had participated in mediation. One case had been settled while the other one was still pending.

Observations

5.112 The large number of complaints against the six banks after the collapse of LB in September 2008 stood in sharp contrast to the very few complaints received by them before the LB incident. The Subcommittee is no doubt aware of the severity of the impact of the incident and its pressure on the complaint-handling systems available at individual banks at that time. Nevertheless, the small number of settlements reached

[130] BOCHK, DSB and RBS.
[131] DSB.
[132] BOCHK and RBS.
[133] DSB and RBS.
[134] Please see paragraphs 6.21 and 6.39 of Chapter 6 about the Lehman Brothers-related Products Disputes Mediation and Arbitration Scheme.

between the six banks and individual customers on a case-by-case basis many months after the collapse of LB highlighted the need for individual banks to review and enhance their complaint-handling systems in order to deal with large numbers of complaints expeditiously.

5.113 The Subcommittee is concerned that in their investigation of LB-related complaints, some banks might have over-relied on the documentation signed by complainants, instead of critically reviewing how the sales process had been conducted, such as whether suitability assessment had been properly done and the LB structured products, properly explained by the sales staff. The Subcommittee considers that if the complainants were not interviewed and in the absence of any audio recording, verification of what had transpired during the sales process was very difficult. While some of the banks claimed that they had conducted "independent" investigation into the complaints received after the LB incident, the Subcommittee has noted that the teams designated by these banks to carry out the investigation consisted of staff who were independent of the sales teams of the banks, but not external parties independent of the bank.

5.114 The Subcommittee notes that individual banks are required by the Code of Conduct, the Internal Control Guidelines and HKMA's SPM to put in place policies and procedures to ensure the proper handling of complaints. With a view to enhancing the efficacy of the complaint-handling systems of individual banks, HKMA should consider requiring banks to incorporate certain requirements, such as interviewing the complainants (unless it is impracticable to do so), into the complaint-handling procedures as a mandatory requirement.

Chapter 6 The handling and resolution of Lehman Brothers-related complaints under the existing regulatory regime

6.1 This chapter examines how the large number of complaints from investors of LB structured products were dealt with by HKMA and SFC under the existing regulatory regime.

Initial response of the Administration and regulators to LB-related complaints

6.2 The Subcommittee has noted that a large number of complaints were lodged with HKMA and SFC following the collapse of LB in September 2008, as investors realized that they had incurred significant losses on the LB structured products they had purchased. In its circular issued to all LCs and RIs on 19 September 2008, SFC urged all LCs and RIs to take a more proactive role in addressing investors' enquiries about their investments, and handle complaints in a timely and appropriate manner[1]. On 22 September 2008, HKMA convened a meeting between representatives of investors and representatives of banks that had distributed LB structured products to facilitate communication among the relevant parties. HKMA had encouraged banks to be as transparent and forthcoming as possible in providing information to the affected investors[2]. Both the distributing banks and HKMA set up dedicated hotlines to answer enquiries and receive complaints from investors of LB structured products[3].

[1] Circular dated 19 September 2008 issued by SFC is available on SFC's website at http://www.sfc.hk. This circular was re-attached in a circular dated 23 September 2008 issued by HKMA to RIs which is available on HKMA's website at http://www.hkma.gov.hk.

[2] Press releases dated 21 and 22 September 2008 issued by HKMA are available on HKMA's website at http://www.hkma.gov.hk.

[3] Press release dated 22 September 2008 and circular dated 23 September 2008 issued by HKMA are available on HKMA's website at http://www.hkma.gov.hk.

6.3 The Subcommittee has also noted that on various public occasions in September 2008, FS and SFST expressed concern and sympathy with the investors. They also assured the public that HKMA and SFC would deal with investors' enquiries and complaints expeditiously[4]. Meanwhile, FS had asked HKMA and SFC to submit a report to him before the end of 2008 on the issues identified in the course of their investigation into LB-related complaints so that the Administration might undertake a systematic review and consider, on a policy level, ways to further improve the regulatory framework[5].

6.4 On 6 October 2008, the Administration announced that it had put up a "buy-back" proposal whereby the distributors of Minibonds would offer to buy back the Minibonds from the investors at the prevailing estimated value[6]. On 17 October 2008, the Task Force on Lehman Incident of the HKAB announced the decision of the distributing banks to accept the "buy-back" proposal[7]. However, due to the legal challenge raised by the US lawyers acting for the liquidator of LBHI in late November 2008 against the unwinding of the underlying collateral of Minibonds by the trustee[8], the banks put on hold any "buy-back" action until the legal issues had been resolved.

---

[4] For example, FS's speech at the luncheon of HKAB on 24 September 2008 and SFST's remarks on 27 and 30 September 2008 which are available on Information Services Department's website at http://www.isd.gov.hk.

[5] FS's speech at the luncheon of HKAB on 24 September 2008 is available on Information Services Department's website at http://www.isd.gov.hk.

[6] Remarks of FS and SFST made after a meeting with representatives of distributing banks on 6 October 2008 are available on Information Services Department's website at http://www.isd.gov.hk.

[7] The Task Force on Lehman Incident of HKAB was formed on 2 October 2008 and comprised the banks that distributed LB-related structured products. Its purpose was to facilitate distributing banks' discussion of common issues in assisting affected investors who were holding outstanding LB structured products. Press releases issued by the Task Force are available on HKAB' website at http://www.hkab.org.hk.

[8] In late November 2008, the legal advisers of Lehman Brothers Special Financing Inc. wrote to the trustee of Minibonds claiming that the proceeds from any sale of underlying collateral for the Minibonds should be paid to the swap counterparty (an LB entity) first before the issuer and investors of Minibonds. Given that the legal issues involved had not been clarified and addressed, the distributors found it impracticable to determine the market value of the Minibonds and therefore decided to put on hold the buy-back. Relevant documents and discussion on the "buy-back" proposal at the meetings of Panel on Financial Affairs held on 18 and 30 December 2008 are available on LegCo's website at http://www.legco.gov.hk.

6.5 At the special meeting of the House Committee held on 13 October 2008[9], FS re-affirmed the responsibility of the Administration and the regulators in safeguarding the interest of investors. He also made it clear that the Administration would not use public money to compensate investors for their losses on LB structured products as this would be unfair to taxpayers. FS also said that the Administration should refrain from intervening too much into market operations, and should play the role of a facilitator in assisting the parties concerned to resolve the matter.

Complaints of the investors of LB structured products

6.6 At the special meeting of the House Committee on 13 October 2008, Mr Joseph YAM, then MA, informed members that HKMA had received over 9 000 complaints[10]. The number rose to 19 699 by December 2008[11]. As reported in the SFC Review Report, at the end of November 2008, SFC received 8 055 complaints, 7 712 of which were made against distributing banks[12].

6.7 The Subcommittee notes that since mid October 2008, HKMA has published on its website statistics on the number of LB-related complaints it received and the progress of its investigation into these complaint cases. The information is usually updated on a weekly basis and the statistics have varied over time in the light of progress. According to the statistics published by HKMA at the end of September 2009 (about one year after the collapse of LB), the number of LB-related complaints received by HKMA stood at 21 712[13].

---

[9] The opening remarks by FS at the special meeting of the House Committee on 13 October 2008. The verbatim transcript of the meeting is available on LegCo's website at http://www.legco.gov.hk.

[10] Please see footnote 2 of Chapter 1.

[11] Please see footnote 3 of Chapter 1.

[12] Paragraph 17.2.1 of SFC Review Report.

[13] Complaints statistics concerning Lehman-related investment products (up to 30 September 2009) are available on HKMA's website at http://www.hkma.gov.hk.

6.8 As pointed out in the SFC Review Report published in December 2008, the most common allegations made by investors of LB structured products against banks included the following[14]:

(a) the frontline staff proactively induced the complainants to turn their matured fixed deposits into investments in LB structured products;

(b) the frontline staff failed to consider the complainants' risk profile and personal circumstances when selling the products, particularly in the case of retirees, elderly persons, less educated and risk averse customers;

(c) the frontline staff did not provide explanation on product features and risks at the point of sale. Some even misrepresented that the products, in particular Minibonds, were risk-free and similar to time deposits; and

(d) the distributing banks did not respond to the complainants' enquiries and complaints.

6.9 When testifying to the Subcommittee, many investors of LB structured products made similar complaints against the distributing banks regarding the sale of LB structured products to them. The above allegations were also found in many written submissions received by the Subcommittee. Many investors indicated in the written submissions that they did not know whether to approach HKMA or SFC for filing complaints.

6.10 As stated by some investors, they had also lodged their complaints with the Consumer Council (CC) and the Commercial Crime Bureau (CCB) of the Hong Kong Police, as they considered that they had

[14] Paragraph 17.2.2 of SFC Review Report.

been misled by the banks to purchase the LB structured products. According to available information, CC had received about 12 000 LB-related complaints[15]. After assessing the complaints, CC referred the majority of suspected mis-selling cases to HKMA for follow-up action. Meanwhile, the Consumer Legal Action Fund (CLAF) received 156 applications from investors of LB structured products to pursue their claims[16]. Given the large number of applications for assistance, CLAF decided to bring to court a small number of representative cases that would serve to clarify important legal principles and establish precedents for better consumer protection in future. The CLAF granted assistance to three cases involving four investors[17].

6.11 According to the information of the Police, CCB had received about 3 100 complaints relating to the sale of LB structured products since September 2008. The majority of these complaints were categorized as "misleading investor" cases. There were 39 cases related to "forgery" and one related to "conspiracy to defraud"[18]. It is known to the Subcommittee that prosecution had been taken against four bank employees in connection with their sale of LB structured products. On 15 November 2010, one bank employee was ordered to perform community services after pleading guilty to an offence of forgery in relation to the sale of Minibonds[19]. Three other bank employees had been charged under section 107 of SFO[20]. Among them, two employees were acquitted after trial on 18 February 2011 and 25 May 2011

[15] CC's Annual Reports 2008-2009 and 2009-2010 available on CC's website at http://www.consumer.org.hk.

[16] According to CC's Annual Report 2009-2010 available on CC's website at http://www.consumer.org.hk, CLAF received 156 applications from affected investors of LB structured products after the collapse of LB.

[17] According to CC's Annual Report 2010-2011 available on CC's website at http://www.consumer.org.hk, one assisted investor had accepted a settlement offer from the bank. The other two assisted cases had commenced legal proceedings against the banks concerned in the District Court.

[18] Press release dated 29 March 2012 issued by the Police is available on its website at http://www.police.gov.hk.

[19] Please see the judgement of the case HCMA 527 of 2010 available on Judiciary's website at http://www.judiciary.gov.hk.

[20] Under section 107 of SFO, it is a criminal offence for a person to make a fraudulent or reckless misrepresentation for the purpose of inducing another person to invest in securities.

respectively[21]. The prosecution offered no evidence on the charge against the remaining employee on 2 August 2011[22]. On 29 March 2012, the Police announced that after seeking legal advice from the Department of Justice and reviewing the evidence available, it had curtailed the investigation into cases relating to the sale of LB structured products except five cases in respect of suspected forgery which were still under investigation. The Police have informed the complainants concerned accordingly[23].

Investigation of LB-related complaints by the regulators

6.12 The Subcommittee has noted that in order to deal with the large volume of LB-related complaints that arose after the collapse of LB, HKMA and SFC had agreed on a set of specifically designed procedures. Under these procedures, HKMA would, in accordance with its powers under BO and SFO, conduct preliminary investigation into each complaint to ascertain whether there was prima facie evidence to support referral to SFC. According to HKMA, irrespective of whether the cases had been referred to SFC, HKMA would continue its investigation of individual complaints so as to ascertain whether disciplinary action should be taken against individual ReIs and EOs in relation to their sale of LB structured products. HKMA has published on its website weekly statistics on the progress in processing the complaints received.

6.13 As informed by SFC, upon receipt of referrals from HKMA concerning alleged mis-selling of LB structured products by banks, SFC would commence investigation into the RIs concerned by adopting a top-down investigatory approach. Under this top-down approach, SFC would not look into each complaint individually, but would review the

[21] Please see the reasons for verdict of the cases DCCC 526 of 2010 and DCCC 527 & 1272 of 2010 available on Judiciary's website at http://www.judiciary.gov.hk.

[22] Please see press reports of the case DCCC 1295 of 2010 in local newspapers dated 3 August 2011.

[23] Press release dated 29 March 2012 issued by the Police is available on its website at http://www.police.gov.hk.

distributing bank's systems and controls over its selling process, and would examine key issues including[24]:

(a) the management controls;

(b) the due diligence process;

(c) the training and supervision of sales staff;

(d) the record keeping; and

(e) the procedures used at the point of sale, especially the way in which suitability was determined.

6.14 According to SFC, the top-down investigatory approach described above would enable it to form views about the respective positions of the largest number of complainants in the shortest time-frame, and to identify whether there was a systemic problem in the sale of LB structured products that had to be remedied[25]. As informed by SFC, its investigatory process involved compelling the production of relevant documentation, interviewing witnesses/suspects and analyzing the evidence obtained.

6.15 The Subcommittee notes that under the existing regime, where an RI was found to have failed to comply with the regulatory requirements, SFC may consider imposing sanctions under SFO, which include public and private reprimands, revocation or suspension of the registration of the RI, fines up to HK$10 million or three times the total profit gained or loss avoided by the misconduct in question[26]. In cases where SFC contemplates the exercise of its disciplinary power, section 201(3) of SFO also permits SFC to agree to other means of resolving

[24] Paragraph 18.2 of SFC Review Report.
[25] Paragraph 18.3 of SFC Review Report.
[26] Sections 196(1)(i) and (ii), and 196(2) of SFO.

complaints where it considers it appropriate to do so in the interest of the investing public or in the public interest. Nevertheless, neither SFC nor MA is empowered under the existing legislation to order the payment of compensation to individual customers, even if their complaints against the RIs are substantiated.

6.16 According to the evidence of Mr Joseph YAM, then MA and Mr Y K CHOI, then DCE/HKMA, given in June 2009, HKMA had received 21 226 complaints regarding LB structured products sold through RIs. More than 20 000 preliminary assessments had been carried out by HKMA, and 482 cases had been referred to SFC[27]. According to HKMA, the objective of such referral was to speed up SFC's top-down investigation of the RIs concerned, to help SFC focus on possible areas of concern, and to identify any systemic failure at the RI level. Meanwhile, HKMA would continue its investigation into individual ReIs and EOs involved in these cases.

6.17 When taking evidence from Mr Joseph YAM and Mr Y K CHOI from April to June 2009, the Subcommittee was informed that HKMA's target was to conclude work on at least 70% of the LB-related complaints by March 2010. SFC, on the other hand, had not announced any time-frame for completion of its work on the LB-related complaints. As stated by Mr Martin WHEATLEY, then CEO/SFC, at the hearing on 26 June 2009, SFC did not provide general updates of its investigation, although Mr WHEATLEY had repeatedly stated to the Subcommittee that SFC was making the best endeavours to expedite its investigation work while observing the necessary legal and procedural requirements. In response to members' questions at the hearing on 23 June 2009 concerning the progress of investigation, Mr WHEATLEY informed the Subcommittee that SFC had commenced investigation into all 19 banks that distributed LB structured products, and that SFC would not need to

[27] Complaints statistics concerning Lehman-related investment products (up to 11 June 2009) are available on HKMA's website at http://www.hkma.gov.hk.

await receipt of complaint cases from HKMA in order to open and complete investigations. He said that instead of handling the complaints individually, SFC would look at the controls and processes of RIs with a view to achieving settlements that could deal with all the complaints.

Disciplinary actions

6.18 The Subcommittee has noted that as a result of the investigation of LB-related complaints, HKMA took disciplinary action against two ReIs in connection with their sale of LB structured products. In November 2009, HKMA announced that it would suspend the particulars of an ReI from the register maintained by HKMA for three months. In May 2010, the particulars of another ReI were suspended from the aforesaid register for five months[28]. At the time of preparing this report, no further disciplinary sanction has been announced by HKMA.

6.19 At the time when the Subcommittee took evidence from Mr Y K CHOI, it noted that as at 12 November 2009, a total of 822 cases were under disciplinary consideration by HKMA[29]. In response to questions about the progress of any disciplinary action contemplated by HKMA, Mr Y K CHOI explained that before MA could impose disciplinary sanction and make public announcement, he must observe the due process to ensure fairness and give the subjects of investigation an opportunity to be heard. He said that the enforcement process might last for more than six months as the following procedural steps were involved:

(a) issuance of Notice of Intention to Impose Disciplinary Sanction (NID) to the regulated person,

[28] The relevant press releases issued by HKMA on 20 November 2009 and 14 May 2010 are available on HKMA's website at http://www.hkma.gov.hk.

[29] Complaints statistics concerning Lehman-related investment products (up to 12 November 2009) are available on HKMA's website at http://www.hkma.gov.hk.

(b) representation made by the regulated person, normally within 30 days upon the issuance of the NID,

(c) review and consideration on the representation by HKMA,

(d) consultation with SFC,

(e) issuance of Notice of Disciplinary Decision (NDD),

(f) appeal to the Securities and Futures Appeals Tribunal (SFAT) by the regulated person for a review of MA's decision within 21 days after the NDD had been served,

(g) review and decision made by SFAT, and

(h) MA imposing disciplinary sanction subject to the decision of SFAT or withdrawal of appeal by the regulated person.

6.20 The Subcommittee has continued to keep in view the progress of the disciplinary process of HKMA in relation to LB-related complaints, and noted that up to 29 March 2012, a total of 25 cases were under disciplinary consideration[30]. According to HKMA, these were cases in respect of which proposed disciplinary notices were being prepared after detailed investigation by the HKMA.

Disputes resolution mechanism

6.21 On 31 October 2008, HKMA announced that to assist distributing banks of LB structured products and individual investors to settle their disputes, it had engaged the Hong Kong International

[30] Complaints statistics concerning Lehman-related investment products (up to 29 March 2012) are available on HKMA's website at http://www.hkma.gov.hk.

Arbitration Centre to provide mediation and arbitration services under the Lehman Brothers-related Products Disputes Mediation and Arbitration Scheme. Participation in the Scheme is voluntary and the consent of both the investor and the distributing bank is required for mediation/arbitration to proceed. HKMA would pay the investor's share of the fee for (i) investors whose complaints had been referred to SFC, or (ii) investors whose complaints had resulted in a finding against an ReI or EO[31].

6.22 The Subcommittee has noted that in the HKMA Review Report and SFC Review Report submitted to the FS in December 2008, the regulators had recommended that the Government should explore the need and feasibility of setting up an independent dispute resolution mechanism to provide a simple and efficient channel to settle disputes between investors and financial intermediaries. After a public consultation exercise conducted in early 2010, the Administration announced in December 2010 the decision to establish the Financial Dispute Resolution Centre (FDRC) by mid 2012. Approval had also been obtained from the Finance Committee of LegCo in June 2011 to create a new commitment of HK$92 million for supporting the establishment of the FDRC and its operating costs for the first three years of operation. The FDRC is incorporated as a limited company by guarantee to administer a financial dispute resolution scheme for settling monetary disputes between individual customers and financial institutions regulated by HKMA and SFC by way of primarily mediation and, failing which and if the claimant so wishes, arbitration. The Government appointed the Board of Directors and the Chief Executive Officer of the FDRC on 1 March 2012 to spearhead the preparatory work for its operation by mid 2012[32].

[31] Information on the Scheme is available on HKMA's website at http://www.hkma.gov.hk.

[32] The press release dated 1 March 2012 is available on Information Services Department's website at http://www.isd.gov.hk.

Settlement agreements entered into by SFC, MA and RIs

6.23 On 22 July 2009, SFC, HKMA and the 16 Minibonds-distributing banks jointly announced that they had reached an agreement in relation to the repurchase of Minibonds from eligible customers. Thereafter, during the period from December 2009 to July 2011, SFC and HKMA announced further agreements with the following banks to make repurchase offers of outstanding LB structured products which included LB-CLNs and various structured notes distributed through private placement[33]:

(a) DSB and Mevas Bank Ltd;

(b) DBSHK;

(c) SCBHK; and

(d) CHKL.

The agreements were entered into by SFC and MA with the banks in question pursuant to section 201 of SFO. Further details on the five settlement agreements are given in **Appendix 6(a)**. According to the settlement agreement reached with 16 distributing banks of Minibonds, each of them were required to make a further payment to eligible customers once the collateral was recovered and paid to the distributing banks. On 28 March 2011, the distributing banks and the Receivers of the collateral securing certain series of Minibonds announced a collateral recovery agreement, details of which are set out in **Appendix 6(b)**.

6.24 The Subcommittee has taken note of the following matters arising from the five settlement agreements:

[33] The relevant press releases and related information on all the five settlement agreements are available on SFC's website at http://www.sfc.hk.

(a) The repurchase offers were made by the distributing banks without admission of liability.

(b) There were different eligibility criteria for the repurchase offers made under the five settlement agreements. According to the information in the relevant press releases issued by SFC announcing these agreements, it was estimated that a majority (ranging from 64% to 95%) of the customers of the banks holding outstanding LB structured products were eligible for the offers under these agreements.

(c) With the exception of the settlement agreement in respect of LB-CLNs, the other settlement agreements only provided for offers amounting to partial repayment of the investment principal to eligible customers.

(d) SFC set out its concerns raised in the course of its investigation into the distributing banks regarding their sale of LB structured products. These included concerns over the overall monitoring of the sales process, the appropriateness of the risk rating assigned to the LB structured products and the adequacy of the suitability assessments conducted with customers.

(e) Under most of these settlement agreements, the distributing banks were required to implement ECHP to handle complaints from customers who did not accept the repurchase offers or who were not eligible for the offers.

(f) SFC and HKMA would not take any enforcement/disciplinary action against the banks and their employees in relation to the sale of the LB structured

products covered by the agreements except for acts of a criminal nature. HKMA would continue to handle complaints of ineligible customers or customers who rejected the repurchase offers.

6.25 The SFC's approach in considering whether to exercise its power under section 201 of SFO in any contemplated or actual disciplinary case was the subject of members' questions at the hearings on 23 June, 26 June and 3 August 2009[34]. In response, Mr Martin WHEATLEY said that in negotiating and entering into agreements pursuant to section 201 of SFO, SFC would seek outcomes that:

(a) provide reasonable remediation arising from the consequences flowing from any regulatory concerns that have been identified;

(b) ensure any systems and control deficiencies are rectified and that measures are put in place to reduce the chance of re-occurrence; and

(c) provide a deterrent or lesson to other market participants.

6.26 The Subcommittee notes that according to the press releases issued on the settlement agreements, both SFC and HKMA welcomed the agreements as reasonable and practical resolutions since eligible customers would be able to recover a reasonable amount of their investment without incurring the costs and associated risks of separate legal proceedings. They considered that the same outcome could not have been achieved through disciplinary action against the distributing banks and their employees. However, the Subcommittee has also

[34] As at 3 August 2009, the only agreement reached with distributing banks pursuant to section 201 of SFO in relation to their sale of LB structured products was the settlement agreement reached with 16 distributing banks of Minibonds.

received submissions from some investors of LB structured products expressing the following dissatisfaction over these agreements:

(a) The affected investors had not been consulted on the terms of the agreements reached by the regulators with the distributing banks.

(b) As the LB structured products had been mis-sold to them by banks, the investors considered that they should be compensated in full.

(c) Under the agreement announced by SFC, HKMA and 16 Minibonds distributing banks on 22 July 2009, certain investors were arbitrarily designated as "experienced investors"[35] and excluded from the repurchase offers. Given that such designation is not found in existing legislation, it was unfair and unjustifiable to exclude these investors from the repurchase offers.

(d) It was unfair that under another settlement agreement for LB-ELNs announced on 1 March 2011, the repurchase offer price would be reduced by 5% (or 10%) of the investors' total assets held at the bank (Available Assets). At the initial period after the announcement of the agreement, there was ambiguity over what constituted Available Assets[36].

[35] "Experienced investors" refers to those investors who in the three years preceding their first purchase of Minibonds, executed five or more transactions in Leveraged Products, Structured Products or a combination of these products. This category of investors is not eligible for the repurchase offer announced on 22 July 2009. Please see the relevant press release dated 22 July 2009 which is available on SFC's website at http://www.sfc.hk. According to the Minibonds collateral recovery agreement subsequently announced on 28 March 2011 by the distributing banks and the Receivers of collateral, all note-holders (including the customers previously classified as "experienced investors") of the relevant series of Minibonds were able to recover from the collateral 70% to 93% of their original investment. Please see Appendix 6(b).

[36] After discussions with the regulators, the concerned bank announced that investment linked assurance scheme products and insurance products would not be regarded as Available Assets for the purpose of calculating the repurchase price.

Observations

6.27 Arising from its examination of how LB-related complaints were handled and resolved by the regulators under the existing regulatory regime, the Subcommittee has made a number of observations.

Lodging of complaints

6.28 The Subcommittee is deeply concerned about the predicament faced by the aggrieved investors, and notes that some of them have staged protests and demonstrations for months. The Subcommittee also appreciates that many investors were confused as to which authority they should approach for seeking assistance or lodging their complaints against RIs. Quite a number of them had filed complaints with HKMA, SFC, CC and the Police. To a certain extent, this might reflect the serious and complicated nature of the LB-related complaints, and the lack of clarity on whether HKMA or SFC should take lead responsibility in handling such complaints. The Subcommittee considers that since most of the investors had purchased the LB structured products through banks, HKMA, being the frontline regulator of banks, should have proactively advised the aggrieved investors to lodge their complaints with HKMA. This would also enable HKMA to better gauge the extent of the problem.

Progress of complaints investigation

6.29 All along, the Subcommittee has considered it incumbent upon the regulators to take all necessary measures to expedite the investigation of LB-related complaints, as the aggrieved investors would be in a stronger position to seek remedies if the regulators find mis-selling on the part of the RIs. The Subcommittee did not find it helpful when HKMA only aimed at completing enforcement work on at least 70% of the complaints by the end of March 2010 (which was some 18 months from

the collapse of LB in September 2008). It has asked HKMA to advance the target date to, say, the end of 2009.

6.30 According to Mr Joseph YAM and Mr Y K CHOI, HKMA had difficulty in recruiting the personnel with the necessary knowledge in structured financial products, familiarity with the regulatory requirements and investigative experience. Taking into account the lead time for on-the-job training, the man-days required for information gathering, analysis of evidence and preparation of reports and the need to observe the due process, HKMA maintained that its target of completing work on 70% of the complaints by the end of March 2010 was realistic.

6.31 As the Subcommittee has noted in paragraph 6.16 above, HKMA had only completed preliminary assessments on the bulk of the 20 000 complaints and referred less than 500 cases to SFC by June 2009. However, following the eligible customers' acceptance of the repurchase offers under various settlement agreements announced since July 2009, resulting in SFC and HKMA not taking any enforcement/disciplinary action against the RIs in the cases of these customers, the number of outstanding LB-related complaints dropped considerably. According to the statistics of LB-related complaints published by HKMA on a weekly basis, by the end of March 2010 (i.e. HKMA's previous target date for completion of work on 70% of the complaints), investigation of over 99% of the 21 547 complaint cases had been completed. Out of these cases, 13 060 cases were resolved under the Minibonds repurchase agreement announced on 22 July 2009[37]. By 29 March 2012, a total of 15 769 cases out of 21 851 complaint cases had been resolved under different settlement agreements reached pursuant to section 201 of SFO[38]. Another 3 370 cases had been resolved through the ECHP put in place by various banks. 2 467 cases were closed due to insufficient prima facie

[37] Complaints statistics concerning Lehman-related investment products (up to 31 March 2010) are available on HKMA's website at http://www.hkma.gov.hk.

[38] Complaints statistics concerning Lehman-related investment products (up to 29 March 2012) are available on HKMA's website at http://www.hkma.gov.hk.

evidence or disciplinary grounds[39]. Disciplinary sanctions had been imposed in respect of two cases[40] while disciplinary action was pending on 25 cases. Investigation into another 168 cases had been completed and the decision on these cases was pending. There remained 50 cases that were still under investigation by HKMA. The Subcommittee considers that it was the various agreements, rather than the investigation into each and every complaint case by the regulators, that had been instrumental in bringing about the resolution of outstanding LB-related complaints.

Disciplinary actions

6.32 According to the information published by HKMA on its website, the number of cases under disciplinary consideration grew significantly from 822 in November 2009 to more than 2 800 in July and August 2010[41]. However, the Subcommittee has noted that since September 2010, there has been a downward trend in the number of such cases. The Subcommittee has observed that the drop was hardly the outcome of completion of investigation and enforcement action, but one of the results of various settlement agreements reached by SFC, MA and the distributing banks under which HKMA and SFC would not take enforcement/disciplinary action against the RIs and their employees in relation to the sale of LB structured products covered by those agreements.

6.33 Notwithstanding the steps required to be taken by HKMA to ensure fairness to the subjects of investigation as mentioned in paragraph 6.19 above, the Subcommittee finds it inexplicable that by the end of March 2012, over 40 months after the collapse of LB, only two ReIs had

[39] As stated by HKMA, investigation into these cases may be re-opened if more information is available. Please see Note 3 of the Complaints statistics concerning Lehman-related investment products (up to 29 March 2012) available on HKMA's website at http://www.hkma.gov.hk.

[40] Please see paragraph 6.18 of this chapter.

[41] Complaints statistics concerning Lehman-related investment products (up to 8 July 2010 and 12 August 2010) are available on HKMA's website at http://www.hkma.gov.hk.

been sanctioned by MA while the disciplinary outcomes/decision relating to about 200 LB-related cases were still pending. The Subcommittee cannot but doubt the efficacy of the disciplinary process.

Transparency of investigation or enforcement actions

6.34 The Subcommittee notes that since mid October 2008, HKMA has published on its website statistics on its progress of investigating into LB-related complaints against RIs distributing LB structured products. Individual RIs were not named in the statistics which were usually updated on a weekly basis. SFC however has not published on a regular basis information relating to its investigation work. The Subcommittee finds this unsatisfactory and considers that SFC should have adopted a similar or comparable practice as that of HKMA to achieve at least the same level of transparency in respect of its investigation into LB-related complaints.

6.35 The Subcommittee recognizes that there are secrecy provisions under BO and SFO[42] which constrain MA and SFC respectively in disclosing information obtained in the course of performing their statutory functions. Nevertheless, given the widespread public concerns engendered by the LB incident, the Subcommittee considers that public expectation can be better met if information on the progress of investigation or enforcement actions can be published by the regulators as far as permissible under existing legislation.

6.36 The Subcommittee also considers that the complainants have every right to know the progress and outcome of investigation into their complaints. Where HKMA decides not to proceed further with a complaint, the Subcommittee is of the view that HKMA should provide the complainant with an explanation of the reasons for its decision.

[42] Section 120(1) of BO and section 378(1) of SFO.

Individual settlement agreements between investors and RIs

6.37 It is noted that some investors had negotiated directly with the distributing banks for settlement of their complaints [43]. The Subcommittee had sought clarification from Mr Joseph YAM on whether it was in order for RIs to enter into settlement agreements with individual investors which contained provisions requiring the investor to withdraw the complaints he/she had lodged with SFC, HKMA and other regulatory agencies. In this regard, Mr Joseph YAM referred to a circular issued by HKMA on 5 March 2009 requiring RIs to ensure that fair and reasonable arrangements were in place for settling LB-related complaints. He stated that HKMA's investigation into any case would not be closed due to the investor's withdrawal of the relevant complaint. Even if a complainant was not willing to provide information to HKMA for the purpose of its investigation, HKMA would make all reasonable efforts to gather relevant information and evidence from other sources. Notwithstanding such explanation, the Subcommittee is of the view that investors' right of lodging complaints with regulators should be upheld and it is not fair in principle if an RI required a complainant to withdraw the complaint lodged with the regulators as a condition for settlement.

Disputes resolution mechanism

6.38 The Subcommittee has noted with concern the absence of a simple, speedy and affordable disputes resolution mechanism through which aggrieved investors of LB structured products could seek remedies.

6.39 As discussed in Chapter 5, there is no evidence that direct negotiations between individual investors and the RIs had produced fruitful settlement outcomes in great numbers[44]. As pointed out in

[43] Please see paragraphs 5.102 to 5.114 of Chapter 5 for discussion on RIs' handling of customers' complaints relating to LB structured products.

[44] Please see paragraph 5.108 of Chapter 5.

paragraph 6.31 above, the vast majority of the 21 851 complaint cases had in fact been resolved as a result of the various settlement agreements pursuant to section 201 of SFO. The Subcommittee has also found that the Lehman Brothers-related Products Disputes Mediation and Arbitration Scheme, which was launched by HKMA in November 2008 specifically for LB-related cases, had not been widely used by aggrieved investors and the distributing bank. According to the evidence given by the top/senior management of the six banks, only two of the banks had made use of the mediation service under this Scheme[45]. The Subcommittee considers that a thorough independent review of the Scheme should be made as soon as practicable so that the experience gained or the lessons learnt can throw light on the operation of the FDRC.

Agreements pursuant to section 201 of SFO

6.40 As observed in paragraph 6.31, the various settlement agreements entered into by the regulators and the distributing banks pursuant to section 201 of SFO had been instrumental in resolving the bulk of outstanding LB-related complaints. Investors were given an option to settle their cases with the distributing banks without having to wait for the outcome of investigation into their respective complaints or to engage in lengthy negotiation or litigation with the banks.

6.41 The Subcommittee is concerned that some investors were designated as "experienced investors" and excluded from the Minibonds repurchase offers announced on 22 July 2009. Some members questioned the rationale and fairness of such designation which is not found in existing legislation. According to the testimony of Mr Martin WHEATLEY, then CEO/SFC, the definition of "experienced investors" had set a very high benchmark of demonstrated experience in purchasing structured financial products (namely five or more transactions within the three years prior to the first purchase of Minibonds). Accordingly, such

[45] Please see paragraph 5.111 of Chapter 5.

an investor had to be a person with very recent experience and familiarity with products like Minibonds. SFC therefore considered it reasonable for "experienced investors" to be treated differently from inexperienced investors in the Minibonds repurchase offers. The Subcommittee has noted that according to the information available to HKMA at that time, approximately 25 000 customers were eligible for the Minibonds repurchase offers. Out of 1 098 customers who were not eligible for the repurchase offer, 879 were "experienced investors"[46]. Although "experienced investors" and other ineligible customers were able to obtain remediation based on assessment of the merits of individual complaint cases through the ECHP, the Subcommittee considers it unfair and unjustifiable to draw certain lines which are arbitrary and lack legal basis to exclude certain investors from the repurchase offers.

Power to compel payment of compensation

6.42 The Subcommittee notes that before SFC exercise its power under section 201 of SFO and enters into any agreement, two statutory pre-conditions must be met. Firstly, SFC must be contemplating the exercise of its disciplinary power against the person concerned. Secondly, SFC must be satisfied that the agreement to be entered into is one that is appropriate in the interest of the investing public or in the public interest[47].

6.43 In the light of the above, it is clear to the Subcommittee that when contemplating to enter into an agreement pursuant to section 201 of SFO in relation to the LB-related complaints, SFC must have already gathered evidence from its investigation which enabled it to exercise disciplinary power against the RIs. Under the existing legislation, while SFC may impose penalties for breaches of regulatory requirements under SFO, neither SFC nor MA has the power to order the RIs to make

[46] "Experienced investors" in respect of relevant series of Minibonds were able to recover part of their original investment from the collateral. Please see footnote 35 of this chapter and Appendix 6(b).
[47] Section 201(3) of SFO.

payment of compensation to the affected investors. As explained by Mr WHEATLEY at the hearings on 26 June and 3 August 2009, banks might make voluntary offers if they felt that SFC had a strong case that they had failed in their duties and breached the Code of Conduct. They might realize that providing an equitable solution would be in their interests. However, the making of such offers was a voluntary action on the part of the RIs.

6.44 The Subcommittee notes that the agreements pursuant to section 201 of SFO are often the compromise reached after long-drawn negotiation, as reflected in the length of time taken to reach the five settlement agreements with the RIs in question, and the terms of such agreements, such as the repurchase price which fell short of the principal amount and/or the exclusion of certain investors from the repurchase offers. Another issue of concern is the decision of SFC and HKMA not to pursue enforcement/disciplinary action against the RIs in question and their employees in respect of the cases covered by the settlement agreements. The Subcommittee believes that the regulators' not pursuing enforcement/disciplinary action might be a crucial condition without which the settlement agreements with distributing banks could not have been reached. In this regard, the Subcommittee is seriously concerned that these agreements can lead to the impression that a regulated person who has failed to comply with regulatory requirements can escape sanction so long as the person is willing to come to a monetary settlement with the complainants.

6.45 The Subcommittee considers that if the regulator responsible for enforcement is also vested with appropriate powers to order the payment of compensation where the findings so justify, the existing system of handling and resolving LB-related complaints can be enhanced. In particular, the regulator needs not consider discontinuing their enforcement actions in deserving cases in return for a settlement deal with the regulated persons. Payment of compensation and consideration

of disciplinary action (where required) may proceed in parallel. The Subcommittee would however emphasize that even if a regulator is empowered to order the party guilty of misconduct to pay compensation, the entitlement of aggrieved investors to compensation and the amount payable would still depend on the circumstances of individual cases. The exercise of the power by the regulator to order payment of compensation may also be the subject of litigation.

Chapter 7 Investor protection

7.1 Arising from the LB incident, a major concern to the Subcommittee is whether investors in Hong Kong are adequately protected under the existing regulatory regime. This chapter examines the issue of investor protection in the light of the LB incident.

Policy on investor protection

7.2 According to Prof CHAN Ka-keung, SFST, and Mr John TSANG, FS, the Administration attaches great importance to investor education and to protecting the interests of the investing public. At the policy level, investor protection has always been one of the Administration's core policy objectives. The Administration makes every effort to ensure that the financial regulators are sufficiently resourced and appropriately empowered to maintain and promote a fair, efficient, transparent and orderly financial market for the better protection of investors. The Subcommittee was informed by Prof CHAN Ka-keung that the Administration and regulators had stayed in close touch and exchanged views on issues related to investor protection and education on an ongoing basis.

The responsibilities of the regulators in investor protection

7.3 In his testimony, Mr Joseph YAM, then MA, stated that one of MA's key focuses in the day-to-day regulation of the securities business of banks is investor protection, in particular the prevention and detection of mis-selling of financial products to investors. According to Mr YAM, although investor protection is not expressly stated in BO, it can be construed from the relevant provisions of BO that this is a function of

MA. Mr YAM also stated that MA's functions as specified in section 7(2) of BO are relevant to the protection of investors. Other provisions of BO touching upon investor protection include sections 58A, 71C, 71E(6) and 132A(9). The Subcommittee notes that as stipulated in section 7(1) of BO, the principal function of MA under BO is to promote the general stability and effective working of the banking system. One of the specific functions of MA set out in section 7(2)(g) of BO is that MA shall take all reasonable steps to ensure that any banking business, any business of taking deposits, or any other business, carried out by an AI is carried on (i) with integrity, prudence and the appropriate degree of professional competence; and (ii) in a manner which is not detrimental, or likely to be detrimental, to the interests of depositors or potential depositors.

7.4 The Subcommittee notes that SFC is the financial regulator with an explicit statutory remit for investor protection. One of SFC's regulatory objectives as specified in section 4(c) of SFO is to provide protection for members of the public investing in or holding financial products. Regarding the statutory functions of SFC, section 5(1)(i) of SFO requires SFC to promote understanding by the public of the benefits, risks and liabilities associated with investing in financial products; while section 5(1)(k) requires SFC to promote understanding by the public of the importance of making informed decisions regarding transactions or activities related to financial products and of taking responsibility therefor. As specified in section 5(1)(l) of SFO, SFC has the function to secure an appropriate degree of protection for members of the public investing in or holding financial products, having regard to their degree of understanding and expertise in respect of investing in or holding financial products. In pursuing its regulatory objectives and performing its functions, SFC is required under section 6(2)(a) and (b) of SFO to have regard to the desirability of maintaining the status of Hong Kong as a competitive international financial centre and the desirability of facilitating innovation in connection with financial products.

Investor protection and investor education

7.5 As stated by Mr Martin WHEATLEY, then CEO/SFC, investor protection has always been and will remain SFC's first priority. This is done through regulation, enforcement[1] and education. According to Mr WHEATLEY, SFC fulfils its role of protecting investors by ensuring sufficient disclosure of product information in the offer documentation for the investor to make an informed investment decision. Intermediaries conducting the sale have the duty to ensure the suitability of an investment product for the particular customer.

7.6 The Subcommittee has noted that surveys on investors had been conducted by SFC[2]. One of these surveys was the Structured Product Investor Survey[3] conducted in 2006 which revealed, amongst others, that about 87.9% of the investors covered in the survey had bought unlisted structured financial products through banks. It was also found that investors' understanding of structured financial products needed strengthening. For example, nearly 30% of the investors had purchased these products with capital preservation as the objective, or they had perceived these products as low risk investments. Where sales representatives were involved, a significant number of investors did not recall having received advice from their sales representatives, while other investors noted difficulty in understanding sales representatives' explanations due to product complexity and the use of jargon[4]. As stated by Mr WHEATLEY, on the same day when the findings of this survey were released, SFC published a Dr Wise article on retail structured notes, issued a press release and another circular to issuers of unlisted structured products drawing their attention to the survey findings. To

[1] The work of SFC and HKMA in regulation and enforcement in respect of the securities business of RIs has been discussed in Chapters 3 and 4.

[2] Reports of about 10 investor surveys conducted during the period from 1999 to 2008 are available on SFC's website at http://www.sfc.hk.

[3] The report on Structured Product Investor Survey published in November 2006, as well as the relevant press release dated 28 November 2006, is available on SFC's website at http://www.sfc.hk.

[4] The summary of these findings is prepared on the basis of the press release dated 28 November 2006 available on SFC's website at http://www.sfc.hk.

follow up, SFC conducted a second round of themed inspections on investment advisers in 2006. This was done in parallel with HKMA's thematic examinations on selected RIs[5].

7.7 The Subcommittee has been informed by Mr WHEATLEY that since 2003, the features and risks of specific types of products and the promotion of informed investing had been active in SFC's investor education work on unlisted structured financial products. SFC also disseminates information through its investor education portal to draw investors' attention to the nature and risks of investment in structured financial products[6]. The Subcommittee has noted from the evidence of Mr WHEATLEY that over 100 publicity initiatives, many of which focused on the investment risks of structured financial products, had been undertaken by SFC. Some examples are given in **Appendix 7(a)**.

7.8 According to Mr Joseph YAM, then MA, it was not appropriate for any regulator to issue public warnings related to individual institutions or specific products. However, he considered that regulators could give general warnings when financial markets experienced heightened volatility. The Subcommittee has noted from his evidence that during the period June 2006 to August 2008, Mr YAM had issued general warnings and urged caution with regard to developments in the global and local economies, in particular the impacts of the sub-prime problems and the ensuing credit crisis through his regular briefings at the Panel on Financial Affairs, his interviews with the media and media briefings. In addition, Mr Joseph YAM also informed the Subcommittee that during this period, he had published articles in his Viewpoint column[7] on the website of HKMA to alert the investing public of market

[5] Please see paragraph 4.37 of Chapter 4.

[6] SFC had operated an Electronic Investor Resource Centre (http://www.eirc.hk) which is now its designated portal for investor education (http://www.invested.hk).

[7] Viewpoint is a bilingual column published weekly on HKMA's website for disseminating messages about monetary and financial issues on-line to the community and in a timely manner. About 500 articles have been written by Mr Joseph YAM, then MA, from September 1999 to September 2009. These articles were carried in a number of local newspapers.

volatilities and financial innovation. For example, on 6 September 2007, he wrote about the impact of the sub-prime issue. On 28 February 2008, he highlighted the risks arising from financial innovation and warned that "investors could find themselves holding assets whose risk-return profile turns out to be different from what they believed". In the Viewpoint article published on 27 March 2008, Mr YAM emphasized the importance for investors to exercise due diligence over their investments, particularly when the structures of the financial instruments and the dynamics of the markets grew in complexity[8]. Some examples of Mr YAM's general forewarnings issued through various channels are given in **Appendix 7(b)**.

7.9 The Subcommittee has noted the proposed establishment of a cross-sectoral Investor Education Council (IEC)[9] to holistically oversee the needs of investor education and delivery of related initiatives. The IEC will be set up as a wholly owned subsidiary company of SFC and will leverage and enhance the current investor education initiatives undertaken by SFC, and on that basis offer expanded education programme across the financial services industry.

"Treating Customers Fairly"

7.10 In examining the issue of investor protection, the Subcommittee has noted that the Financial Services Authority (FSA) in the United Kingdom (UK) introduced a principle-based "Treating Customers Fairly" (TCF) initiative in recent years[10]. The Subcommittee further notes that pursuant to the TCF initiative, investors of a financial product should be

[8] All the Viewpoint articles cited are available on HKMA's website at http://www.hkma.gov.hk.

[9] The IEC is one of the proposals in the Securities and Futures (Amendment) Bill 2011 passed by LegCo on 25 April 2012. Documents related to the Bill are available on LegCo's website at http://www.legco.gov.hk.

[10] In July 2004, FSA issued a paper "Treating customers fairly – progress and next steps" which set out its plan to address the fair treatment of customers throughout the product life-cycle. The paper and other documents relevant to Treating Customers Fairly are available on FSA's website at http://www.fsa.gov.uk.

treated fairly throughout the product life-cycle, including product design, marketing, sale, after-sale and complaint-handling. The TCF defines six consumer outcomes which firms under the supervision of FSA are expected to deliver[11]. They are:

(a) consumers can be confident that they are dealing with firms where the fair treatment of customers is central to the corporate culture;

(b) products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly;

(c) consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale;

(d) where consumers receive advice, the advice is suitable and takes account of their circumstances;

(e) consumers are provided with products that perform as firms have led them to expect, and the associated service is both of an acceptable standard and as they have been led to expect; and

(f) consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint.

[11] The six outcomes are explained in FSA's paper "Treating customers fairly – towards fair outcomes for consumers" issued in July 2006, which is available on FSA's website at http://www.fsa.gov.uk.

7.11 In reply to the Subcommittee's question of whether consideration should be given to implementing a similar TCF initiative under the present regulatory regime governing banks' securities business in Hong Kong, Mr Joseph YAM considered that the nine principles (i.e. GP1 to GP9)[12] set out in the Code of Conduct are in line with the fundamental principles underlying the TCF initiative in UK. The Subcommittee notes that the TCF initiative has a wider coverage in that it extends to the design of a financial product which appears to be beyond the ambit of the Code of Conduct. It is further noted that in 2007, FSA issued a regulatory guide[13] setting out the responsibilities of providers and distributors of financial products for the fair treatment of customers. The regulatory guide requires, amongst others, 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.

Professional investor

7.12 The Subcommittee notes that under the existing regime, the investor population is not categorized and is broadly referred to as the investing public or investors. The only group identified and being treated differently from the rest of the investor population is "professional investors" which is defined in SFO to mean:

(a) market professionals comprising specified entities set out in paragraphs (a) to (i) in Part 1 of Schedule 1 to SFO including investment banks, brokers and managers of authorized funds; and

[12] GP1 to GP9 are explained in paragraph 4.27 of Chapter 4.

[13] In July 2007, FSA issued a Regulatory Guide "The Responsibilities of Providers and Distributors for the Fair Treatment of Customers" and set out its view on the respective responsibility of providers and distributors under the Principles for Businesses to treat customers fairly during the product life-cycle or various stages of provisions of the service. The Guide is available on FSA's website at http://www.fsa.gov.uk.

(b) high net worth investors who are persons (entities and individuals) who have been prescribed under the Securities and Futures (Professional Investor) Rules (Cap. 571D) as professional investors. These include high net worth individuals with a portfolio of not less than HK$8 million (or the equivalent in foreign currency).

7.13 In this connection, the Subcommittee has noted that since the Companies (Amendment) Ordinance 2004 (No. 30 of 2004) came into effect on 3 December 2004, the authorization requirements in respect of offer documentation were exempted under the CO prospectus regime if an offer of investment was made to professional investors only[14]. Certain requirements in the Code of Conduct would, subject to the fulfilment of certain conditions, also be waived regarding professional investors[15]. Nevertheless, irrespective of whether a client is a professional investor, where the transaction involved derivative products such as Minibonds, an intermediary must comply with the provisions under paragraph 5.3 on "Know your client: derivative products" of the Code of Conduct, and satisfy itself that the client understands the nature and risks of the products and has sufficient net worth to be able to assume the risks and bear the potential losses of trading in the products[16].

7.14 The Code of Conduct also requires intermediaries to take necessary steps to ascertain that a high net worth investor is knowledgeable and has sufficient experience in the relevant products and markets, and that he has chosen and confirmed in writing to be treated as a professional investor. The intermediary is also required to confirm

[14] Please see paragraph 4.16 of Chapter 4 on the offer of investment products by private placement. The latest legislative amendments that disapply the "safe harbour" provisions under CO on the offer of structured products are set out in Appendix 4(b).

[15] Paragraph 15.5 of the Code of Conduct.

[16] A new paragraph 5.1A was added to the Code of Conduct with effect from 4 September 2011. Henceforth, except where a client is a professional investor, the intermediary is required to assess the client's knowledge of derivatives and characterize the client based on his knowledge of derivatives. Where a client without knowledge of derivatives wishes to purchase a derivative product, the intermediary is required to warn the client about the transaction and provide appropriate advice to the client on the suitability of the transaction for the client.

annually that the client continues to meet the requirements to be categorized as a professional investor[17].

Observations

7.15 The Subcommittee has identified and examined a number of issues relating to investor protection in the light of the LB incident, and made certain observations as set out in the ensuing paragraphs.

Financial innovation and investor protection

7.16 As explained in paragraph 7.4 above, SFO sets out the regulatory framework for the regulation of the securities market in Hong Kong, with the key objectives to, inter alia, provide protection for members of the public investing in or holding financial products. In pursuing its regulatory objectives, SFC must have due regard to the desirability of maintaining the status of Hong Kong as a competitive international financial centre and the desirability of facilitating innovation in connection with financial products.

7.17 An issue of concern to the Subcommittee is the potential conflict between financial innovation and investor protection; and whether financial innovation and market development had been pursued over the years at the expense of investor protection. Mr Martin WHEATLEY, then CEO/SFC, has stated that investor protection has always been and will remain SFC's first priority, and that this is done through regulation, enforcement and education. In response to the Subcommittee's questions at the hearing on 26 March 2010, Mr WHEATLEY said that SFC is required to strike a proper balance between

[17] Paragraphs 15.3 and 15.4 of the Code of Conduct. In June 2011, new paragraphs 15.3A and 15.3B were added to the Code of Conduct under which the intermediary is required to undertake separate assessment prior to treating an existing Professional Investor as a Professional Investor in a different product type or market, and to undertake a new assessment if the Professional Investor has ceased to trade in the relevant product or market for more than two years.

the need for investor protection and the promotion of market development, and that investor protection would never be sacrificed in order to develop the market. Although there is no ranking of the regulatory objectives specified in SFO, Mr WHEATLEY pointed out that in practice, SFC had always put investors' interest first, and this was so reflected in various issues of SFC's Annual Report[18].

7.18 In examining the initiatives to facilitate market development, the Subcommittee has noted that one such initiative was the enactment of the Companies (Amendment) Ordinance 2004 (No. 30 of 2004) to facilitate the offer of shares or debentures on a repeat or programme basis by introducing a "dual prospectus" structure for programme offerings[19]. The said Ordinance, which came into effect on 3 December 2004, also excluded from the definition of "prospectus" documents containing or relating to offers and invitations that fell within the "safe harbours" set out in the Seventeenth Schedule to CO[20].

7.19 According to Mr WHEATLEY, these measures were not intended to, and did not, adversely affect SFC's regulatory standard applied to issuers and its regulatory function to secure an appropriate degree of protection for the investing public. In the view of the Subcommittee, the above change, which had simplified the requirements on prospectuses, had the effect of facilitating the issuance of certain series of Minibonds and LB-CLNs for public offer. Product issuers were also able to make use of the "safe harbour" provisions under the Seventeenth Schedule to CO to issue LB-ELNs without the need for a prospectus[21]. In the view of the Subcommittee, these measures might have contributed

[18] Please see SFC's Annual Report 2004-05, 2006-07, 2007-08 and 2008-09, which are available on SFC's website at http://www.sfc.hk.

[19] Please see paragraph 4.8 of Chapter 4.

[20] Please see paragraphs 4.16 and 4.17 of Chapter 4 on investment products offered by private placement.

[21] Minibonds and LB-CLNs were structured notes issued in a series under a programme and therefore the "dual prospectus" approach applied. Programme prospectus was not required for every series of the products. LB-ELNs were distributed by banks making use of the "safe harbour" provisions in the Seventeenth Schedule to CO and therefore authorization of the offer documentation by SFC was not required.

to the proliferation of structured financial products, including LB structured products. The Subcommittee has noted that according to the information published by SFC[22], a total of 147 retail structured notes, with an aggregate issue size of HK$9.75 billion, were issued during the 12-month period ending June 2006, as compared to 31 retail structured notes, with an aggregate issue size of HK$7.45 billion, issued during the 12-month period ending June 2004.

Sale of LB structured products in Hong Kong

7.20 Noting that LB structured products had been widely sold to retail investors in Hong Kong, some members of the Subcommittee have enquired whether overseas regulatory authorities had adopted a more stringent approach to prohibit such products from retail sale and as a result, prevented investors from suffering heavy losses. According to the findings in the HKMA Review Report, there did not appear to be absolute restriction on the sale of structured financial products to the retail public in the overseas jurisdictions reviewed by HKMA. The UK, US, Australia, Singapore, the Netherlands and Germany adopted a broadly similar approach based on (i) disclosure by product issuers in public offers; (ii) licensing of financial intermediaries; and (iii) requirements on the intermediaries to treat customers fairly, assess their suitability for products recommended to them, and disclosure of adequate product information to enable the customers to make informed investment decisions. Some jurisdictions required the issuers of products to identify the target market and the types of customers for whom the product was likely to be unsuitable[23].

7.21 The Subcommittee has also noted from the findings in the SFC Review Report that Minibonds were also sold in Singapore. Other LB structured products were sold in Singapore, Taiwan and Indonesia. In

[22] Please see SFC Research Paper No.34 published in September 2006 which is available on SFC's website at http://www.sfc.hk.

[23] Paragraph 7.2 of HKMA Review Report.

Europe, examples included the product with the name "Zertifikate", sold by banks to around 60 000 small investors in Germany. Certain Principal Protected Notes issued by LB were sold in US[24].

7.22 In response to the Subcommittee's question, Mr Joseph YAM said that according to his understanding, there was no prohibition on the sale of LB structured products in US. As stated by Mr Brian HO at the hearing on 21 July 2009, the Securities and Exchange Commission in US had authorized the prospectuses of LB structured products for offers to the public. According to the evidence given by the top management of two banks that had distributed LB-ELNs through private placement, the reason why the LB-ELNs distributed by way of private placement in Hong Kong could not be distributed in US was because they were issued under the EMTN Programme which had not been registered in US. The Subcommittee is not aware of any absolute prohibition on the sale of LB structured products to retail investors in overseas jurisdictions.

Investor education

7.23 The Subcommittee has observed that there is no lack of investor education initiatives taken by SFC and HKMA over the years. However, the LB incident has called into question the effectiveness of these initiatives, in particular whether the key messages had reached those individuals who needed them most. As the majority of the topical articles issued by SFC and HKMA are posted online, they might not be accessible to elderly and less educated persons. Greater use should be made of radio and TV broadcasts as they are the main channels through which these individuals obtain information.

7.24 In addition to the dissemination of information and general advice, the Subcommittee believes that any investor education initiatives must unequivocally convey the message that any investment decision is a

[24] Paragraph 14.3 of SFC Review Report.

decision of the investor, and that he should not invest in products that he does not know or understand.

Suitability assessment in investor protection

7.25 The Subcommittee has noted that ensuring the suitability of a product for the investor is a cornerstone for investor protection. As discussed in Chapter 5[25], there is divergence in the evidence given by the management and frontline staff of the six banks and by the investors on whether and how suitability assessment had been conducted at the point of sale. The Subcommittee has found that each of the six banks had put in place practices and procedures requiring their staff to observe proper standards of conduct when selling LB structured products (as well as other products) to customers. One bank, for example, required the completion of a product-specific suitability questionnaire in addition to assessing the risk tolerance level of the customer[26]. The senior management of another bank raised concern about the need for relevant training and proper suitability assessment as a result of an enlarged customer base for certain LB structured products to be distributed by the bank through private placement[27].

7.26 Notwithstanding the above, the evidence given by the investors on how they had acquired LB structured products has reflected that individual banks had not been resolute and effective in implementing the very procedures laid down by them, and in ensuring that proper conduct at the point of sale was maintained in all cases. The Subcommittee is concerned that where there was a conflict between strict observance of regulatory requirements and the need to maximize business earnings, individual banks had not given due priority to investors' interest in all cases.

[25] Please see paragraphs 5.59 to 5.60 of Chapter 5.
[26] Please see paragraph 5.50 of Chapter 5.
[27] Please see paragraph 5.54 of Chapter 5.

Responsibility for investor protection

7.27 The Subcommittee has no doubt that the Administration and regulators have a vital responsibility in investor protection and must take effective measures to prevent unfair treatment of investors. However, the Subcommittee must also point out that one should not expect the Administration and the regulators to provide a risk-free investment environment for investors. Investors must also exercise a reasonable degree of vigilance and due diligence. In the light of the LB incident, the Subcommittee finds it equally important for investors to take responsibility in protecting their own interest. When being offered certain structured financial products with above-average return, investors, in particular those who are not familiar with financial products or who do not follow market conditions closely, should question and find out why such products would carry a much higher rate of return than, for example, what they would receive on placing plain fixed deposits with the bank. It is essential for investors to recognize the fact that the return on an investment is proportionate to the risks it carries.

7.28 The evidence given by investors of LB structured products[28] clearly shows that there are individuals who, due to their personal circumstances such as age, lack of education or financial illiteracy, have difficulty in comprehending LB structured products no matter how much information or explanation is provided, not to mention making an informed investment decision in relation to these products. To protect these vulnerable individuals, reliance on suitability assessment at the point of sale alone would not suffice. The Administration and the regulators should consider additional measures to prevent the sale of similar structured products to these individuals.

[28] Please see paragraphs 5.46 and 5.52 of Chapter 5.

Fair treatment for customers

7.29 The Subcommittee considers that investor protection cannot be achieved if the product originator or promoter is most keen on product innovation but least minded to treat prospective customers fairly; and if the intermediaries conducting the sale of structured financial products have not fulfilled their obligations (such as undertaking product due diligence, conducting KYC and suitability assessment). As noted by the Subcommittee, the relevant prospectuses and termsheets of certain LB structured products (e.g. Minibonds, LB-CLNs and LB-ELNs) contained statements to the effect that the products were not suitable for everyone, or were only suitable for the more experienced and knowledgeable investors[29]. When selling LB structured products, intermediaries are required to ensure suitability of the product in question for the particular customer.

7.30 Based on the evidence given by witnesses from the six banks, the Subcommittee has found that not all the banks had specified the target customers to whom LB structured products would be sold. Customers were sold LB structured products subject to being assessed as suitable for acquiring such products in accordance with the banks' relevant requirements and procedures[30]. However, the evidence given by many of the investors revealed that the LB structured products sold to them were not in line with their investment experience, objectives and risk appetite[31].

7.31 The Subcommittee has also noticed from the evidence of the investors of LB structured products that many of them were long-time customers of the banks, and had placed considerable trust in the banks and their staff[32]. The Subcommittee considers that banks enjoy

[29] Please see paragraph 2.17 of Chapter 2.
[30] For more details, please see paragraphs 5.41 to 5.64 of Chapter 5.
[31] Please see paragraphs 5.46 and 5.52 to 5.53 of Chapter 5.
[32] Please see paragraph 5.46 of Chapter 5.

proximity to their customers by virtue of their branch networks and banking services. In principle, the Subcommittee does not have any objection for banks to promote their securities business (e.g. sale of structured financial products). However, it believes that individual banks should implement effective measures to ensure that their customers were fairly treated, and not to take unfair advantage of long-time customers' trust in them by selling financial products which were not suitable or comprehensible to these customers. In this context, the Administration and the regulators are urged to study whether product issuers and RIs (as well as other intermediaries conducting securities business) should be required to implement appropriate measures to deliver the desired outcomes for treating customers fairly during the product life-cycle, broadly similar to the requirements contemplated under the TCF initiative of FSA in UK.

Investor types

7.32 One key issue that has emerged from the LB incident is whether the Administration or the regulators should require intermediaries to restrict the sale of derivative products such as LB structured products to those investors who are conversant with financial market products. A related question is whether the investor population should be categorized so that certain products can only be sold to specified categories of investors. As the Subcommittee has noted in paragraph 7.12 above, the only distinct investor type is "professional investor" as defined under SFO. The rest of the investor population is not categorized, although the investment knowledge, market experience and risk tolerance may vary widely among these investors.

7.33 In examining the offer documentation of LB structured products, the Subcommittee has noted that the termsheets of several LB-ELNs contained reminders to prospective investors that the issuer, the guarantor and the dealer of the notes consider that "the notes are only

suitable for highly sophisticated investors who are able to determine themselves the risk of an investment linked to shares". According to the termsheet of one LB structured note[33] which was linked to the performance of a basket of market indices and distributed by way of private placement, prospective investors should be experienced with respect to derivatives, particularly options and options transactions.

7.34 In this context, the Subcommittee has noted that according to the guidance issued by the National Association of Securities Dealers (NASD) in US in September 2005, individual investors who wish to acquire structured financial products are required to have an account approved for options trading, given the similar risk profile of many structured products and options[34]. The Subcommittee sees merits in using certain tangible "qualifications" such as the past or current investment activity of the investor as a requirement in determining whether certain financial products can be sold to the investor in question.

[33] Termsheet of Lehman Brothers 2.5 years USD Market Leader, Monthly Auto-call Principal Protected Note produced by the management of one of the six banks.

[34] NASD Notice to Members 05-59 dated September 2005. NASD was the predecessor of the Financial Industry Regulatory Authority, which is currently the largest self-regulatory organization in US operating under the oversight of the Securities and Exchange Commission and responsible for regulating all securities firms that do business with the public, including with respect to professional training, testing and licensing of registered persons, arbitration and mediation. Broker-dealers in US cannot conduct business until they are members of a self-regulatory organization.

Chapter 8 Concluding observations and recommendations

8.1 In the preceding chapters, the Subcommittee has analyzed the evidence according to the themes relevant to the Subcommittee's study, and stated its observations on issues of concern. This chapter sets out the Subcommittee's concluding observations and recommendations on the basis of the foregoing analysis and observations.

CONCLUDING OBSERVATIONS

The regulatory structure

(Please refer to paragraphs 3.11 to 3.12, 3.31 to 3.34)

8.2 Since the commencement of SFO and BAO in April 2003, HKMA, being the frontline regulator of banks, has taken on the added responsibility of supervising the regulated activities carried on by banks in accordance with the standards and requirements set and applied by SFC to its licensed intermediaries. Unlike SFC which maintains a licensing regime for intermediaries, HKMA does not regulate ReIs directly but relies on the bank management to ensure compliance of their ReIs with regulatory requirements. The LB incident has exposed the inefficacy of the current regulatory structure, as manifested in the following facts:

(a) HKMA had not detected and rectified at an early stage the non-compliance by RIs and their staff with regulatory requirements in their sale of investment products; and

(b) during the five years or so preceding the collapse of LB, relatively few enforcement actions had been taken by HKMA against ReIs.

Policy role of the Government

(Please refer to paragraphs 3.3 to 3.5, 3.20 to 3.22, 3.35 to 3.36)

8.3 One of the objectives of enacting SFO and BAO is to bring the securities business of banks under the regulatory regime of SFO so that both the banking and securities sectors would be subject to consistent regulation in respect of their securities business. Given the importance of the new regulatory framework put in place since April 2003, the Subcommittee considers that the Administration should have taken a proactive role in initiating a comprehensive review of the effectiveness of the regulatory arrangement and whether the policy objectives can be met. The fact that no comprehensive review has been carried out means that many existing weaknesses have been left to subsist for years and remained unaddressed.

Regulation of the distribution of LB structured products by RIs

8.4 The twin pillars of "disclosure under the CO prospectus regime" and "regulation of intermediaries' conduct at the point of sale" were separately administered by two different regulators. SFC is responsible for the disclosure regime to ensure sufficient disclosure of information in the product documentation; while HKMA is responsible for supervising RIs in their conduct of regulated activities. Through its examination of the LB incident, the Subcommittee has come to the view that this system suffered from the following deficiencies that rendered it ineffective:

<u>CO prospectus regime</u>

(Please refer to paragraphs 4.5 to 4.10, 4.12 to 4.17, 4.19 to 4.25, 7.6)

(a) Since about 2005, there had been increased exposure of retail investors to structured financial products sold through banks. The public offer of most of these products was regulated under the CO prospectus regime. However, the CO prospectus regime was intended to

cater for equity or traditional debt capital-raising issues, not structured financial products structured as "debentures" (such as Minibonds). The matters required to be disclosed under the Third Schedule to CO, although very detailed and exacting, were not specifically directed at structured financial products. Little detailed guidance was provided on disclosure specific to structured financial products.

(b) Prospectuses were often lengthy and difficult to read. The information had not been disclosed in a manner which could effectively apprise prospective investors of key product features and risks.

(c) Some HK$6.2 billion worth of LB structured products had been sold to about 6 000 investors by way of private placement[1], under which the offer documentation and marketing materials did not require authorization by SFC. The fact that a sizable portion of LB-related product documentation could make use of the exemptions under CO and avoid oversight by SFC was incongruent with the objective of a disclosure regime emphasizing SFC's role to ensure sufficient disclosure, and undermined the usefulness of such a regime.

Regulation of conduct at the point of sale
(Please refer to paragraphs 4.26, 4.32 to 4.49)

(d) The current arrangements, under which HKMA relies on the management of RIs to ensure compliance of their ReIs instead of regulating them directly, had not been conducive to the early detection of mis-selling of structured financial products.

[1] Please see Appendix 2(b) of Chapter 2.

(e) Prior to the collapse of LB, both HKMA's day-to-day regulation and thematic examinations had not detected serious failure in compliance. This is in sharp contrast to the large number of complaints about mis-selling after September 2008. The ongoing regulatory process of HKMA had largely been ineffective in detecting non-compliance in RIs' sale of investment products.

(f) HKMA is responsible for supervising RIs, detecting and conducting initial investigation into non-compliance. However, the power to impose sanctions on RIs for breaches of regulatory requirements rests with SFC and can only be exercised after consultation with MA. The division of regulatory powers between the two regulators has given rise to operational complexities which are not conducive to effective complaints handling and enforcement.

Compliance with regulatory requirements by RIs

8.5 The Subcommittee has found that there were deficiencies in compliance with regulatory requirements in the sale of LB structured products, as set out in the following paragraphs.

Product due diligence
(Please refer to paragraphs 5.7 to 5.22)

(a) There was little evidence that RIs had reviewed in what aspects the LB structured products were considered suitable for different risk categories of investors.

(b) There were instances of inappropriate risk ratings being assigned to LB structured products, such as non-principal protected LB-CLNs being rated as a product of low-to-medium risk.

(c) There was little evidence that the risk ratings of LB structured products had been subject to continuous reviews.

Staff training and guidance
(Please refer to paragraphs 5.24, 5.32 to 5.34, 5.37 to 5.40)

(d) The "basic" academic[2] qualification for ReIs stipulated in the Guidelines on Competence are no longer adequate in enabling ReIs to discharge their duties to their clients in the light of the changes and developments in the financial markets.

(e) The training materials (supplied by the co-ordinating distributor) used by some RIs contained misleading information to the effect that Minibonds was authorized by SFC for offer to ordinary investors. It did not appear that these RIs had conducted their own independent review of such materials. However, the training materials were likely relied upon by sales staff in understanding the product. Not all sales staff and bank management had understood correctly what was meant by "SFC authorization" in relation to Minibonds.

KYC and suitability assessment
(Please refer to paragraphs 5.46 to 5.47, 5.52 to 5.53, 5.56, 5.58 to 5.64)

(f) Notwithstanding the policies and procedures put in place by individual RIs, there was evidence that not all the requisite procedures on KYC and suitability assessment had been followed in every transaction (e.g. suitability assessment not done before the transaction, special arrangements not carried out in respect of golden age

[2] Passes in English or Chinese, and Mathematics in the Hong Kong Certificate of Education Examination, as stipulated in Paragraph 5.4 of Guidelines on Competence issued by SFC in March 2003. Please see also paragraph 5.24 of Chapter 5.

customers, questions in the risk-profiling questionnaires not understood by the investor).

(g) The fact that some individuals who could hardly be assessed as suitable for LB structured products had been sold such products demonstrated that not all RIs had effectively ensured that KYC and suitability requirements had been properly carried out by sales staff in all cases.

The sales process
(Please refer to paragraphs 5.67, 5.69 to 5.71, 5.73 to 5.75, 5.77 to 5.81)

(h) The lack of understanding of LB structured products as revealed by some investors cast serious doubt on whether the product had been properly explained to them. It was questionable whether individual investors had been provided with relevant prospectuses or given the opportunity to read the prospectuses and ask questions.

(i) Placing a deposit and making an investment require very different considerations on the part of the customer. However, some customers were not aware that they were making an investment, and could not distinguish between banking services and investment services, especially if they had been sold LB structured products when their original intention was only to place or renew a time deposit with the bank. Some customers who were general depositors hardly regarded themselves as investors.

(j) In selling LB structured products to customers, RIs claimed that they only provided investment information, not investment advice. From the perspective of some customers, the line between the two was far from clear, as it was often the case that they had been introduced to such products by the bank staff who also persuaded them to subscribe for these products for higher returns. As the

giving of investment advice which is incidental to the sale of the investment product is permissible under existing regulatory requirement, certain clarification is needed to minimize contention over whether the customers had been given "information" or "advice" in relation to his purchase of an investment product.

(k) RIs tended to rely on the relevant forms, which included certain declarations or acknowledgements, signed by the investors as proof of their understanding of the LB structured products and the suitability of the products for them. There should be other means to collaborate any proof that the product had been properly explained to and understood by the investors.

Monitoring and internal controls
(Please refer to paragraphs 5.94 to 5.96, 5.99 to 5.100)

(l) RIs had relied heavily on reviews of transaction documents to ascertain whether all requisite steps of the sales process had been completed. However, if these documents were not prepared as a true record of what had been done, they could not be relied upon for any review of compliance, or for detecting irregularities.

Handling of complaints
(Please refer to paragraphs 5.104 to 5.105, 5.108, 5.111 to 5.114)

(m) The large number of complaints that remained outstanding before the settlement agreements announced since July 2009 had raised doubts about the adequacy of the complaint-handling processes of individual RIs in resolving LB-related complaints expeditiously. Aggrieved investors had encountered difficulties in the course of pursuing their complaints with the distributing banks and very few complaints had been settled through direct negotiation between the investors and the RIs.

Sales targets and incentives
(Please refer to paragraphs 5.83 to 5.92)

8.6 The evidence available to the Subcommittee did not show that frontline bank staff had relied heavily on the sale of LB structured products in order to meet sales targets and earn incentives, nor were there indications that sales performance was the overriding factor in appraising staff performance. Nevertheless, the Subcommittee considers that the regulators should pay ongoing attention to the remuneration and incentives structures of RIs to ensure that they do not place undue emphasis on sales performance at the expense of compliance.

Agreements pursuant to section 201 of SFO

(Please refer to paragraphs 6.24 to 6.26, 6.31, 6.40 to 6.41)

8.7 The Subcommittee has found that while the settlement agreements entered into by SFC, MA and the distributing banks pursuant to section 201 of SFO had led to the resolution of the bulk of LB-related complaints, these agreements had their limitations. Whilst it is understood that these agreements are the compromise reached after long-drawn negotiation between SFC, HKMA and the distributing banks, the Subcommittee considers it unfair to exclude certain investors from the repurchase offers by arbitrarily designating them as "experienced investors", when no such designation is found in existing legislation.

Power to order payment of compensation

(Please refer to paragraphs 6.42 to 6.45)

8.8 Currently, neither SFC nor MA has the power to order an RI to compensate an investor, even if there are adverse findings against the RI. In the absence of such power, the regulators might have to agree not to take enforcement action against the RIs in order to reach an agreement with them pursuant to section 201 of SFO to settle the outstanding LB-related complaints. The Subcommittee considers that the regulator(s)

should be empowered to order the payment of compensation without prejudice to disciplinary actions in deserving cases.

Handling and resolution of LB-related complaints

(Please refer to paragraphs 5.104 to 5.105, 5.112 to 5.114, 6.9 to 6.10, 6.28, 6.37 to 6.39)

8.9 The Subcommittee considers that individual investors' lack of bargaining power and access to information had placed them in a disadvantaged position when negotiating with individual RIs to settle their cases. The recourse to legal action might not be a practicable option due to the time and costs incurred. There is thus a strong need to put in place a simple, speedy and affordable mechanism for resolving disputes between the aggrieved investors and the financial institutions.

Investor protection

(Please refer to paragraphs 7.2 to 7.4, 7.23 to 7.34)

8.10 The LB incident has exposed the inadequacies of the regulatory system in safeguarding investors' interest. While investors should not look forward to an investment environment which is risk-free, the Administration and the regulators have an undisputable responsibility in investor protection. As demonstrated in the LB incident, the prevailing "disclosure-cum-conduct regulation" regime has failed to provide sufficient protection to investors for the following reasons:

(a) Disclosure of information, often in copious product documentation, was not helpful in facilitating investors to understand the product and make an informed decision.

(b) The large number of complaints about mis-selling and the regulatory concerns raised by SFC (as set out in the relevant press releases on the various settlement agreements announced since July 2009) are strong

indication of the failure of RIs to comply properly with relevant regulatory requirements at the point of sale.

(c) It does not suffice to require only the intermediaries to ensure suitability of the investment product for the customer in question. Many investors who were not suitable for acquiring LB structured products had acquired such products. The Administration and regulators should introduce additional safeguards so that certain products can only be sold to specified categories of investors by intermediaries.

8.11 Despite various investor education initiatives, it does not appear that certain key messages, such as "investor should not invest in products they do not understand" and how investors themselves can best protect themselves, have been delivered to reach the investing public.

Accountability

8.12 The Subcommittee has also examined the accountability of the following key government officials and CEO/SFC in the LB incident.

Mr Joseph YAM, former MA

8.13 Mr Joseph YAM held office as MA from 1 April 1993 to 30 September 2009 and was the Chief Executive of HKMA. He was accountable for the performance of HKMA, including its role as the frontline regulator of banks supervising their regulated activities in accordance with the standards and requirements set by SFC.

8.14 The phenomenal growth in the securities business of banks since 2003, the increased exposure of retail investors to structured financial products available at banks and investors' insufficient knowledge on such products (as revealed in the surveys conducted by SFC in 2005 and 2006) should have alerted HKMA of the need to step up surveillance on the compliance of RIs so as to ensure that customers

would not be mis-sold investment products. However, as observed in paragraphs 4.45 and 4.46 of Chapter 4, the ongoing regulatory process of HKMA had not detected any serious irregularities in the selling practices of RIs prior to the collapse of LB. This is in contrast to the Subcommittee's findings on the deficiencies in compliance with regulatory requirements by RIs as described in paragraph 8.5 above. The Subcommittee considers that in his capacity as MA and the Chief Executive of HKMA, Mr Joseph YAM should take ultimate responsibility for HKMA's failure to detect and rectify problems related to the sale of investment products before they became widespread among RIs and should be reproved.

8.15 Noting the deficiencies in compliance by RIs as described in paragraph 8.5 above and the large number of complaints alleging the mis-selling of LB structured products, the Subcommittee does not subscribe to any view that the relatively few enforcement actions taken by HKMA against ReIs in the years preceding the collapse of LB were indicative of a good level of compliance with the regulatory requirements at the point of sale. Had HKMA been more effective in enforcing the regulatory requirements on the conduct of regulated activities, cases of mismatch in which LB structured products had been sold to investors who were hardly suitable for these products could have been reduced.

<u>Mr Martin WHEATLEY, former CEO/SFC</u>

8.16 Mr Martin WHEATLEY was CEO/SFC from 23 June 2006 to 8 June 2011. The proposal to transfer the regulation of public offers of structured products from the CO prospectus regime to the offers of investments regime under SFO was one of the consultation conclusions published by SFC in September 2006. If this initiative was implemented, SFC would be able to issue product codes to prescribe structural requirements, in addition to disclosure requirements, taking into account the nature of the product. Product issuers could no longer make use of the "safe harbours" in the Seventeenth Schedule to CO (commonly relied on for issuing private placement notes) and the "dual prospectus" approach under CO to issue structured products frequently and successively. However, the legislative amendments did not materialize

until May 2011 following the passage of the Securities and Futures and Companies Legislation (Structured Products Amendment) Bill 2010. The original plan of SFC was to pursue this legislative proposal together with the other initiatives under Phase 3 of the CO rewrite exercise. It was only after the LB incident in 2008 that SFC decided to advance this legislative proposal ahead of the original schedule.

8.17 Through its own studies and surveys conducted in 2005 and 2006, it was clear to SFC that an increasing number of structured products had found their way into the retail market. SFC was also fully aware that the disclosure requirements under the CO prospectus regime had its limitations and were not adequate in regulating the public offers of structured financial products. Had the legislative amendments been introduced at an earlier time in, for example, 2006 or 2007, the public offers of structured financial products, such as Minibonds and other LB structured products issued by way of private placement, could have been more effectively regulated under the offers of investments regime of SFO. The Subcommittee is greatly disappointed that Mr Martin WHEATLEY, then CEO/SFC, had not secured the enactment of the relevant amendment legislation in a timely manner, and considers that he should take certain responsibility for the belated transfer of the regulation of public offers of structured notes from the CO prospectus regime to the offers of investments regime under SFO.

8.18 SFC was aware from the outset that Minibonds would likely be distributed to the general public through retail banks. Its studies and surveys conducted in 2005 and 2006 also revealed, amongst others, that investors' knowledge on structured financial products was inadequate. Hence, SFC should have no difficulty in envisaging that retail investors might, by virtue of the product name, understand Minibonds as a type of traditional bonds. However, as described in paragraphs 4.20 to 4.22 of Chapter 4, SFC had taken a strictly legalistic view on the term "Minibonds" (迷你債券) and considered that it was not in itself misleading. As the then CEO/SFC, Mr Martin WHEATLEY should take responsibility for not having sufficient sensitivity to the needs and perception of general investors in connection with SFC's vetting of product documentation.

Mr John TSANG, FS and Prof CHAN Ka-keung, SFST

8.19 Mr John TSANG and Prof CHAN Ka-keung have taken up their current posts since 1 July 2007. As the principal officials with the policy responsibility in financial matters, it is incumbent upon Mr TSANG and Prof CHAN to keep abreast of market developments and to provide the necessary policy steer to ensure the effective regulation of the financial system in Hong Kong.

8.20 The regulation of the securities business of banks by both HKMA and SFC has been in operation since April 2003 and there is no lack of developments calling for regulatory attention. These included the phenomenal growth in the securities business conducted by banks since 2003, concerns from brokers that banks appeared to have been more favourably treated in carrying out regulated activities (as noted in paragraph 3.35 of Chapter 3) and the relatively lack of enforcement action and sanctions on ReIs. The Administration's role is to ensure not only that the regulators are sufficiently resourced and appropriately empowered to carry out their functions, but that the relevant regulatory objectives are achieved.

8.21 Notwithstanding the above, there is no evidence that before the collapse of LB, Mr John TSANG and Prof CHAN Ka-keung, in their capacity as FS and SFST respectively, had initiated, or required the regulators to undertake, a comprehensive review of the current regulatory arrangement. Not until the collapse of LB affecting tens of thousands of investors did Mr John TSANG, FS, require HKMA and SFC to submit review reports to him. Mr John TSANG and Prof CHAN Ka-keung should take responsibility for failing to initiate a timely review of the current regulatory arrangement to identify and address issues of concern. Being the chairman of CFR and FSC respectively, there is no indication that Mr John TSANG and Prof CHAN Ka-keung had been aware of issues of regulatory concern straddling the work of HKMA and SFC, and consequently did not sense the need to conduct a review of the regulatory arrangement.

8.22 As described in paragraph 3.26 of Chapter 3, in about mid September 2008, the principal concern of the top level of government was the stability of the local banking and financial sectors. It is not apparent that Mr John TSANG and Prof CHAN Ka-keung, in their capacity as FS and SFST respectively, had been aware of the extent of exposure of local retail investors to structured financial products, and the fact that the credit risks inherent in LB structured products had indeed been assumed by the investors of such products. At that time, they did not have a reasonable grasp of the dire consequences for these retail investors should LB fail. The Subcommittee expresses disappointment that Mr John TSANG and Prof CHAN Ka-keung had not performed their respective functions to a level that was expected of them in overseeing the regulation of the securities business of banks by HKMA and SFC.

RECOMMENDATIONS

8.23 Arising from its concluding observations, the Subcommittee has formulated the following recommendations with a view to improving the regulation of the securities business carried on by banks and the protection available to investors.

The disclosure regime for the offer of investment products

Disclosure requirements specific to structured financial products

8.24 The Subcommittee notes that as a result of the transfer of the regulation of the offer of structured financial products from CO to SFO[3] in May 2011, SFC has been able to stipulate the disclosure requirements that are specific to structured financial products by issuing the Code on Unlisted Structured Investment Products (SIP Code)[4] under section 399 of SFO. A structured product cannot be offered unless the offer

[3] Please see paragraph 4.5 of Chapter 4 and Appendix 4(b).

[4] The SIP Code is part of the SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products published under section 399 of SFO in June 2010.

documentation of the product has complied with the disclosure requirements and has been authorized by SFC under SFO. The Subcommittee considers the new arrangements an improvement over the CO prospectus regime.

8.25 Given the innovation in financial products, **the Subcommittee recommends that SFC should review regularly, and where necessary, revise the disclosure requirements set out in the SIP Code having regard to market developments and its regulatory experience.**

Quality of disclosure

8.26 In the context of the guidance provided in the SIP Code, **the Subcommittee recommends that SFC should:**

(a) consider making it mandatory for disclosure of information on structured financial products for sale to retail investors to be written in plain language; and

(b) evaluate at regular intervals the effectiveness of the Advertising Guidelines applicable to structured products, such as how best to present the risks and returns of a product in a balanced manner.

8.27 The Subcommittee notes that as required under the SIP Code, every offering document must contain a Product Key Facts Statement (PKFS) which highlights the key features and risks of a product in a clear and concise manner.

8.28 The Subcommittee considers the PKFS a useful aid, but **recommends that SFC should proactively evaluate the effectiveness of the PKFS with a view to ensuring that the information is presented in a way that can be comprehended by lay investors.**

Need for review of the disclosure regime

8.29 One of the issues that has emerged from the LB incident and examined by the Subcommittee is whether the disclosure regime should be retained or replaced by another regime, such as a product approval regime which operates by way of certain products being prohibited from sale to investors, or subject to vetting before approval can be given for their sale. In the light of financial innovations and the diversity of investment products, such a regime may arguably safeguard investors against risky products. However, according to information available to the Subcommittee, this approach is not found in other jurisdictions commonly looked to by Hong Kong when considering international practices. A number of problems are envisaged under this regulatory approach, including the following:

(a) Financial innovation may be stifled resulting in less choice to investors. This may work to the detriment of fostering Hong Kong's status as an international financial centre.

(b) There are practical difficulties in determining the products that should be approved or disapproved, as a product not suitable for retail investors may suit certain investors who are conversant with financial products and willing to assume higher risks in order to achieve higher returns.

(c) A pre-approval regime will risk substituting the regulator's judgement for that of the investors. Moral hazard will arise as investors may become less wary of potential risks and decide to purchase an "approved" product in the mistaken belief that it must be sound and safe. This pre-approval will also reduce intermediaries' awareness of their obligations to conduct product due diligence and ensure suitability of the product for the particular customer.

8.30 **The Subcommittee recommends that the current disclosure regime should be beefed up with reference to the TCF initiative announced by FSA in UK requiring due consideration be given to treating customers fairly throughout the product cycle[5], and by requiring the product issuer to disclose the following matters:**

(a) the target customers for whom the product is likely to be suitable; and

(b) how the product characteristics are suitable for that particular group of target customers.

Regulation of the conduct of RIs and their staff

8.31 Irrespective of whether and how the regulatory structure may be changed, the Subcommittee believes that the regulators should take measures to remedy the deficiencies in RIs' compliance with regulatory requirements.

Strengthening the supervision of RIs

8.32 To strengthen supervision of RIs, **the Subcommittee recommends that both on-site examinations and off-site surveillance of RIs should focus on the capability of the management controls and systems within the RIs to ensure that:**

(a) sales staff are fit and proper, adequately trained and have sufficient understanding of the investment products being sold by them;

(b) the remuneration and incentives structure for sales staff gives sufficient recognition to due compliance, in addition to sales performance;

[5] Please see paragraphs 7.29 to 7.31 of Chapter 7.

(c) product due diligence is performed in full compliance with the requirements under the Code of Conduct and Suitability FAQ. Assessments of the products should demonstrate in what aspects such products are considered suitable or unsuitable for different risk categories of investors;

(d) prior to the transaction, all necessary steps are taken to fulfil an intermediary's obligations in respect of the KYC requirements and suitability assessment;

(e) there is adequate and effective means to monitor the sales process without placing undue reliance on documentation only; and

(f) processes are in place for handling customers' complaints expeditiously and fairly.

8.33 The Subcommittee notes that one of the measures implemented by SFC and HKMA after the LB incident is the mystery shopper programme to test the sales processes of RIs periodically. The Subcommittee sees merits in this regulatory tool to obtain first-hand information on the way RIs sell investment products to their customers.

8.34 **The Subcommittee recommends that the regulators should:**

(a) make use of tools such as mystery shoppers; and

(b) publish the general findings of these initiatives for reference by the industry and the public.

Benchmarking the practices of RIs

8.35 The Subcommittee recognizes that it is a matter for individual RIs to devise their own practices and procedures to carry out regulated activities in compliance with regulatory requirements; and regulators should not seek to prescribe how RIs should manage their affairs.

However, the LB incident has revealed deficiencies in the practices adopted by certain RIs, as highlighted in paragraph 8.5 above.

8.36 To better assist RIs to fulfil their obligations which will in turn provide better protection to investors, **the Subcommittee recommends SFC and HKMA to consider the feasibility of setting benchmarks on the following key requirements to achieve consistency in standards and better protection for investors:**

(a) product due diligence and the risk-rating of investment products (e.g. whether products sharing common features, such as non-principal-protected structured financial products, should receive a uniform risk-rating);

(b) training for sales staff (e.g. whether intermediaries should be required to provide training to staff in respect of each series of a product, and the basic requirements that should be adopted for testing the staff's knowledge after training);

(c) the risk profiling conducted on customers (e.g. whether it is necessary for certain assessment methodology to be adopted across the board in order to avoid anomalous results that are hard to justify);

(d) the basic information on an investment product that must be explained to the customer by the intermediaries before completion of transaction (e.g. the lock-up period for the investment, whether the product is principal-protected, the worst scenario arising from the investment etc.);

(e) handling of risk-mismatched transactions (e.g. whether it is necessary to set certain thresholds for permitting such transactions); and

(f) complaint-handling procedures (e.g. to make it a mandatory requirement that RIs should interview the complainants (where practicable), and specify their performance pledges in handling customer complaints).

Review of the minimum qualifications for ReIs

8.37 In the light of the Subcommittee's observation in paragraph 8.5(d) above, **the Subcommittee recommends that the regulators should consider raising the minimum academic qualification of ReIs (e.g. a university degree and/or professional training in specified fields such as finance or accounting).**

Sales process

8.38 As highlighted in paragraph 8.5(i) above, there is potential confusion between banking services and investment services in the mind of a customer if the same staff who handles his bank accounts also sells him investment products. The Subcommittee agrees that RIs should be required to take steps to ensure clearer differentiation between traditional deposit-taking activities and retail securities business. It notes that after the LB incident, RIs have already been required by HKMA to put in place a number of measures such as segregation of premises, complete separation of information on a customer's deposit accounts and his investment accounts, etc.

8.39 **The Subcommittee recommends that HKMA should:**

(a) review the effectiveness of the above improvement measures; and

(b) publish the findings of such reviews for reference by the industry and the public.

8.40 Arising from its observation in paragraph 8.5(j) above, the Subcommittee considers that the line between the offering of investment information and of investment advice was far from clear. Besides, it was often the RIs' view that the sale of an investment product was a transaction on a one-off basis, and their duty towards the investors ceased upon completion of the transaction. However, the Subcommittee doubts whether such a stance is fair and in the interest of investors.

8.41 The Subcommittee recommends that the regulators should consider, whether by legislation or by amending the Code of Conduct, stipulating that:

(a) when providing investment information to their customers, RIs would be deemed to be providing also incidental investment advice, unless RIs have proof to the contrary; and

(b) where the investor who has acquired an investment product remains a customer of the RI by holding valid account(s), the duty of the RI to the investor should continue throughout the product tenor.

8.42 As analyzed in Chapter 5[6] , the evidence given by the RIs and the investors differs considerably on whether and how the relevant steps in the sales process of LB structured products had been properly completed. The Subcommittee is of the view that the investor, who is also a party to the transaction, should also be informed of the requisite steps leading to conclusion of the transaction.

8.43 **The Subcommittee recommends that the regulators should consider requiring RIs to take the following measures:**

(a) to provide their ReIs with a checklist setting out the requisite steps to be taken for the transaction;

[6] Please see paragraphs 5.59 to 5.60 and 5.80 of Chapter 5.

(b) the ReI to inform the customer of these requisite steps;

(c) the ReI to seek the customer's acknowledgment upon completion of each of the specified steps; and

(d) to audio-record the above steps as part of the sales process.

Through the above measures, the ReIs can assure themselves that the requisite steps had been duly completed while the customers will also be in a position to ascertain the completion or otherwise of the necessary steps applicable to the transaction in question. These measures will contribute to a structured sales process and facilitate RIs to make a reasonable estimate of the minimum time required to conduct a typical sale process properly.

Complaint-handling and disputes resolution

Regulatory powers

8.44 The division of regulatory powers between HKMA and SFC has given rise to operational complexities which are not conducive to effective handling of complaints and enforcement.

8.45 **The Subcommittee therefore recommends that:**

(a) investigatory and disciplinary powers against RIs and their staff should rest with a single regulator;

(b) as far as permissible under the relevant legislation, the regulator should introduce greater transparency through -

(i) publication of general information or statistics on the investigation and enforcement outcomes of complaint cases;

(ii) keeping the complainants informed of the progress of investigation of their complaints, including the actions taken/to be taken; and

(c) in case the regulator decides not to take further action on a complaint, it should provide a proper explanation of the reasons to the complainant.

Exercise of the power under section 201 of SFO

8.46 The Subcommittee has noted that the majority of LB-related complaints had been resolved through various settlement agreements reached between SFC, MA and the distributing banks pursuant to section 201 of SFO. The purpose of this section is to give SFC an explicit power to enter into negotiated settlements with persons intended to be disciplined where the particular circumstances of a case render it appropriate to do so. Although it may be questioned whether SFC's entering into the various settlement agreements in relation to LB structured products is a use of its power envisaged when section 201 was first enacted, there can be no doubt that the power to enter into negotiated settlements is a necessary and legitimate part of the disciplinary powers of SFC. The Subcommittee sees no need to modify SFC's power under section 201 of SFO to enter into settlements with persons intended to be disciplined.

8.47 The Subcommittee is deeply concerned about some investors being designated as "experienced investors" and excluded from certain repurchase offers. **The Subcommittee therefore recommends that when exercising its power under section 201 of SFO, SFC should not agree to adopt any arbitrary and non-statutory threshold to exclude certain persons from the settlement offers.**

Power to compel payment of compensation

8.48 The Subcommittee sees merits in empowering the regulator(s) to order RIs to pay compensation. **The Subcommittee therefore recommends that the regulator responsible for enforcement should**

also be vested with appropriate statutory powers to order the payment of compensation where the findings so justify.

Need for a dispute resolution mechanism

8.49 The LB incident has demonstrated the need to put in place an independent and affordable avenue for resolving financial disputes between individual investors and the financial institutions. The Subcommittee notes the establishment of the FDRC for resolving monetary disputes between financial institutions and individual customers by way of mediation or arbitration.

8.50 In this connection, **the Subcommittee recommends that HKMA should review the effectiveness of the LB-related Products Disputes Mediation and Arbitration Scheme in resolving disputes so that the lessons learned can shed light on the future operation of FDRC.**

Investor protection

8.51 As described in paragraphs 7.3 and 7.4 of Chapter 7, investor protection is one of the regulatory objectives and functions of SFC specified in SFO. However, investor protection is not explicitly stated in BO as one of the functions of MA, although Mr Joseph YAM, then MA, has stated that investor protection is also a function of MA that can be construed from the relevant provisions of BO. To ensure better protection for investors, many of whom may obtain investment services from banks, the Subcommittee considers it necessary to impose on MA a statutory duty of investor protection. **The Subcommittee therefore recommends that investor protection should be added as one of MA's functions under BO**.

8.52 As discussed in paragraphs 8.29 and 8.30 above, the Subcommittee does not consider that Hong Kong should put in place an investor protection regime based on pre-approval of certain products for sale. Instead, it recommends beefing up of the disclosure-based regime

(complemented by regulation of intermediaries' conduct at the point of sale).

8.53 Notwithstanding the above, it is clear to the Subcommittee that there are individuals who may not be capable of protecting themselves against malpractices such as mis-selling of investment products[7]. The regulators should not overlook the need of these vulnerable individuals for higher protection. Financial innovations have also brought to the market new products whose structures and risks are increasingly difficult to comprehend. The Subcommittee therefore sees a need for measures to be introduced to require that certain products can only be sold to specified categories of investors.

8.54 **The Subcommittee recommends the Administration and the two regulators to:**

(a) make reference to overseas practices such as the guidance issued by NASD on the type of investors who could acquire structured financial products[8]; and

(b) consider setting some tangible and objective criteria for determining the category of persons that are suitable for acquiring specified products (such as structured financial products), with the result that the products can only be sold to the designated category of investors.

8.55 The FSA in UK has implemented the TCF initiative to stipulate the respective roles of the product providers and distributors in the fair treatment of their customers throughout the product cycle.

8.56 **The Subcommittee recommends that the Administration and regulators should consider whether and how the UK experience could be applied locally to enhance investor protection.**

[7] Please see paragraph 7.28 of Chapter 7.
[8] Please see paragraph 7.34 of Chapter 7.

Investor education

8.57 The Subcommittee has noted that there is no lack of investor education initiatives undertaken by the regulators. However, the LB incident has raised questions of whether the messages had effectively reached the investing public. In anticipation of the establishment of the IEC[9], the Subcommittee considers it important for IEC to reach out proactively to different sectors of the community, in particular vulnerable individuals.

8.58 **The Subcommittee recommends that:**

(a) while the Internet and printed media can continue to be used, greater use should be made of radio and TV as they are the main channels through which less educated and elderly persons obtain information, and that sufficient financial provision for such purposes should be earmarked;

(b) SFC should include updates on its regulation of unlisted structured financial products in its Quarterly Reports;

(c) banks should be required to make available to their customers the flyers or leaflets published by SFC to apprise prospective investors of "dos" and "don'ts", and that sufficient copies of these materials should be placed in the zones designated for investment services;

(d) investor protection and personal financial education should form part of the school curriculum; and

(e) in addition to the dissemination of information, any investor education initiatives must unequivocally convey the message that investors should exercise

[9] Please see paragraph 7.9 of Chapter 7.

vigilance and due diligence in order to protect themselves, and that they should not invest in products that they do not know or understand.

The way forward

8.59 As observed in Chapters 3 and 4 and paragraphs 8.2 and 8.4 above, the Subcommittee has found the present regulatory structure under which the securities business of banks being regulated by both HKMA and SFC largely ineffective.

8.60 **The Subcommittee recommends the Administration and the regulators to examine the feasibility of placing the securities business conducted by banks under the regulation of SFC, which is the regulator for the securities and futures industry; and if this proposed arrangement is adopted, to introduce the necessary legislative amendments.** This will better ensure that the regulated activities conducted by banks and by securities brokers will be subject to consistent regulation.

8.61 The Subcommittee recognizes the importance of safeguarding the independence of SFC and HKMA in performing their respective functions. However, it considers it incumbent upon the Administration to play a proactive role to ensure that its policy objectives are met, and to provide the necessary policy steer.

8.62 **The Subcommittee therefore recommends that the Administration should:**

(a) keep the regulatory regime (including issues such as the need to align the secrecy provision in BO with that in SFO) under regular reviews, identify and address issues of concern and shortcomings;

(b) strengthen the existing forums (such as CFR and FSC) and explore new platforms to facilitate the effective exchange of views among the regulators and between them and the Administration; and

(c) enhance the transparency of CFR and FSC by publishing or reporting to the Panel on Financial Affairs the main deliberations and decisions reached at their meetings.

8.63 As there are still unresolved LB-related complaints, **the Subcommittee recommends that HKMA should:**

(a) continue to investigate and take appropriate action on these unresolved complaints;

(b) re-open unsubstantiated cases if more information is available; and

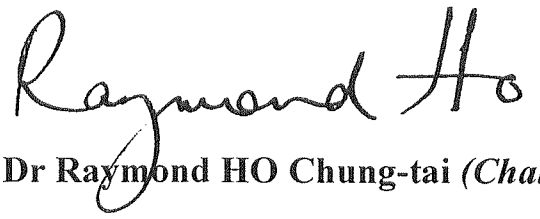
(c) provide full explanation to the complainant if it decides not to proceed further with the complaint in question.

8.64 **The Subcommittee recommends that the Panel on Financial Affairs should follow up the above recommendations in due course.**

Acknowledgement

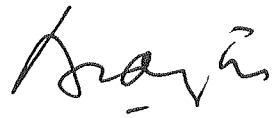
The Subcommittee to Study Issues Arising from Lehman Brothers-related Minibonds and Structured Financial Products wishes to thank all witnesses who have appeared before it to give evidence and all parties who have produced documents and/or made submissions to facilitate its inquiry. The Subcommittee also records its appreciation to the staff of the Legislative Council Secretariat for their support and assistance throughout its work.

Members of the Subcommittee who signed the report



Ir Dr Raymond HO Chung-tai *(Chairman)*

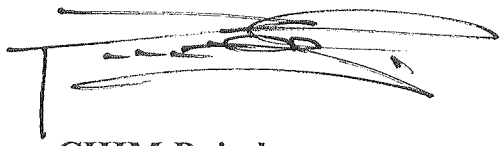
James TO Kun-sun



Audrey EU Yuet-mee

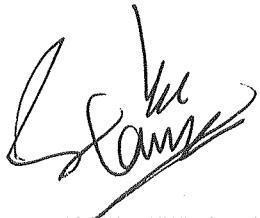
WONG Ting-kwong

Ronny TONG Ka-wah

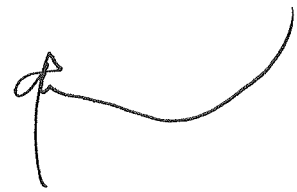


CHIM Pui-chung

KAM Nai-wai

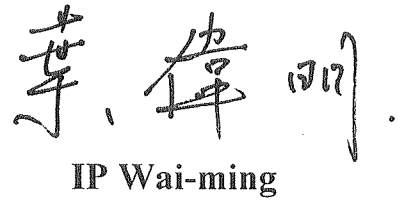


Starry LEE Wai-king

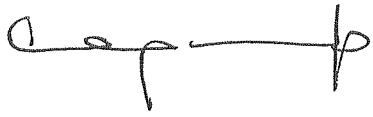


CHAN Kin-por

Dr Priscilla LEUNG Mei-fun



IP Wai-ming



Mrs Regina IP LAU Suk-yee

LEUNG Kwok-hung

Members of the Subcommittee who did not sign the report

Dr Philip WONG Yu-hong (Deputy Chairman)

Abraham SHEK Lai-him

Jeffrey LAM Kin-fung

Abbreviations

Abbreviations

AIs	authorized institutions
BAO	Banking (Amendment) Ordinance 2002
BMs	branch managers
BO	Banking Ordinance (Cap. 155)
BOCHK	Bank of China (Hong Kong) Limited
CC	Consumer Council
CCB	Commercial Crime Bureau
CDO	collateralized debt obligations
CDS	credit default swap
CEO/SFC	Chief Executive Officer of the Securities and Futures Commission
CFD	Corporate Finance Division
CFR	Council of Financial Regulators
CHKL	Citibank (Hong Kong) Limited
CLAF	Consumer Legal Action Fund
CO	Companies Ordinance (Cap. 32)
CO Marketing Guidelines	"Guidelines on use of offer awareness and summary disclosure materials in offerings of shares and debentures under the Companies Ordinance" issued by the Securities and Futures Commission

Code of Conduct	Code of Conduct for persons licensed by or registered with the Securities and Futures Commission
DBSHK	DBS Bank (Hong Kong) Limited
DCE/HKMA	Deputy Chief Executive of the Hong Kong Monetary Authority
DPE	Diploma Programme Examination
DSB	Dah Sing Bank, Limited
ECHP	enhanced complaint-handling procedures
ED	executive director
EMTN	Euro Medium Term Note
EOs	executive officers
FDRC	Financial Dispute Resolution Centre
FPE	Foundation Programme Examination
FS	Financial Secretary
FSA	Financial Services Authority
FSC	Financial Stability Committee
FSTB	Financial Services and the Treasury Bureau
GP	general principles fundamental to the undertaking of regulated activities by intermediaries in the Code of Conduct
HKAB	The Hong Kong Association of Banks
HKMA	Hong Kong Monetary Authority

HKMA Review Report	Report of the Hong Kong Monetary Authority on Issues Concerning the Distribution of Structured Products Connected to Lehman Group Companies
HKSI	Hong Kong Securities Institute
ICs	investment consultants
IEC	Investor Education Council
Internal Control Guidelines	Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the Securities and Futures Commission
IPD	Investment Products Department
KYC	know your client
LB	Lehman Brothers
LB structured products	Lehman Brothers-related structured financial products
LBAL	Lehman Brothers Asia Limited
LB-CLNs	Lehman Brothers-related Constellation Notes
LB-ELNs	Lehman Brothers-related equity-linked notes
LBHI	Lehman Brothers Holdings Inc.
LB-PPNs	Principal Protected Notes issued by LB
LBTC	Lehman Brothers Treasury Co. B.V.
LCs	licensed corporations

LCPPO	Legislative Council (Powers and Privileges) Ordinance (Cap. 382)
LE	Licensing Examination
LegCo	Legislative Council
MA	Monetary Authority
Mevas	Mevas Bank Limited
MLNs	Market-linked Notes
MoU	Memorandum of Understanding signed between the Securities and Futures Commission and the Hong Kong Monetary Authority in December 2002
NASD	National Association of Securities Dealers
NDD	Notice of Disciplinary Decision
NID	Notice of Intention to Impose Disciplinary Sanction
NPDAs	Notices of Proposed Disciplinary Action
OCI	Office of the Commissioner of Insurance
PIFL	Pacific International Finance Limited
PKFS	Product Key Facts Statement
RBS	The Royal Bank of Scotland N.V.
ReIs	relevant individuals
RIs	registered institutions
RMs	relationship managers

SCBHK	Standard Chartered Bank (Hong Kong) Limited
SFAT	Securities and Futures Appeals Tribunal
SFC	Securities and Futures Commission
SFC Review Report	Issues raised by the Lehmans Minibonds crisis – Report to the Financial Secretary
SFO	Securities and Futures Ordinance (Cap. 571)
SFST	Secretary for Financial Services and the Treasury
SHKIS	Sun Hung Kai Investment Services Limited
SIP Code	Code on Unlisted Structured Investment Products
SPM	Supervisory Policy Manual of the Hong Kong Monetary Authority
Suitability FAQ	"Frequently Asked Questions and Answers on Suitability Obligations" issued by the Securities and Futures Commission in May 2007
TCF	Treating Customers Fairly
the Subcommittee	Subcommittee to study issues arising from Lehman Brothers-related Minibonds and structured financial products
UK	United Kingdom
US	United States of America

Appendices

Appendix 1(a)
(Paragraph 1.6)

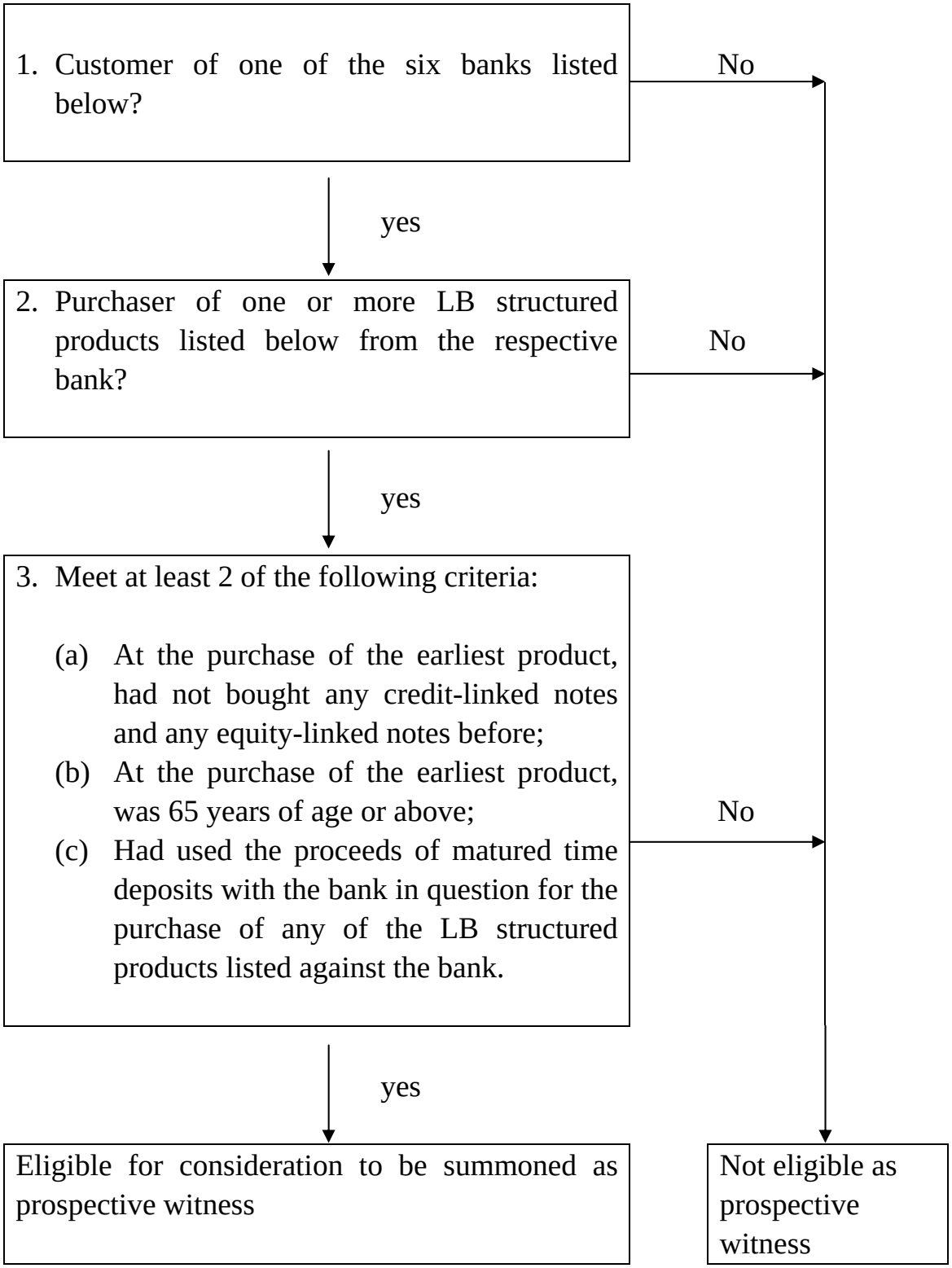
Subcommittee to Study Issues Arising from Lehman Brothers-related Minibonds and Structured Financial Products

Membership list

Chairman	Ir Dr Hon Raymond HO Chung-tai, SBS, S.B.St.J., JP	
Deputy Chairman	Dr Hon Philip WONG Yu-hong, GBS	
Members	Hon Albert HO Chun-yan	(up to 17 November 2008)
	Dr Hon David LI Kwok-po, GBM, GBS, JP	(up to 27 October 2008)
	Dr Hon Margaret NG	(up to 15 January 2009)
	Hon James TO Kun-sun	
	Hon CHAN Kam-lam, SBS, JP	(up to 6 December 2010)
	Hon Emily LAU Wai-hing, JP	(up to 23 August 2010)
	Hon Abraham SHEK Lai-him, SBS, JP	
	Hon Audrey EU Yuet-mee, SC, JP	
	Hon Vincent FANG Kang, SBS, JP	(up to 21 October 2009)
	Hon Jeffrey LAM Kin-fung, GBS, JP	
	Hon WONG Ting-kwong, BBS, JP	
	Hon Ronny TONG Ka-wah, SC	
	Hon CHIM Pui-chung	
	Prof Hon Patrick LAU Sau-shing, SBS, JP	(up to 14 October 2010)
	Hon KAM Nai-wai, MH	
	Hon Starry LEE Wai-king, JP	
	Dr Hon LAM Tai-fai, BBS, JP	(up to 3 February 2009)
	Hon Paul CHAN Mo-po, MH, JP	(up to 31 October 2010)
	Hon CHAN Kin-por, JP	
	Dr Hon Priscilla LEUNG Mei-fun, JP	
	Dr Hon LEUNG Ka-lau	(up to 21 October 2010)
	Hon IP Wai-ming, MH	
	Hon Mrs Regina IP LAU Suk-yee, GBS, JP	
	Hon LEUNG Kwok-hung	(up to 28 January 2010, rejoined on 4 June 2010)
	Hon Tanya CHAN	(up to 30 October 2008)

Appendix 1(b)
(Paragraph 1.23)

Eligibility criteria to be met by investors volunteering to assist the Subcommittee



Bank	LB structured products
DBS Bank (Hong Kong) Limited	● Constellation Notes Series 34 ● Constellation Notes Series 56 ● Constellation Notes Series 81
Standard Chartered Bank (Hong Kong) Limited	● Lehman Brothers 1-Year HKD All Weather Coupon Daily Callable ELN – Series 17 (390+1800) ● Lehman Brothers 1-Year USD All Weather Coupon Daily Callable ELN – Series 17 (390+1800) ● Lehman Brothers 1-Year HKD All Weather Coupon Daily Callable ELN – Series 18 (390+1800+2800)
Citibank (Hong Kong) Limited	● Lehman Brothers 1 Year USD Daily Accrual Coupon Auto-call Note with Daily Knock-In – Series 10 linked to PetroChina (0857.HK) and China Life Insurance (2628.HK) ● Lehman Brothers 8-month HKD Daily Accrual All Season Coupon Auto-call Note with Daily Knock-In – Series 22
The Royal Bank of Scotland N.V.	● Minibonds Series 35 ● Lehman Brothers 2 Year USD Airbag Range Accrual Note S888 23NOV09 (07PLE888QU) ● Lehman Brothers 2 Year USD Airbag Range Accrual Note S889 23NOV09 (07PLE889QU)
Bank of China (Hong Kong) Limited	● Minibonds Series 27 ● Minibonds Series 34 ● Minibonds Series 35
Dah Sing Bank, Limited	● Minibonds Series 36 ● LM 2 Yrs HKD Index Bonus Fixed Coupon PPN – Private Placement (LMP0017) – Mini PPN ● 24 months USD Quanto 27.00% p.a. Callable Accrual Note – 9628244

Appendix 1(c)
(Paragraph 1.26)

Practice and Procedure of the Subcommittee

Introduction

The Subcommittee to Study Issues Arising from Lehman Brothers-related Minibonds and Structured Financial Products (the Subcommittee) is a subcommittee of the House Committee of the Legislative Council. Its practice and procedure are based on the relevant provisions in the Rules of Procedure and the House Rules applicable to subcommittees of committees of the Council. For the purpose of performing its functions, the Subcommittee has been authorized by resolution of the Council on 12 November 2008 to exercise the powers conferred by section 9(1) of the Legislative Council (Powers and Privileges) Ordinance (Cap. 382). Accordingly, its practice and procedure are also regulated by the relevant provisions of the Ordinance.

Principles

2. In determining its own practice and procedure, the Subcommittee has drawn reference from those adopted by subcommittees set up under the House Committee and by previous Select Committees. Due regard has also been given to the following principles -

(a) the practice and procedure should be fair and seen to be fair, especially to parties whose interests or reputation may be affected by the proceedings of the Subcommittee;

(b) there should be maximum transparency in its proceedings as far as practicable;

(c) the practice and procedure should facilitate the ascertaining of the facts relevant to, and within the scope of, its study, as set out in the Subcommittee's Terms of Reference, which do not include the adjudication of the legal liabilities of any parties or individuals;

(d) its proceedings should be conducted with efficiency; and

(e) the cost of the proceedings should be kept within reasonable bounds.

Practice and procedure

Chairmanship

3. All meetings are chaired by the Chairman or, in his absence, by the Deputy Chairman. In the event of the temporary absence of the Chairman and Deputy Chairman, the Subcommittee may elect a chairman to act during such absence.

Quorum

4. The quorum of the Subcommittee shall be one-third of the members including the Chairman (a fraction of the whole number being disregarded). Unless a quorum is present within 15 minutes of the time appointed for the meeting, the meeting will not be held.

Voting

5. Decision of the Subcommittee shall be decided by a majority of the members present and voting. Abstentions are not counted for the purpose of determining the result of the vote, but the number of members who abstained from voting will be recorded. Where the Chairman so orders, any matter for the decision of the Subcommittee may be considered by circulation of papers to members of the Subcommittee.

6. Voting is done by a show of hands. If a member wishes to claim a division of the votes, the member must so request before the Chairman or the presiding member declares the result of the voting. Unless a division is called, it is the normal practice to record only the number of members who have voted for, voted against and abstained from voting.

7. The Chairman of, or any member presiding at, the Subcommittee shall not vote, unless the votes of the other members are equally divided, in which case he shall have a casting vote which shall not be exercised in such a way as to produce a majority vote in favour of the question put.

Power to compel evidence

8. Subject to the provisions of Cap. 382, the Subcommittee may order any person to attend before it and to give evidence or to produce any paper, book, record or document in the possession or under the control of such person.

9. In obtaining evidence, the Subcommittee may request any person or body to attend a meeting to give evidence orally, invite any person or body to give evidence in writing or any person or body to produce specified documents to the Subcommittee.

10. The privileges and immunities provided in Cap. 382 are available only in proceedings before the Subcommittee which include hearings and deliberative meetings. In addition, every person not lawfully ordered to attend to give evidence or to produce any paper, book, record or document before the Subcommittee is not protected by section 14(1) of Cap.382 relating to privileges of witnesses.

Conduct of meetings

11. The relevant provisions in the Rules of Procedure and the House Rules shall apply to the Subcommittee. Where witnesses are examined and evidence is received pursuant to the exercise of powers under section 9 of Cap. 382, paragraphs 12 to 22 will apply.

Meetings for the examination of witnesses

12. Examination of witnesses will normally be conducted in public. Exceptions to open hearings may be made as decided by the Subcommittee, based on the individual circumstance of each occasion. During open hearings, members should only ask questions for the purpose of establishing the facts in connection with the study. Members should not make comments or statements during these hearings.

13. Public hearings are generally conducted in the following manners :

(a) at the beginning of each open hearing, the Chairman reminds the public and the media that disclosure of the evidence given at the hearing outside the proceedings is not protected under Cap. 382. The media should obtain legal advice as to their legal responsibilities;

(b) where it is decided that witnesses should be examined on oath, the Chairman will administer the oath under section 11 of Cap. 382 before the examination starts;

(c) facts are established by questions and evidence given at hearings. Usually, the Chairman will first make an introduction and then ask the witness an appropriate opening question, giving him an opportunity to state his case;

(d) members wishing to ask questions should so indicate by a show of hands, and are called upon to ask questions. The Chairman will ensure, as far as possible, that members have equal opportunities to ask questions and that the hearing is conducted in a structured manner;

(e) the Chairman will decide whether a question or evidence is relevant to, and within the scope of, the Subcommittee's study, as set out in its Terms of Reference;

(f) short follow-up questions may be allowed. Follow-up questions should be questions seeking further answers to the original questions or clarifications to the answers given. The Chairman has the discretion to decide whether a question is a follow-up question and whether it should be allowed or otherwise; and

(g) all Members, including non-Subcommittee members, should refrain from making comments relating to the hearing outside the proceedings. Evidence given in closed meetings should not be made public by any members.

14. Unless excused under section 13(2) of Cap. 382 or justifiably claiming privilege under section 15, a witness summoned under section 9 of Cap. 382 must answer all lawful and relevant questions from the Subcommittee. If he refuses to do so, he commits an offence under section 17 of Cap. 382 and is liable to prosecutions. If the witness claims privilege from disclosure of evidence on grounds of public interest immunity, the procedure as set out in the Council's resolution concerning the usage and practice in regard to the determination of claims of public interest privilege in **Appendix I** will be followed.

15. Subject to the Subcommittee's decision, witnesses attending before the Subcommittee may be allowed to be accompanied by other persons, who may include legal adviser(s), to assist the witnesses concerned. However, such accompanying person(s) may not address the Subcommittee.

Measures taken to avoid possible prejudice to a person's interest in pending legal proceedings

16. In accordance with Rule 41(2) of the Rules of Procedure, a Member shall not make reference in his speech to a case pending in a court of law in such a way as, in the opinion of the President or the Chairman, might prejudice that case. This rule applies to the proceedings of the Subcommittee by virtue of Rule 43 of the Rules of Procedure.

17. If there are pending legal proceedings arising from matters which are related to the subject of the Subcommittee's study, the following measures will be adopted to avoid possible prejudice to a person's interest in pending legal proceedings -

(a) the Department of Justice will be asked to keep the Subcommittee informed of the development of the criminal proceedings concerned, if any;

(b) the Chairman would explain to each witness that the function of the Subcommittee is not to adjudicate on the legal liability of any party or individual and advise him of the Chairman's power to disallow the making of any reference to a case pending in a court of law if such reference might, in his opinion, prejudice the proceedings;

(c) where it is considered necessary and justified, either on an application by a witness or on the Subcommittee's own motion, the Subcommittee may determine to hold closed meetings to obtain evidence from a witness; and

(d) where the Subcommittee considers necessary, it will provide the Department of Justice with a copy of the draft findings and observations of the Subcommittee and request it to comment whether the contents of the draft might prejudice pending criminal proceedings, if any.

18. In respect of pending civil proceedings, the following principles also apply:-

(a) references to matters awaiting adjudication in a court of law should be excluded if there is a risk that they might prejudice its adjudication;

(b) references would include comments on, inquiry into and the making of findings on such matters;

(c) matters awaiting adjudication would include matters in respect of which proceedings have been initiated by the filing of the appropriate documents; and

(d) prejudice might arise from an element of explicit or implicit prejudgment in the proceedings of the Subcommittee in two possible ways -

(i) the references might hinder the court or a judicial tribunal in reaching the right conclusion or lead it to reach other than the right conclusion; and

(ii) whether the court or judicial tribunal is affected in its conclusion or not, the references might amount to an effective usurpation of the judicial functions of the court or judicial tribunal.

Handling of information contained in classified documents or obtained at closed hearings

19. In fairness to persons who have provided classified documents for the Subcommittee, if information contained in such documents is to be used at a public hearing, the source of the information will only be disclosed if it is necessary to do justice to the witness or to enable him to understand a question.

20. If closed meetings are held to obtain evidence from a witness who is a party to pending legal proceedings, information obtained in these closed hearings should be used with care, and where possible, the identity of the witness who has provided the information should not be disclosed.

21. Where the Subcommittee is inclined to refer to information obtained in closed hearings in the Subcommittee's report, an extract of the relevant part of the report in draft form should be provided to the witness concerned for comment. The comments received will be carefully considered by the Subcommittee before its report is finalized.

22. Any information obtained by way of oral evidence or in the form of documents provided at closed hearings shall not be disclosed.

Internal deliberations

23. The Subcommittee may hold closed meetings to deliberate on procedural matters, progress of its work, the logistical arrangements for hearings, the evidence obtained, the draft report of the Subcommittee and any other matters relevant to the Subcommittee's work. Members including the Chairman and the Deputy Chairman should not disclose any information about the internal deliberations held or documents considered at these meetings. The Subcommittee Chairman or the Deputy Chairman should be the only persons authorized to handle media enquiries.

Handling of documents

24. All documents submitted to the Subcommittee are numbered: by document and by page. Each member of the Subcommittee will be given a copy of the documents produced to the Subcommittee, unless advised otherwise with the consent of the Subcommittee.

25. A room in the Legislative Council Building is reserved for keeping a complete set of documents produced to or compiled by the Subcommittee. Where a document is classified confidential, members should not remove it from the room, nor should they make photocopy of it, in whole or in part.

Disclosure of interests

26. Rules 83A and 84 of the Rules of Procedure relating to Members' pecuniary interest shall apply to the proceedings of the Subcommittee.

27. In addition, there may be situations in which a member wishes to declare non-pecuniary interests. In such a case, he should write to the Chairman to declare such interests. Where appropriate, the Chairman may announce at public meetings or hearings of the Subcommittee the nature of interests so declared by individual members.

Participation of Non-Subcommittee members

28. While meetings held in public shall be attended by members of the Subcommittee, non-Subcommittee members may also be in attendance at these meetings, but may not speak at the meeting. If a non-Subcommittee member wishes to direct any questions to a witness, he/she should put his/her questions in writing and pass them to the Chairman without interrupting the proceedings, and the Chairman will decide whether or not he will ask the questions.

29. Non-Subcommittee members are not allowed to be present at closed meetings of the Subcommittee or at hearings held at closed meetings.

Minutes of proceedings of the Subcommittee

30. All proceedings of hearings and meetings are sound-recorded. Members of the public may obtain copies of the sound recordings of hearings and meetings held in public upon the payment of a fee.

31. Minutes of evidence, usually in the form of a verbatim transcript, are kept for each meeting at which witnesses are examined. Relevant parts of the draft transcript are forwarded to the person or body giving evidence for sight and correction, if any, before being incorporated into the minutes of evidence, subject to their signing of an undertaking that they would not make any copy of the draft and would return it to the Subcommittee before a specified date. The procedures in **Appendix II**, which apply to witnesses, shall also apply to persons or bodies other than the witnesses giving evidence requesting copies of transcripts of evidence. Any person may obtain a copy of the finalized form of transcript for meetings held in public upon the payment of a fee.

32. For hearings held in closed meetings, no transcripts will be provided for any person including the witnesses concerned. All witnesses however are provided with the relevant parts of the draft transcripts of evidence for sight and correction. The undertaking they are required to sign includes an additional requirement that any part of the draft transcript in question must not be divulged.

33. For meetings not attended by any outside party, the minutes of meetings are normally presented in a condensed form, recording the Subcommittee's decisions, follow-up actions required, procedural matters and declarations of interest made by members. Verbatim record of such meetings may be prepared on the direction of the Subcommittee.

Report of the Subcommittee

34. The draft report of the Subcommittee is considered by the Subcommittee at closed meetings. The relevant minutes record all proceedings on the consideration of the report and on every amendment proposed thereto, with a note of divisions, if divisions were taken in the subcommittee, showing the names of members voting in the division or declining to vote.

35. In order to ensure that the procedure is fair and seen to be fair to people whose interests or reputations may be affected by its proceedings, any party, person or organization against whom adverse comments are intended to be made in the Subcommittee's report will be given an opportunity to comment on relevant parts of the draft findings and observations of its report. The comments received will be carefully considered by the Subcommittee before its report is finalized.

36. The Subcommittee shall make a report to the House Committee after it has completed its work. Where necessary and if agreed to by the House Committee, the Subcommittee report may be tabled at the Council.

Premature publication of evidence

37. The evidence taken before the Subcommittee and documents presented to it shall not, except in the case of its meetings held in public, be published by a member of the Subcommittee or by any other person before the Subcommittee has presented its report to the House Committee.

Practice and Procedure of the Subcommittee

38. Without prejudice to the Rules of Procedure, the House Rules and the procedure endorsed by the House Committee, the Subcommittee is authorized to determine its own practice and procedure.

Resolution under Legislative Council (Powers and Privileges) Ordinance passed on 25 May 1994 and amended on 20 November 1996 and further amended on 16 April 1997

That with effect from 25 May 1994 the usage and practice in regard to the determination of claims of "public interest privilege" made by persons appearing before a committee of the Council shall be as set out in the Schedule annexed to this Resolution.

1. In this Schedule –

"relevant body", (有關方面) in relation to a committee before which a witness is attending to give evidence or to produce any paper, book, record or document, means -

(a) the chairman and deputy chairman of the committee, where both are present (and references to the delivering of the opinion of the relevant body shall be taken to mean the opinion of the chairman where the chairman and deputy chairman disagree);

(b) the chairman alone where the deputy chairman is absent;

(c) the deputy chairman alone where the chairman is absent; or

(d) where both the chairman and deputy chairman are absent, the member elected to act as chairman during such absence.

"witness" (證人) means –

(a) a person lawfully ordered to attend to give evidence or to produce any paper, book, record or document before a committee; and

(b) any public officer designated by the Governor under section 8A(2)(b) of the Legislative Council (Powers and Privileges) Ordinance (Cap. 382) for the purpose of attending sittings of a committee.

2. If, at a public sitting of a committee, a witness refuses to answer publicly or privately any question that may be put to him, or to produce any paper, book, record or document, and claims privilege on the ground that the giving of the answer or the production of the paper, book, record or document would be contrary to the public interest the following procedure will apply -

(1) The chairman shall inform the witness that he may explain his reasons in confidence to the relevant body and that the relevant body will then deliver an opinion to the committee without disclosure of any information or paper, book, record or document claimed by the witness to be privileged from disclosure.

(2) If the witness agrees to explain his reasons to the relevant body the relevant body shall make arrangements to consider the reasons and deliver its opinion to the committee.

(3) If the relevant body delivers its opinion that the claim of privilege by the witness is justified in respect of an answer to a question or the production of any paper, book, record or document the committee shall excuse the answering of such question or the production of such paper, book, record or document.

(4) If the relevant body delivers its opinion that the claim of privilege by the witness is not justified in respect of any answer to a question or the production of any paper, book, record or document the committee may order the answering or production thereof.

(5) If the witness continues to refuse to answer any question or produce any paper, book, record or document the committee may take such action within its powers as it considers appropriate.

(6) If the witness does not agree to explain his reasons to the relevant body under subparagraph (2) the committee may take such action within its powers as it considers appropriate.

3. If, at a public sitting of a committee, a witness refuses to answer in public any question that may be put to him, or to produce in public any paper, book, record or document on the ground of public interest privilege, but requests to answer such question or produce such paper, book, record or document at a private sitting of the committee, the following procedure will apply -

(1) The committee will deliberate in private whether to agree to the request by the witness.

(2) The decision of the committee will be taken by formal vote.

(3) If the committee decides to agree to the request by the witness no answer given by the witness at a private sitting nor any paper, book, record or document produced by him thereat shall be made public unless the committee decides during the private sitting that the request by the witness for confidentiality is not justified. Before reaching such a decision the committee shall give the witness an opportunity to state the grounds upon which he claims public interest privilege in respect of the particular answer or paper, book, record or document.

Appendix II
of the Subcommittee's Practice and Procedure

Provision of Transcripts of Evidence

The following procedures shall apply to the provision of transcripts of evidence taken by the Subcommittee to Study Issues Arising from Lehman Brothers-related Minibonds and Structured Financial Products -

(a) where considered appropriate, the Subcommittee may permit copies of the transcripts of evidence taken in public be provided to witnesses and prospective witnesses on request;

(b) "witnesses" refers to persons on whom summonses have been served by the Subcommittee to order their appearance before it; "prospective witnesses" refers to witnesses whom the Subcommittee has decided to summon to appear before it;

(c) where copies of transcripts of evidence taken in public are provided to witnesses or prospective witnesses, the unpublished and/or uncorrected status of the transcripts shall be stated clearly; and

(d) the provision of unpublished and/or uncorrected transcripts of evidence taken in public to witnesses or prospective witnesses be made on the condition that they shall not make public use of the transcripts; shall not quote directly from the transcripts; and shall not use the transcripts in a manner prejudicial to the interest of the Subcommittee or other persons.

Appendix 1(d)
(Paragraph 1.29)

Schedule of hearings and attending witnesses

Phase I of Stage 2 – Hearings to receive evidence from the Administration and the regulators		
Hearing	**Dates**	**Witnesses**
1	20 February 2009	Professor CHAN Ka Keung Secretary for Financial Services and the Treasury
2	24 February 2009	
3	27 February 2009	
4	20 March 2009	
5	14 April 2009	Mr Joseph YAM Chi-kwong Monetary Authority
6	17 April 2009	
7	28 April 2009	
8	8 May 2009	
9	15 May 2009	
10	22 May 2009	
11	26 May 2009	Mr Y K CHOI Deputy Chief Executive of Hong Kong Monetary Authority
12	2 June 2009	
13	5 June 2009	
14	12 June 2009	
15	23 June 2009	Mr Martin WHEATLEY Chief Executive Officer Securities and Futures Commission
16	26 June 2009	
17	3 July 2009	
18	7 July 2009	

Hearing	**Dates**	**Witnesses**
19	17 July 2009	Mr Brian HO Executive Director Corporate Finance Division of the Securities and Futures Commission
20	21 July 2009	
21	3 August 2009	Mr Martin WHEATLEY Chief Executive Officer Securities and Futures Commission
22	10 November 2009	Mr Y K CHOI Deputy Chief Executive of Hong Kong Monetary Authority
23	17 November 2009	
24	11 December 2009	Mr John C TSANG Financial Secretary
25	18 December 2009	
26	8 January 2010	Mr Martin WHEATLEY Chief Executive Officer Securities and Futures Commission
27	19 January 2010*	Mr KO Ping Chung Harold Former employee Securities and Futures Commission
28	26 January 2010	
29	29 January 2010	
30	9 February 2010	Mr Martin WHEATLEY Chief Executive Officer Securities and Futures Commission
31	26 March 2010	

(* denotes closed hearings)

Phase II of Stage 2 – Hearings to receive evidence from the top/senior management of six selected banks		
Hearing	**Dates**	**Witnesses**
32	16 April 2010	Ms Amy YIP Chief Executive Officer DBS Bank (Hong Kong) Limited Ms Linda WONG Managing Director and Head of Consumer Banking Hong Kong & Mainland China DBS Bank (Hong Kong) Limited Ms Janet Hey CHONG Senior Vice President Consumer Investment & Insurance Products Consumer Banking DBS Bank (Hong Kong) Limited
33	20 April 2010	
34	23 April 2010	
35	30 April 2010	
36	7 May 2010	Mr HUNG Pi-cheng, Benjamin Executive Director & Chief Executive Officer Standard Chartered Bank (Hong Kong) Limited Ms Mary Wai Yi HUEN Head of Consumer Banking Standard Chartered Bank (Hong Kong) Limited
37	11 May 2010	
38	14 May 2010	
39	25 May 2010	Mr LO Wai-pak, Weber Chief Executive Officer & Country Business Manager Citibank (Hong Kong) Limited Ms Fanny LUM Director of Wealth Management Citibank (Hong Kong) Limited
40	28 May 2010	
41	1 June 2010	

Hearing	**Dates**	**Witnesses**
42	4 June 2010	Mr HUNG Pi-cheng, Benjamin Executive Director & Chief Executive Officer Standard Chartered Bank (Hong Kong) Limited Ms Mary Wai Yi HUEN Head of Consumer Banking Standard Chartered Bank (Hong Kong) Limited
43	29 June 2010	Ms Amy YIP Chief Executive Officer DBS Bank (Hong Kong) Limited Ms Linda WONG Managing Director and Head of Consumer Banking Hong Kong & Mainland China DBS Bank (Hong Kong) Limited Ms Janet Hey CHONG Senior Vice President Consumer Investment & Insurance Products Consumer Banking DBS Bank (Hong Kong) Limited
44	6 July 2010	Mr CHU Ren-yee, Alexander Country Executive, Hong Kong The Royal Bank of Scotland N.V. Mr John SHELLEY Chief Operating Officer (Retail and Commercial Markets, Asia) The Royal Bank of Scotland N.V.
45	9 July 2010	
46	13 July 2010*	Mr Martin WHEATLEY# Chief Executive Officer Securities and Futures Commission

Hearing	**Dates**	**Witnesses**
47	13 July 2010	Mr CHU Ren-yee, Alexander Country Executive, Hong Kong The Royal Bank of Scotland N.V. Mr John SHELLEY Chief Operating Officer (Retail and Commercial Markets, Asia) The Royal Bank of Scotland N.V.
48	21 September 2010	
49	28 September 2010*	Ms Linda WONG Managing Director and Head of Consumer Banking Hong Kong & Mainland China DBS Bank (Hong Kong) Limited
50	28 September 2010*	Mr LAM Yim-nam Deputy Chief Executive Bank of China (Hong Kong) Limited
51	28 September 2010*	Ms Fanny LUM Director of Wealth Management Citibank (Hong Kong) Limited
52	28 September 2010*	Mr John C LAM Alternate Chief Executive and Executive Director Dah Sing Bank, Limited
53	5 October 2010	Mr HE Guangbei Vice Chairman and Chief Executive Bank of China (Hong Kong) Limited Mr LAM Yim-nam Deputy Chief Executive Bank of China (Hong Kong) Limited
54	8 October 2010	
55	8 October 2010*	Mr LAM Yim-nam Deputy Chief Executive Bank of China (Hong Kong) Limited

Hearing	**Dates**	**Witnesses**
56	19 October 2010*	Mr CHU Ren-yee, Alexander Country Executive, Hong Kong The Royal Bank of Scotland N.V.
57	19 October 2010*	Ms Mary Wai Yi HUEN Head of Consumer Banking Standard Chartered Bank (Hong Kong) Limited
58	19 October 2010*	Ms Fanny LUM Director of Wealth Management Citibank (Hong Kong) Limited
59	19 October 2010	Mr HE Guangbei Vice Chairman and Chief Executive Bank of China (Hong Kong) Limited Mr LAM Yim-nam Deputy Chief Executive Bank of China (Hong Kong) Limited
60	23 October 2010(am)	
61	23 October 2010(pm)	
62	2 November 2010	Mr WONG Hon-Hing, Derek Managing Director and Chief Executive Dah Sing Bank, Limited Mr John C LAM Alternate Chief Executive and Executive Director Dah Sing Bank, Limited
63	5 November 2010	
64	9 November 2010	
(The post titles/positions indicated against the names of the above witnesses are those held by the witnesses when they attended the hearings)		

(* denotes closed hearings)

(# The evidence received from the witness was in connection with Phase I)

Phase III of Stage 2 – Hearings to receive evidence from the frontline staff of the six banks		
Hearing	**Dates**	**Witnesses**
65 to 90	From December 2010 to January 2011*	26 frontline staff from the six banks
Phase IV of Stage 2 – Hearings to receive evidence from certain investors who had purchased LB structured products through the six banks		
Hearing	**Dates**	**Witnesses**
91	25 February 2011	Ms IP Chun
92	25 February 2011	Mr NG Joong-yee
93	25 February 2011	Ms HO Lai-yuet
94	18 March 2011	Ms TAM Sui-lin
95	18 March 2011	Ms KO Yuk-ha
96	22 March 2011	Ms CHUNG Kit-chu
97	22 March 2011	Mr KAN Bing-kwong
98	25 March 2011	Mr TSE Chin-to
99	25 March 2011	Ms FUNG Kit-mui
100	12 April 2011	Ms FUNG King-cheung, Vency
101	12 April 2011	Ms CHAN King-hing
102	12 April 2011	Mr YIP Kai-chiu
103	19 April 2011	Ms LI Yuk-mui
104	19 April 2011	Ms LAW Siu-luen
105	19 April 2011	Mr KWOK Ming-sum
106	31 May 2011	Mr YEE Heung-ming

(* denotes closed hearings)

Appendix 2(a)
(Paragraph 2.4)

Retail banks which distributed LB structured products[1]

- Bank of China (Hong Kong) Limited
- Bank of Communications Company, Limited, Hong Kong Branch
- The Bank of East Asia, Limited
- Chiyu Banking Corporation Limited
- Chong Hing Bank Limited
- Citibank (Hong Kong) Limited
- CITIC Bank International Limited[2]
- Dah Sing Bank, Limited
- DBS Bank (Hong Kong) Limited
- Fubon Bank (Hong Kong) Limited
- Industrial and Commercial Bank of China (Asia) Limited
- MEVAS Bank Limited
- Nanyang Commercial Bank, Limited
- Public Bank (Hong Kong) Limited
- The Royal Bank of Scotland N.V.[3]
- Shanghai Commercial Bank Limited
- Standard Chartered Bank (Hong Kong) Limited
- Wing Hang Bank, Limited
- Wing Lung Bank Limited

[1] Based on the information published by HKMA, SFC and Hong Kong Association of Banks.
[2] The bank was formerly known as CITIC Ka Wah Bank Limited when LBHI filed for bankruptcy protection.
[3] The bank was formerly known as ABN AMRO Bank N.V. Hong Kong Branch when LBHI filed for bankruptcy protection.

Appendix 2(b)
(Paragraph 2.4)

Outstanding LB structured products distributed by banks

Category	Issuer and Arranger	Outstanding series	Issue dates	Total amount of investment HK$(mn)	No. of investment accounts
(I) Structured notes issued by LB-related Corporations with LBHI as swap guarantor					
Minibonds - credit-linked notes	Issuer : Pacific International Finance Ltd Arranger : LBAL	5 to 12, 15 to 23, 25 to 36	Between Jul 03 and May 08	11,205	33 611
Pyxis Notes - Equity-linked notes	Issuer : Pyxis Finance Ltd Arranger : LBAL	8 to 10, 13, 14, 19 to 21	Between Aug 04 and May 07	72	458
ProFund Notes - Fund-linked notes	Issuer : Atlantic International Finance Ltd Arranger : LBAL	1 , 2	Aug 06 and Apr 07	80	426
(II) Credit-linked notes with LBHI as one of the reference entities					
Constellation Structured Retail Notes	Issuer : Constellation Investment Ltd Arranger : DBS Bank Limited	34 to 37, 43 to 46, 55 to 74, 78 to 81	Between Mar 06 and Jul 07	2,188	6 901

Category	Issuer and Arranger	Outstanding series	Issue dates	Total amount of investment HK$(mn)	No. of investment accounts
Retail-Aimed Callable Investment Notes	Issuer : SPARC Ltd Arranger : UBS Securities Asia Limited	1, 2	May 07	64	143
Octave Notes	Issuer : Victoria Peak International Finance Ltd Arranger : Morgan Stanley & Co International Limited	10 to 12	Between Sep 06 and Nov 06	374	1 205
(III) A variety of LB-related structured notes sold by private placement					
Equity-linked notes, market-linked notes and others				6,248	6 130
Total				**20,231**	**43 707**[1]

[1] This figure refers to the total number of customers. As individual customers may have more than one investment account, the total number of accounts is different from the total number of customers.

Major distributing banks of certain outstanding LB structured products

Product Category	Total amount of investment HK$(mn)	Total no. of investment accounts	Major distributing banks			
			Banks	Amount of investment HK$(mn)	Percentage share in the total amount of investment	No. of customers or customer accounts
Minibonds	11,205	33 611	• Bank of China (Hong Kong) Limited	4,846	43%	14 038
LB-related Constellation Notes	2,188	6 901	• DBS Bank (Hong Kong) Limited	1,286	59%	3 396[1]
Equity-linked notes, market-linked notes, principal-protected notes and other notes sold by private placement	6,248	6 130	• Standard Chartered Bank (Hong Kong) Limited	2,180	35%	2 234
			• Citibank (Hong Kong) Limited	1,567	25%	1 421
			• The Royal Bank of Scotland N.V.	784	13%	871
			• Dah Sing Bank, Limited	395	6%	648
						5 174

[1] Number of customer accounts

Appendix 3(a)
(Paragraph 3.18)

Division of regulatory responsibilities for AIs' securities business under the Memorandum of Understanding between the HKMA and the SFC		
	HKMA	**SFC**
Registration		
Institutional registration	● To consider applications for registration by AIs for the carrying on of regulated activities ● To advise the SFC on whether the applicant is fit and proper to be registered	● To grant, or refuse to grant, registration to AIs as registered institutions for the carrying on of regulated activities ● To maintain a register of registered institutions (including details of their executive officers) and to make the register available for public inspection
Executive officers	● To give, or refuse to give, consent to individuals to be executive officers of registered institutions	● The public register maintained by the SFC should include details of the executive officers of registered institutions
Relevant individuals	● To maintain a register of relevant individuals (including executives officers) and to make the register available for public inspection	

Division of regulatory responsibilities for AIs' securities business under the Memorandum of Understanding between the HKMA and the SFC		
	HKMA	**SFC**
Regulatory and supervisory processes		
Developing rules, codes and guidelines	● To be responsible for making guidelines under the BO ● To consult the SFC in so far as such guidelines apply to registered institutions	● To be responsible for making rules and publishing codes and guidelines under the SFO ● To consult the HKMA in so far as such rules, codes and guidelines apply to AIs by reason of their being registered institutions
Exercising supervisory functions	● To be the frontline supervisor of registered institutions ● To be responsible for the day-to-day supervision of registered institutions	● To consult the HKMA before exercising its powers of supervision under s.180 of the SFO in relation to an AI
Complaints		
Complaint referral	● To refer complaints to the SFC whenever they are considered by the HKMA to be relevant to a matter that the SFC can investigate under s.182 of the SFO (e.g. an offence under the SFO or market misconduct) or to relate to the SFC's functions under the SFO	● To refer to the HKMA complaints concerning any registered institution, any executive officer of a registered institution, any member of the management of a registered institution, and any relevant individual

Division of regulatory responsibilities for AIs' securities business under the Memorandum of Understanding between the HKMA and the SFC		
	HKMA	**SFC**
Investigation		
Conducting investigations and sharing of results	For potential disciplinary cases identified: ● to open a case for investigation ● to notify the SFC ● to keep the SFC informed of the progress ● to forward to the SFC a copy of the investigation report, together with the HKMA's conclusions ● to report any related matter to the SFC before completing the investigation where considered appropriate	● To consult the HKMA before exercising its power to initiate an investigation under s.182(1)(e) of the SFO ● To share the investigation findings with the HKMA
Disciplinary action		
Consultation prior to disciplinary action	To consult the SFC before exercising its power to: ● withdraw or suspend any consent given to a person to be an executive officer of a registered institution ● remove or suspend the registration of a relevant individual	To consult the HKMA before exercising its power to: ● suspend or revoke a registered institution's registration ● reprimand, fine or issue a prohibition order against a registered institution, any of its executive officers, any member of its management involved in the carrying on of a regulated activity or any of its staff who is registered as a relevant individual

Division of regulatory responsibilities for AIs' securities business under the Memorandum of Understanding between the HKMA and the SFC		
	HKMA	**SFC**
Appeals		
Conducting appeals	● To be responsible for conducting appeals against a decision of the HKMA ● To consult the SFC during the course of any appeal where considered appropriate	● To be responsible for conducting appeals against a decision of the SFC ● To consult the HKMA during the course of any appeal where considered appropriate

Source: Based on Table 2 of HKMA Review Report.

Appendix 4(a)
(Paragraph 4.5)

CO COMPLIANCE CHECKLIST

Application for authorisation for registration of the [*name of document*] pursuant to section 38D(5) or section 342C(5) of the Companies Ordinance

Compliance Checklist

Compliance Checklist for [***name of issuer/guarantor***] in respect of [***name of document***].

The following checklist is to assist you in ensuring compliance with the Companies Ordinance. Please enclose the completed checklist with your application. The checklist is divided into 4 parts as follows:

Part 1: Information to be supplied to the Securities and Futures Commission

Part 2: Compliance with the Third Schedule of the Companies Ordinance

Part 3: Compliance with sections 44A and 44B of the Companies Ordinance (sections 38 and 44A are not applicable to Rights/Warrants Issue)

Part 4: Compliance with sections 342, 342B, and 342C of the Companies Ordinance (section 342 is not applicable to Rights/Warrants Issue)

Part 3 is to be completed by companies incorporated in Hong Kong while Part 4 is to be completed by companies incorporated outside Hong Kong.

Part 1
Information to be submitted to the Securities and Futures Commission

Name of Applicant Company/Issuer:

Address of Company:

Type of Issue:

Proposed Date of Registration:

Contact Person:

In Hong Kong:

Solicitors:

Parties Involved:

Please ensure that you have submitted all the relevant documents as required under the Companies Ordinance.

Part 2
Compliance with the Third Schedule of the Companies Ordinance

Para No. in the third schedule	Particulars	Complied with			Page	Remark
		Yes	No	N/A		
1.	The general nature of the business of the company, and if the company carries on 2 or more activities which are material having regard to profits or losses, assets employed or any other factor, information as to the relative importance of each such activity.					
2.	The authorised share capital and the description and nominal value of the shares into which it is divided, the amount of share capital issued or agreed to be issued, and the amount paid up on the shares which have been issued.					
3.	Sufficient particulars and information to enable a reasonable person to form as a result thereof a valid and justifiable opinion of the shares or debentures and the financial condition and profitability of the company at the time of the issue of the prospectus, taking into account the nature of the shares or debentures being offered and the nature of the company, and the nature of the persons likely to consider acquiring them.					
4.	The number of founders or management or deferred shares, if any, and the nature and extent of the interest of the holders in the property and profits of the company.					
5.	The number of shares, if any, fixed by the articles as the qualification of a director, and any provision in the articles as to the remuneration of the directors.					
6.	Names, descriptions and addresses of directors or proposed directors.					
7.	Where shares are offered to the public for subscription, particulars as to: (a) the minimum amount which, in the opinion of the directors, must be raised by the issue of those shares in order to provide the sums, or, if any part thereof is to be defrayed in any other manner, the balance of sums, required to be provided in respect of each of the following matters -					

Para No. in the third schedule	Particulars	Complied with			Page	Remark
		Yes	No	N/A		
	(i) the purchase price of any property purchased or to be purchased which is to be defrayed in whole or in part out of the proceeds of the issue; (ii) any preliminary expenses payable by the company, and any commission so payable to any person in consideration of his agreeing to subscribe for, or of his procuring or agreeing to procure subscriptions for, any shares in the company; (iii) the repayment of any money borrowed by the company in respect of any of the foregoing matters; (iv) working capital; but, so long as the general purpose of the issue is clearly stated and the issue is fully underwritten this sub-paragraph need not be compiled with, and (b) the amounts to be provided in respect of the matters aforesaid otherwise than out of the proceeds of the issue and the sources out of which those amounts are to be provided.					
8.	The date and time of the opening of the subscription lists.					
9.	The amount payable on application and allotment on each share, and, in the case of a second or subsequent offer of shares, the amount offered for subscription on each previous allotment made within the 2 preceding years, the amount actually allotted, and the amount, if any, paid on the shares so allotted.					
10.	The number, description and amount of any shares in or debentures of the company which any person has, or is entitled to be given, an option to subscribe for, together with the following particulars of the option, that is to say:-					
	(a) the period during which it is exercisable; (b) the price to be paid for shares or debentures subscribed for under it; (c) the consideration (if any) given or to be given for it or for the right to it;					

Para No. in the third schedule	Particulars	Complied with			Page	Remark
		Yes	No	N/A		
	(d) the names and addresses of the persons to whom it or the right to it was given or, if given to existing shareholders or debenture holders as such, the relevant shares or debentures.					
11.	The number and amount of shares and debentures which within the 2 preceding years have been issued, or agreed to be issued, as fully or partly paid up otherwise than in cash, and in the latter case the extent to which they are so paid up, and in either case the consideration for which those shares or debentures have been issued or are proposed or intended to be issued.					
12.	(1) As respects any property to which this paragraph applies: (a) the names and addresses of the vendors; (b) the amount payable in cash, shares or debentures to the vendor and, where there is more than 1 separate vendor, or the company is a sub-purchaser, the amount so payable to each vendor; (c) short particulars of any transaction relating to the property completed within the 2 preceding years in which any vendor of the property to the company or any person who is, or was at the time of the transaction, a promoter or a director or proposed director of the company had any interest direct or indirect.					
	(2) The property to which this paragraph applies is property purchased or acquired by the company or proposed so to be purchased or acquired, which is to be paid for wholly or partly out of the proceeds of the issue offered for subscription by the prospectus or the purchase or acquisition of which has not been completed at the date of the issue of the prospectus, other than property:-					

Para No. in the third schedule	Particulars	Complied with			Page	Remark
		Yes	No	N/A		
	(a) the contract for the purchase or acquisition whereof was entered into in the ordinary course of the company's business, the contract not being made in contemplation of the issue nor the issue in consequence of the contract; or (b) as respects which the amount of the purchase money is not material.					
13.	The amount, if any, paid or payable as purchase money in cash, shares or debentures for any property to which paragraph 12 applies, specifying the amount, if any, payable for goodwill.					
14.	The amount, if any, paid within the 2 preceding years, or payable, as commission (but not including commission to sub-underwriters) for subscribing or agreeing to subscribe, or procuring or agreeing to procure subscriptions, for any shares in or debentures of the company, or the rate of any such commission.					
15.	The amount or estimated amount of preliminary expenses and the persons by whom any of those expenses have been paid or are payable, and the amount or estimated amount of the expenses of the issue and the person by whom any of those expenses have been paid or are payable.					
16.	Any amount or benefit paid or given within the 2 preceding years or intended to be paid or given to any promoter, and the consideration for the payment or the giving of the benefit.					
17.	The dates of, parties to and general nature of every material contract, not being a contract entered into in the ordinary course of the business carried on or intended to be carried on by the company or a contract entered into more than 2 years before the date of issue of the prospectus, and a statement that a copy of every such material contract has been delivered to the Registrar for registration.					
18.	The names and addresses of the auditors, if any of the company, and, if the prospectus invites the public to subscribe for debentures which are stated in the prospectus to be guaranteed, the names and addresses of the auditors, if any, of the guarantor corporation.					

Para No. in the third schedule	Particulars	Complied with			Page	Remark
		Yes	No	N/A		
19.	Full particulars of the nature and extent of the interest, if any, of every director in the promotion of, or in the property proposed to be acquired by, the company, or, where the interest of such a director consists in being a partner in a firm, the nature and extent of the interest of the firm, with a statement of all sums paid or agreed to be paid to him or to the firm in cash or shares or otherwise by any person either to induce him to become, or to qualify him as a director, or otherwise for services rendered by him or by the firm in connection with the promotion or formation of the company.					
20.	If the prospectus invites the public to subscribe for shares in the company and the share capital of the company is divided into different classes of shares, the right of voting at meetings of the company conferred by, and the rights in respect of capital and dividends attached to, the several classes of shares respectively.					
21.	In the case of a company which has been carrying on business, or of a business which has been carried on, for less than 3 years, the length of time during which the business of the company or the business to be acquired, as the case may be, has been carried on.					
22.	The contents or a sufficient summary of the contents of the articles of the company with regard to any borrowing powers exercisable by the directors and the manner of variation of such powers.					
23.	Particulars of any bank overdrafts or other similar indebtedness of the company and its subsidiaries, if any, as at the latest practicable date or, if there are no bank overdrafts or other similar indebtedness, a statement to that effect.					
24.	Particulars of any hire purchase commitments, guarantees or other material contingent liabilities of the company and its subsidiaries, if any, or, if there are none such, a statement to that effect.					

Para No. in the third schedule	Particulars	Complied with			Page	Remark
		Yes	No	N/A		
25.	Particulars of the authorised debentures of the company and its subsidiaries; if any, the amount issued and outstanding or agreed to be issued, or if no debentures are outstanding a statement to that effect.					
26.	If the prospectus invites the public to subscribe for debentures of the company:- (a) the rights conferred upon the holders thereof, including rights in respect of interest and redemption, and particulars of the security, if any, therefor; (b) the designation of such debentures which shall incorporate - (i) in the case of debentures not secured by a charge on assets of the company - (A) the word "unsecured" if the designation is in English; (B) the expression in Chinese "無保證" if the designation is in Chinese; or (C) both such word and expression respectively if the designation is both in English and Chinese; and (ii) in the case of debentures secured to a substantial extent by a specific mortgage or charge - (A) the word "mortgage" if the designation is in English; (B) the expression in Chinese "按揭" if the designation is in Chinese; or (C) both such word and expression respectively if the designation is both in English and Chinese;					
	(c) particulars of any guarantee subsisting in respect of the debentures, including the name and address of the guarantor, and the designation or any description of the debentures shall only incorporate the word "guaranteed" or the expression in Chinese "獲擔保" if they are guaranteed to a substantial extent by a legally enforceable guarantee.					

Para No. in the third schedule	Particulars	Complied with			Page	Remark
		Yes	No	N/A		
27.	A statement as to the gross trading income or sales turnover (as may be appropriate) of the company during each of the 3 financial years immediately preceding the issue of the prospectus including an explanation of the method used for the computation of such income or turnover, and a reasonable break-down between the more important trading activities; but a bank, discount house or other company whose business is in the opinion of the directors of a character that such a statement is either not practicable or not of value may instead include an explanation of the absence of such a statement.					
28.	If the prospectus offers shares in the company for sale to the public- (a) the names, addresses and descriptions of the vendor or vendors of the shares, or, if there are more than 10 vendors, the like particulars of the 10 principal vendors and a statement of the number of other vendors; (b) particulars of any beneficial interest possessed by any director of the company in any shares so offered for sale.					
29.	The name, date and country of incorporation, whether public or private (if applicable), the general nature of the business, the issued capital and the proportion thereof held or intended to be held, of every company the whole of the capital of which or substantial proportion thereof is held or intended to be held, or whose profits or assets make or will make a material contribution to the figures in the auditors' report or to the next accounts of the company.					
30.	A statement of the persons holding or beneficially interested in any substantial part of the share capital of the company and the amounts of the holdings in question.					
31.	(1) A report by the auditors of the company with respect to (a) profits and losses and assets and liabilities of the company in accordance with sub-paragraph (2) or (3), as the case required; and					

Para No. in the third schedule	Particulars	Complied with			Page	Remark
		Yes	No	N/A		
	(b)the rates of the dividends, if any, paid by the company in respect of each class of shares in the company in respect of each of the 3 financial years immediately preceding the issue of the prospectus, giving particulars of each such class of shares on which such dividends have been paid and particulars of the cases in which no dividends have been paid in respect of any class of shares in respect of any of those years, and, if no accounts have been made up in respect of any part of the period of 3 years ending on a date 3 months before the issue of the prospectus, containing a statement of that fact. (2) If the company has no subsidiaries, the report shall: (a) so far as regards profits and losses, deal with the profits or losses of the company in respect of each of the 3 financial years immediately preceding the issue of the prospectus; and (b) so far as regards assets and liabilities, deal with the assets and liabilities of the company at the last date to which the accounts of the company were made up. (3) If the company has subsidiaries, the report shall:					
	(a) so far as regards profits and losses, deal separately with the company's (other than subsidiaries) profits or losses as provided by sub-paragraph (2) and, in addition, deal either- (i) as a whole with the combined profits or losses of its subsidiaries; or (ii) individually with the profits or losses of each subsidiary, or, instead of dealing separately with the company's profits or losses, deal as a whole with the profits or losses of the company and with the combined profits or losses of its subsidiaries; and					

Para No. in the third schedule	Particulars	Complied with			Page	Remark
		Yes	No	N/A		
	(b) so far as regards assets and liabilities, deal separately with the company's (other than subsidiaries) assets and liabilities as provided by sub-paragraph (2) and, in addition, deal either- (i) as a whole with the combined assets and liabilities of its subsidiaries, with or without the company's assets and liabilities; or (ii) individually with the assets and liabilities of each subsidiary, and shall indicate as respects the profits or losses and assets and liabilities of the subsidiaries the allowance to be made for persons other than members of the company.					
32.	If the proceeds, or any part of the proceeds, of the issue of the shares or debentures are or is to be applied directly or indirectly in the purchase of any business, a report made by accountants (who shall be named in the prospectus) upon - (a) the profits and losses of the business for each of the 3 financial years immediately preceding the issue of the prospectus; and (b) the assets and liabilities of the business at the last date to which the accounts were made up.					
33.	(1) If: (a) the proceeds, or any part of the proceeds, of the issue of the shares or debentures are or is to be applied directly or indirectly in any manner resulting in the acquisition by the company of shares in any other body corporate; and (b) by reason of that acquisition or anything to be done in consequence thereof or in connexion therewith that body corporate will become a subsidiary of the company, a report made by accountants (who shall be named in the prospectus) upon - (i) the profits or losses of the other body corporate in respect of each of the 3 financial years immediately preceding the issue of the prospectus; and					

Para No. in the third schedule	Particulars	Complied with			Page	Remark
		Yes	No	N/A		
	(ii) assets and liabilities of that other body corporate at the last date to which the accounts of the body corporate were made up. (2) The said report shall: (a) indicate how the profits or losses of the body corporate dealt with by the report would, in respect of the shares to be acquired, have concerned members of the company and what allowance would have fallen to be made, in relation to assets and liabilities so dealt with, for holders of other shares, if the company had at all material times held the shares to be acquired; and					
	(b) where the other body corporate as subsidiaries, deal with the profits or losses and the assets and liabilities of the body corporate and its subsidiaries in the manner provided by paragraph 31(3) in relation to the company and its subsidiaries.					
34.	(1) This paragraph shall apply in the case of every company whose accounts at the last date at which the accounts have been made up disclose that either a value exceeding 10 per cent of the value of the assets of the company or a value of not less than $3,000,000 is placed on the company's interest in land and buildings. (2) A valuation report with respect to all the company's interest in land or buildings which shall include the following particulars of each property: (a) the address; (b) a brief description; (c) the use at the date of report; (d) the nature of tenure; (e) a summary of the terms of any sub-leases or tenancies, including repair obligations granted by the company; (f) the approximate age of buildings; (g) the present capital value;					

Para No. in the third schedule	Particulars	Complied with			Page	Remark
		Yes	No	N/A		
	(h) the estimated current net rental, being the estimated average net annual income from the property accruing to the company over a long period of years (not being less than 3 years) before taking into account tax and any interest or mortgage expenses but after taking into account management and maintenance expenses; (3) A report for the purposes of sub-paragraph (2) shall state- (a) whether the valuation -					
	(i) is the current value in the open market, stating whether - (A) on an investment basis, or (B) on an development basis, or (C) on a future capital realisation basis. (ii) is the current level value as an asset of a going concern; or (iii) is the value after development has been completed; or (iv) has any other basis (which should be stated); (b) Where the valuation is based on value after development completed: (i) the date when the development is expected to be completed; (ii) the estimated cost of carrying out the development or (where part of the development has already been carried out) the estimated cost of completing the development; (iii) the estimated value of the property in the open market in its present condition. (4) If the company has obtained more than one valuation report regarding any of the company's interests in land or buildings within 6 months before the issue of the prospectus then all other such reports shall be included.					

Para No. in the third schedule	Particulars	Complied with			Page	Remark
		Yes	No	N/A		
42.	Any report required by Part II of the Third Schedule to the Companies Ordinance shall either indicate by way of note any adjustments as respects the figures of any profits or losses or assets and liabilities dealt with by the report which appear to the persons making the report necessary or shall make those adjustments and indicate that adjustments have been made.					
43.	Any report by accountants required by Part II shall be made by accountants qualified under the Professional Accountants Ordinance (Cap 50) for appointment as auditors of a company and shall not be made by any accountant who is an officer or servant, or a partner of or in the employment of an officer or servant, of the company or of the company's subsidiary or parent undertaking or of a subsidiary of the company's parent undertaking; and for the purposes of this paragraph the expression "officer" (高級人員) shall include a proposed director but not an auditor.					
46	Any valuation report required by Part II- (a) shall not state or imply that any land or building has been professionally valued unless the valuation is made by a professionally qualified valuation surveyor who is subject to the discipline of a professional body; (b) shall not be made by a person who is an officer or servant or proposed director of the company or the company's subsidiary or parent undertaking or of a subsidiary of the company's parent undertaking; and (c) shall not be made by a company which- (i) is the company's subsidiary or parent undertaking or a subsidiary of the company's parent undertaking; or (ii) has either a paid up capital of less than $1,000,000 or the assets of which do not exceed liabilities by $1,000,000 or more as shown in the company's last balance sheet.					

Part 3
Compliance with sections 44A and 44B of the Companies Ordinance

Section	Particulars	Complied with			Page	Remark
		Yes	No	N/A		
44A(1)	No allotment shall be made of any shares in or debentures of a company in pursuance of a prospectus issued generally and no proceedings shall be taken on applications made in pursuance of a prospectus so issued, until the beginning of the 3rd day after that on which the prospectus is first so issued or such later time (if any) as may be specified in the prospectus.					
44A(2)	Subject to section 38A, no allotment shall be made of any shares in or debentures of a company in pursuance of a prospectus issued generally later than 30 days after the day on which the prospectus is first so issued.					
44A(6)	An application for shares in or debentures of a company which is made in pursuance of a prospectus issued generally shall not be revocable until after the expiration of the 5th day after the time of the opening of the subscription lists, or the giving before the expiration of the said 5th day, by some person responsible under section 40 for the prospectus, of a public notice having the effect under that section of excluding or limiting the responsibility of the person giving it.					
44B(1)	Where a prospectus, whether issued generally or not, states that application has been or will be made for permission for the shares or debentures offered thereby to be listed on any stock exchange, any allotment made on an application in pursuance of the prospectus shall, whenever made, be void if the permission has not been applied for before the 3rd day after the first issue of the prospectus or if the permission has been refused before the expiration of 3 weeks from the date of the closing of the subscription lists or such longer period not exceeding 6 weeks as may, within the said 3 weeks, be notified to the applicant for permission by or on behalf of the stock exchange.					

Section	Particulars	Complied with			Page	Remark
		Yes	No	N/A		
44B(2)	Where the permission has not been applied for as aforesaid, or has been refused as aforesaid, the company shall forthwith repay without interest all money received from applicants in pursuance the prospectus, and, if any such money is not repaid within 8 days after the company becomes liable to repay it, the directors of the company shall be jointly and severally liable to repay that money with interest at the rate of 8 per cent per annum from the expiration of the 8th day: Provided that a director shall not be liable if he proves that the default in the repayment of the money was not due to any misconduct or negligence on his part.					

Part 4
Compliance with sections 342, 342B and 342C of the Companies Ordinance (section 342 is not applicable to Rights/Warrants Issue)

Section	Particulars	Complied with			Page	Remark
		Yes	No	N/A		
342	(1) Subject to section 342A, it shall not be lawful for any person to issue, circulate or distribute in Hong Kong any prospectus offering for subscription or purchase shares in or debentures of a company incorporated outside Hong Kong, whether the company has or has not established a place of business in Hong Kong unless the prospectus is dated (which date shall, unless the contrary is proved, be taken as the date of publication of the prospectus) and: (a) contains particulars with respect to the following matters: (i) the instrument constituting or defining the constitution of the company; (ii) the enactments, or provisions having the force of an enactment, by or under which the incorporation of the company was effected; (iii) an address in Hong Kong where the said instrument, enactments or provisions, or copies thereof, and if the same are in a language other than English or Chinese a translation thereof in English or Chinese certified in the prescribed manner, can be inspected; (iv) the date on which and the country in which the company was incorporated; (v) whether the company has established a place of business in Hong Kong, and, if so, the address of its principal office in Hong Kong;					

Section	Particulars	Complied with			Page	Remark
		Yes	No	N/A		
	(b) subject to the provisions of this section, is either in the English language and contains a Chinese translation or in the Chinese language and contains an English translation, and states the matters specified in Part I of the Third Schedule and sets out the reports specified in Part II of that Schedule, subject always to the provisions contained in Part III of that Schedule: Provided that the provisions of paragraph (a)(i), (ii) and (iii) shall not apply in the case of a prospectus issued more than 2 years after the date at which the company is entitled to commence business, and, in the application of Part I of the Third Schedule for the purposes of the subsection, paragraph 5 thereof shall have effect with the substitution, for the reference to the articles, of a reference to the constitution of the company. (2) Any condition requiring or binding an applicant for shares or debentures to waive compliance with any requirement imposed by virtue of subsection (1)(a) or (b), or purporting to affect him with notice of any contract, document or matter not specifically referred to in the prospectus, shall be void. (2A) Every prospectus to which subsection (1) applies must contain a statement specified in Part 2 of the Eighteenth Schedule. (7) It is hereby declared that the provisions of the Third Schedule applied by this section are also applied to a guarantor corporation in relation to an offer or invitation to the public to subscribe for or purchase debentures of a company incorporated outside Hong Kong.					

Section	Particulars	Complied with			Page	Remark
		Yes	No	N/A		
342B	(1) It shall not be lawful for any person to issue, circulate or distribute in Hong Kong any prospectus offering for subscription or purchase shares in or debentures of a company incorporated outside Hong Kong, whether the company has or has not established a place of business in Hong Kong- (a) if, where the prospectus includes a statement purporting to be made by an expert, he has not given, or has before delivery of the prospectus for registration withdrawn, his written consent to the issue of the prospectus with the statement included in the form and context in which it is included or there does not appear in the prospectus a statement that he has given and has not withdrawn his consent as aforesaid; or (b) if the prospectus does not have the effect, where an application is made in pursuance thereof, of rendering all the persons concerned bound by all the provisions (other than penal provisions) of sections 44A and 44B so far as applicable.					
342C	(1) No prospectus offering for subscription or purchase shares in or debentures of a company incorporated outside Hong Kong (whether the company has or has not established a place of business in Hong Kong) shall be issued, circulated or distributed in Hong Kong unless the prospectus complies with the requirements of this Ordinance and, on or before the date of its publication, circulation or distribution in Hong Kong, its registration has been authorized under this section and a copy thereof has been registered by the Registrar.					

Section	Particulars	Complied with			Page	Remark
		Yes	No	N/A		
	(2) Every prospectus shall: (a) on the face of it, state that a copy has been registered as required by this section and, immediately after such statement, state that neither the Commission nor the Registrar takes any responsibility as to the contents of the prospectus or, where the prospectus is or is to be authorised for issue by a recognised exchange company pursuant to a transfer order made under section 25 of the Securities and Futures Ordinance (Cap. 571), state that neither the Commission nor the recognised exchange company nor the Registrar takes any responsibility as to the contents of the prospectus; (b) on the face of it, specify or refer to statements included in the prospectus which specify, any documents required by this section to be endorsed on or attached to the copy so registered; and (c) conform with such requirements as are prescribed by the Chief Executive in Council or specified by the Registrar under section 346 which are applicable to prospectuses to be registered under this Part. (3) An application for authorization for registration of a prospectus under this section shall be made in writing to the Commission and there shall be delivered to the Commission together with the application a copy of the prospectus proposed to be registered which has been certified by 2 members of the governing body of the company or by their agents authorized in writing as having been approved by resolution of the governing body and having endorsed thereon or attached thereto- (a) any consent to the issue of the prospectus required by section 342B from any person as an expert; and					

Section	Particulars	Complied with			Page	Remark
		Yes	No	N/A		
	(b) in the case of a prospectus issued generally, also: (i) a copy of any contract required by paragraph 17 of the Third Schedule to be stated in the prospectus or, in the case of a contract not reduced into writing, a memorandum giving full particulars thereof or, if in the case of a prospectus exempted under section 342A from compliance with the requirements of section 342(1), a contract or a copy thereof or a memorandum of a contract is required by the Commission to be available for inspection in connection with the request made under section 342A(1), a copy or, as the case may be, a memorandum of that contract; (ii) where the prospectus offers shares in the company for sale to the public, a list of the names, addresses and descriptions of the vendor or vendors of the shares; and (iii) where the persons making any report required by Part II of the Third Schedule have made therein, or have, without giving the reasons, indicated therein, any such adjustments as are mentioned in paragraph 42 of that Schedule, a written statement signed by those persons setting out the adjustments and giving the reasons therefor.					

Section	Particulars	Complied with			Page	Remark
		Yes	No	N/A		
	(4) The references in subsection (3)(b)(i) to the copy of a contract required thereby to be endorsed on or attached to a copy of the prospectus shall, in the case of a contract wholly or partly in a language other than English or Chinese, be taken as references to a copy of a translation of the contract in either language or a copy embodying a translation in English or Chinese of the parts not in either language, as the case may be, being a translation certified in the prescribed manner under subsection (9) to be a correct translation.					

Appendix 4(b)
(Paragraph 4.14)

Legislative amendments effective from 13 May 2011 relating to the regulation of public offers of structured products

In the wake of the LB incident, SFC took forward the proposals to amend the Companies Ordinance (Cap. 32) (CO) in respect of the public offers of structured products separately and ahead of other initiatives to reform CO under a phased exercise. In October 2009, SFC issued the Consultation Paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance and the Offers of Investments Regime in the Securities and Futures Ordinance. The proposals aimed to transfer the regulation of public offers of structured financial products in the form of shares and debentures from the CO prospectus regime to the offers of investments regime under Part IV of SFO. Following the consultation, SFC provided its recommendations on legislative amendments to the Administration which introduced the Securities and Futures and Companies Legislation (Structured Products Amendment) Bill 2010 into LegCo in July 2010.

2. In September 2009, SFC conducted in parallel a consultation exercise on Proposals to Enhance Protection for the Investing Public. Subsequently, a package of measures dealing with investment products and the conduct of intermediaries was introduced for the purpose of strengthening investor protection. A new Code on Unlisted Structured Investment Products was made by SFC under section 399 of SFO in June 2010 and incorporated in the SFC Products Handbook[1]. To enhance product transparency and disclosure, the Code establishes guidelines for authorization of structured financial products and sets out the criteria that SFC will normally consider before authorizing the issue of offering documents or advertisements for these products. Eligibility requirements are stipulated for issuers, guarantors and product arrangers of structured products. The offering documents are required to disclose the details of the key components making up a structured product and information with respect to key product counterparties whose credit or counterparty risks may have an impact on the risks and returns of the product. In addition, issuers will be required to disclose specified information on a continuous basis during the tenor of the structured

[1] The SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products (G.N. (S) 30 of 2010) effective from 25 June 2010.

products. Pursuant to this new Code, a Product Key Facts Statement highlighting the key features and risks of a product in a clear, concise and effective manner will form part of the offering document of the product.

3. New requirements to enhance regulation of intermediaries conduct and selling practices relating to the sale of investment products were also made to SFC's Code of Conduct and implemented in phases within a period of 12 months from 4 June 2010[2]. The new requirements on intermediaries include the following:

(a) not to offer any gift in promoting a specific investment product;

(b) to assess the customers' knowledge of derivatives in the "know your client" process and not to promote a derivative product to customers without such knowledge;

(c) to disclose the monetary and non-monetary benefits received from the product issuer for distributing an investment product; and

(d) to cancel the order and refund the customer in case the customer exercises his right to cancel the transaction under a cooling-off mechanism.

4. The Securities and Futures and Companies Legislation (Structured Products Amendment) Bill 2010 was passed by LegCo on 4 May 2011 and came into effect on 13 May 2011. Henceforth, the public offers of structured financial products are regulated under SFO; and the new Code on Unlisted Structured Investment Products will also apply to such products. The "safe harbour" provisions in the Seventeenth Schedule to CO will no longer apply to structured products as they are now regulated under SFO which has its own exemptions set out in sections 103(2) and (3).

[2] Amendments to SFC's Code of Conduct (G..N. 3217 of 2010) gazetted on 4 June 2010.

Appendix 4(c)
(Paragraph 4.27)

Nine general principles set out in the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission

General principles

The Commission has modelled the Code on principles developed and recognized by the International Organization of Securities Commissions and other principles the Commission believes to be fundamental to the undertaking of a licensed or registered person's business.

GP1. Honesty and fairness

In 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

In 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

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.

GP4. Information about clients

A licensed or registered person should seek from its clients information about their financial situation, investment experience and investment objectives relevant to the services to be provided.

GP5. Information for clients

A licensed or registered person should make adequate disclosure of relevant material information in its dealings with its clients.

GP6. Conflicts of interest

A licensed or registered person should try to avoid conflicts of interest, and when they cannot be avoided, should ensure that its clients are fairly treated.

GP7. Compliance

A licensed or registered person should comply with all regulatory requirements applicable to the conduct of its business activities so as to promote the best interests of clients and the integrity of the market.

GP8. Client assets

A licensed or registered person should ensure that client assets are promptly and properly accounted for and adequately safeguarded.

GP9. Responsibility of senior management

The senior management of a licensed or registered person should bear primary responsibility for ensuring the maintenance of appropriate standards of conduct and adherence to proper procedures by the firm. In determining where responsibility lies, and the degree of responsibility of a particular individual, regard shall be had to that individual's apparent or actual authority in relation to the particular business operations, and the factors referred to in paragraph 1.3 below.

Appendix 4(d)
(Paragraph 4.40)

Production of thematic examination reports as ordered by the Subcommittee

Information required by the Subcommittee

For the purpose of its study, in June 2009, the Subcommittee ordered Mr Y K CHOI, then Deputy Chief Executive of the Hong Kong Monetary Authority (DCE/HKMA), to produce to the Subcommittee 68 thematic examination reports on the registered institutions (RIs) examined in four thematic examinations conducted by HKMA from 2005 to 2008[1]. The Subcommittee also agreed that the names of individual RIs might be covered up if necessary.

HKMA's response

2. DCE/HKMA declined to produce the 68 examination reports to the Subcommittee on account of the secrecy provision in section 120 of the Banking Ordinance (Cap.155) (BO), as the reports were prepared from information obtained by the Monetary Authority (MA) in the course of the exercise of his functions under section 55 of BO. DCE/HKMA also considered that even if the reports were produced in a redacted form as proposed by the Subcommittee, it would still be possible to work out which RIs were being referred to. The redacted reports would therefore still disclose information covered by sections 120(1) and (4) of BO.

3. Earlier on, Mr Joseph YAM, then MA, had stated that for the purpose of performing his key functions under section 7 of BO, he might use his powers under BO or the Securities and Futures Ordinance (Cap.571) (SFO) to obtain the necessary information during the examination or investigation process. Since such information was obtained by MA in performing his functions under BO, it was subject to section 120 of BO, irrespective of whether the information had been obtained by MA exercising his powers under BO or SFO.

[1] Mr Joseph YAM, then Monetary Authority, had provided the Subcommittee with a summary of the 68 thematic examination reports under section 120(5)(a) of BO on 1 June 2009. Nevertheless, for the purpose of its study, the Subcommittee ordered the production of the 68 thematic examination reports.

Action taken by the Subcommittee

4. The Subcommittee had the following observations on the matter:

(a) Section 120(4) of BO provides, inter alia, that MA cannot be compelled to produce in any court information obtained in the exercise of his functions in the course of an examination or investigation under section 55 of BO. It is doubtful whether the prohibition against disclosing information under section 120(4) would also apply to orders of the Subcommittee made under the Legislative Council (Powers and Privileges) Ordinance (Cap.382) (LCPPO).

(b) Section 55 of BO appears to be restricted to the examination of the books, accounts and transactions of any authorized institution (AI) which is defined to mean a bank, a restricted licensed bank or a deposit-taking company in section 2(1) of BO. It is doubtful whether section 55 of BO would also apply to the thematic examinations of RIs, as although all RIs are AIs, the regulatory regime applicable to RIs and AIs is different and separate from each other. For supervision of RIs and relevant individuals, MA may exercise the powers granted under section 180 of SFO which Ordinance contains a separate secrecy provision (i.e. section 378) not identical to section 120 of BO.

5. The Subcommittee also sought clarification from the Administration on the policy intent of whether section 55 of BO should only apply to AIs in relation to activities other than those within the meaning of "regulated activities" as defined in SFO. In response, the Administration advised that the regulatory framework promulgated by BO was intended to allow MA to exercise supervisory oversight over all businesses conducted by an AI. It did not agree that section 55 of BO should only apply to AIs in relation to activities other than "regulated activities" as defined in SFO.

6. In the light of the legal advice it had subsequently obtained, the Subcommittee took note of the following issues related to section 120 of BO:

(a) those parts of the thematic examination reports that consist of information obtained by MA in the course of carrying out the thematic examinations under section 55 of the BO would be within the scope of the privilege under section 120(4) of BO;

(b) section 14(1) of LCPPO provides that a witness before the Legislative Council or any committee of the Council is entitled to invoke the same right or privilege to refuse to give evidence (including the production of any paper, record or document) as in a court of law. Such right and privilege would also include the statutory limitation under section 120(4) of BO; and

(c) in so far as on-site examinations are concerned, the sources of MA's power are either section 55 of BO or section 180 of SFO. There is no valid ground to contend that MA is not entitled to exercise his power under section 55 of BO to carry out the thematic examinations.

7. In view of the above, the Subcommittee put questions to DCE/HKMA, when he next attended before the Subcommittee, on the use of section 55 of BO and section 180 of SFO when MA conducted on-site examinations.

8. In his written reply to the questions so put to him at the hearing on 10 November 2009, DCE/HKMA stated that MA had been using primarily section 55 of BO for all on-site examinations of AIs' businesses, including their banking, securities and insurance businesses. Use of section 180 of SFO alone could only cover SFO-regulated activities and did not provide sufficient power to allow MA to achieve all of its supervisory objectives. Therefore, section 55 of BO had always been used by MA in conducting all on-site examinations (including thematic examinations) of RIs.

Appendix 5(a)
(Paragraph 5.110)

Major requirements under the enhanced complaint-handling procedures

The distributing bank is required to engage a qualified third party, to be approved by HKMA and SFC, to review and enhance its prevailing complaint-handling procedures, and to implement all the recommendations by such third party. The enhanced complaint-handling procedures (ECHP) should meet the following requirements:

1. There are sufficient channels for customers to lodge their complaints.

2. Written responses are sent to the customers promptly to acknowledge receipt of the complaints and to inform the customers about the launch of investigations.

3. Customer complaints are handled in a timely and appropriate manner.

4. Customer complaints are investigated and assessed thoroughly, fairly and objectively, taking into account all the relevant matters including all relevant information relating to the customers, the investment products(s)/service(s) in question and the subject matter of the complaint.

5. Each investigation of customer complaints involves an interview with the relevant customer and other relevant witnesses.

6. Each investigation of customer complaints includes an assessment of the conduct of the relevant staff involved in dealing with the customer and whether the conduct of the relevant staff and that of the distributing bank was in compliance with the Code of Conduct, the Internal Control Guidelines and all other applicable legal and regulatory requirements.

7. If an investigation identifies any non-compliance with the applicable legal and regulatory requirements, the complaints handling staff promptly reports such non-compliance to senior management.

8. The distributing bank promptly informs the customers of the preliminary results of the investigations and provides a reasonable opportunity to be heard to the customers before issuing the final results.

9. The distributing bank examines thoroughly any representations and additional documents provided by the customers after the customers are advised of the preliminary results.

10. Customers are duly advised of the final results and any appropriate remedial actions are taken promptly upon the completion of each investigation.

11. In relation to complaints which are upheld by the distributing bank or where the investigations reveal any non-compliance with any applicable legal and/or regulatory requirements, the distributing bank has a fair and reasonable process (which takes account of the distributing bank's obligations under General Principle 1 of the Code of Conduct) for determining whether, and on what terms, the customer should be offered financial redress in respect of loss of damage the customer has suffered as a result of any breach by the distributing bank of applicable laws or regulatory requirements.

12. If a complaint is not resolved to the customer's satisfaction: (i) the relevant complaints handling staff would, if reasonably considered necessary in the circumstances, report the case to senior management for appropriate follow-up actions; and (ii) the distributing bank would advise the customer of any further steps or action that may be available to the customer under the existing regulatory regime.

13. Each customer complaint is the subject of a written report explaining the findings of the investigation and such reports are submitted to senior management as well as the relevant business functions after the investigations.

14. Senior management and the relevant business functions implement appropriate follow-up actions after each investigation to prevent recurrence of similar errors or omissions (if any).

Source: The written evidence given by one of the distributing banks.

Agreements made by SFC and MA with banks in respect of LB-related Minibonds and structured financial products

(As at 8 July 2011)

	Minibonds Repurchase Scheme	**Repurchase for Equity Index-linked Fixed Coupon Principal Protected Notes**	**Resolution Scheme for Constellation Notes**	**Equity Linked Notes Repurchase Scheme**	**Repurchase Scheme for Market Linked Notes and Equity Linked Notes**
Parties to the agreement pursuant to section 201 of Securities and Futures Ordinance (Cap. 571)	SFC, MA and 16 distributing banks[1]	SFC, MA, Dah Sing Bank Ltd (DSB) and Mevas Bank Ltd (Mevas)	SFC, MA and DBS Bank (Hong Kong) Limited (DBSHK)	SFC, MA and Standard Chartered Bank (Hong Kong) Limited (SCBHK)	SFC, MA and Citibank (Hong Kong) Limited (CHKL)
Date on which the agreement was announced	22 July 2009	23 December 2009	14 July 2010	1 March 2011	8 July 2011
LB-related structured financial product to which the agreement applies	Outstanding LB-related Minibonds[2]	Certain Equity Index-linked Fixed Coupon Principal Protected Notes issued by LB (LB-PPNs) sold by DSB and Mevas on or after 5 August 2008	Certain LB-related Constellation Notes[3] (LB-CLNs)	All Equity Linked Notes issued by LB (LB-ELNs) that were outstanding, at the time of the LB bankruptcy filing on 15 September 2008.	All market-linked notes (LB-MLNs) and equity-linked notes (LB-ELNs) issued by LB and distributed by CHKL[4] between March 2007 and June 2008 that were outstanding, at the time of the LB bankruptcy filing on 15 September 2008.
Distributable collateral, if any, securing the product to which the agreement applies	Yes. Each outstanding series is secured. Each distributing bank made available an amount equivalent to the amount of commission income received by it as a	No	No	No	No

[1] 16 distributing banks are ABN AMRO Bank N.V.; Bank of China (Hong Kong) Ltd; Bank of Communications Co Ltd; The Bank of East Asia, Ltd; Chiyu Banking Corporation Ltd; Chong Hing Bank Ltd; CITIC Ka Wah Bank Ltd; Dah Sing Bank Ltd; Fubon Bank (Hong Kong) Ltd; Industrial and Commercial Bank of China (Asia) Ltd; Mevas Bank Ltd; Nanyang Commercial Bank, Ltd; Public Bank (Hong Kong) Ltd; Shanghai Commercial Bank Ltd; Wing Hang Bank Ltd and Wing Lung Bank Ltd.

[2] Minibond Series 5-7, 9-12, 15-23 and 25-36.

[3] Only the series of the Constellation Notes of which Lehman Brothers Holdings Inc. was one of the reference entities. They were series 34-37, 43-46, 55-58, 59-62, 63-66, 67-70, 71-74 and 78-81.

[4] LB-MLNs and LB-ELNs were distributed by CHKL on a private placement basis with a minimum subscription amount of HK$500,000.

	Minibonds Repurchase Scheme	Repurchase for Equity Index-linked Fixed Coupon Principal Protected Notes	Resolution Scheme for Constellation Notes	Equity Linked Notes Repurchase Scheme	Repurchase Scheme for Market Linked Notes and Equity Linked Notes
	distributor of the outstanding Minibonds to the trustee of the Minibonds to assist in the recovery of the underlying collateral. Once the collateral was recovered and paid to the distributing banks, each of the distributing banks would make a further payment to eligible customers. Please refer to the Appendix 6(b) for details.				
Eligibility for the repurchase / resolution offer	Customers were eligible to receive a repurchase offer if they purchased the outstanding series of the Minibonds through any of the 16 distributing banks as part of a primary offering, with open positions in such outstanding series of Minibonds, and were not professional investors [5], corporate / non-individual investors (with specified exceptions [6]) and experienced investors[7]. Customers who meet the above requirements and have previously reached settlements with distributing banks in relation to the Minibonds would not qualify for the repurchase offer but would receive an ex gratia payment to make up the difference if their settlement amounts were less	Customers who purchased the LB-PPNs from DSB/Mevas on or after 5 August 2008. Customers who purchased the LB-PPNs from DSB/Mevas on or after 5 August 2008 and settled their claims in relation to the product with DSB/Mevas previously would not qualify for the repurchase offer but would receive an ex gratia payment to make up the difference if their settlement amounts were less than the repurchase offer.	Customers were eligible to a resolution offer if they acquired the LB-CLNs through DBSHK, held the LB-CLNs as of 19 September 2008 (the date on which the credit event notice in relation to the bankruptcy of LB Holdings Inc. was issued) and were classified by DBSHK at the time of purchase as either level 1(conservative), 2(moderate) or 3(balanced) investors under DBSHK's investment profiling system (i.e., low risk customers). Customers who meet the above requirements and have previously reached settlements with DBSHK would receive a top up payment to make up the difference if their settlement amounts were less than the resolution offer. No resolution offer was extended to customers who were given a risk profile of either level 4	Customers were eligible to a repurchase offer if they owned (i) the outstanding not principal protected LB-ELNs purchased from SCBHK in amounts exceeding 5% of the customer's available assets [8] or (ii) the outstanding principal protected LB-ELNs purchased from SCBHK in amounts exceeding 10% of their available assets; and were not corporations (other than charities, not for profit organizations, and corporations where the suitability assessment was based on an individual's circumstances rather than the corporation's), professional investors and clients of the private banking division of SCBHK. Customers who meet the above requirements and have previously reached settlements	Customers were eligible to a repurchase offer if they had open positions in the outstanding LB-MLNs and/or LB-ELNs purchased through CHKL; and were not professional investors, corporate / non-individual investors and experienced investors[9]. Customers who meet the above requirements and have previously reached settlements with CHKL in relation to LB-MLNs / LB-ELNs would not qualify for the repurchase offer but would receive a top up payment to make up the difference if their settlement amounts were less than the repurchase offer.

	Minibonds Repurchase Scheme	Repurchase for Equity Index-linked Fixed Coupon Principal Protected Notes	Resolution Scheme for Constellation Notes	Equity Linked Notes Repurchase Scheme	Repurchase Scheme for Market Linked Notes and Equity Linked Notes
	than the repurchase offer.		(growth) or 5(aggressive) investors (i.e, high risk customers).	with SCBHK would receive a top up payment to make up the difference if their settlement amounts were less than the repurchase offer.	
Terms of the repurchase/resolution offers by the bank(s) without admission of any liability	Offers to repurchase from eligible customers all outstanding series of the Minibonds at a price equal to 60% of the nominal value of the original investment for customers below the age of 65 as at 1 July 2009, or 70% of the nominal value of the original investment for customers aged 65 or above as at 1 July 2009. Customers would be entitled to retain any coupon payments received. If the collateral of the relevant series can be recovered, further payment of a specific amount (depending on the recoveries) to eligible customers below the age of 65 as at 1 July 2009 and, if recoveries exceed 70% of the total principal amount of that series, then further payment of a specific amount (depending on the recoveries) to eligible customers aged 65 or above as at 1 July 2009. If an eligible customer accepts the offer, he/she is required to transfer the Minibonds to the distributing bank; release the distributing bank and its staff from any claims arising from	Payment at 80% of the principal amount invested by an eligible customer.	Resolution payment at a price equal to an eligible customer's investment principal, plus interest earned on their investment principal from a fixed term deposit less coupon payments from the LB-CLNs. Customers accepting the offer of the resolution payment or the top up payment will have to give up all civil claims against DBSHK (including its employees); withdraw complaints lodged with DBSHK, SFC, HKMA and the Consumer Council; and discontinue legal proceedings in relation to the LB-CLNs. Any acceptance of the offer in respect of some but not all LB-CLNs will be treated as a rejection.	Payment at a price equal to the total value of an eligible customer's investment: - less 5% of his/her available assets (for customers who own outstanding not principal protected LB-ELNs) or less 10% of his/her available assets (for customers who own outstanding principal protected LB-ELNs); - less the amount of coupon payment already made to him/her as a result of holding the product; and - plus interest calculated according to a specified formula. In the unlikely event that it is determined at a later date that a customer accepting a repurchase offer would have received a greater amount as an unsecured creditor in the LB bankruptcy, SCBHK will pay the difference to that customer. On accepting a repurchase offer or top up payment offer, customers will be asked to give up all civil claims against SCBHK (including its present and past officers and	Payment at 80% of the total amount invested by an eligible customer, less the amount of coupon payment already made to him/her as a result of holding LB-MLNs / LB-ELNs; and plus interest calculated according to a specified formula. In the unlikely event that it is determined at a later date that a customer accepting a repurchase offer would have received a greater amount as an unsecured creditor in the LB bankruptcy proceedings, CHKL will pay the difference to that customer. On accepting a repurchase offer, customers will be asked to give up all civil claims against CHKL (including its present and past officers and employees) in relation to LB-MLNs / LB-ELNs; withdraw complaints about LB-MLNs / LB-ELNs lodged with CHKL, SFC, HKMA, the Consumer Council and other relevant authorities (excluding the Police); and

	Minibonds Repurchase Scheme	Repurchase for Equity Index-linked Fixed Coupon Principal Protected Notes	Resolution Scheme for Constellation Notes	Equity Linked Notes Repurchase Scheme	Repurchase Scheme for Market Linked Notes and Equity Linked Notes
	the sale of Minibonds; withdraw his/her complaints arising from the sale of the Minibonds; and discontinue any legal proceedings or mediation in relation to the Minibonds. Any acceptance of the offer in respect of some but not all of the relevant series of the Minibonds will be treated as rejection of the offer.			employees) in relation to LB-ELNs; withdraw complaints about LB-ELNs lodged with SCBHK, SFC, HKMA and the Consumer Council; and discontinue legal proceedings against SCBHK (including its present and past officers and employees) in relation to LB-ELNs. Any acceptance of the repurchase offer or top up payment offer in respect of some but not all LB-ELNs will be treated as a rejection of the offer.	discontinue legal proceedings against CHKL (including its present and past officers and employees) in relation to LB-MLNs / LB-ELNs. Any acceptance of the repurchase offer or top up payment offer in respect of some but not all of the relevant series of LB-MLNs/LB-ELNs will be treated as rejection of the offer.
Number of investors covered by the repurchase/resolution offers and the amounts involved	More than HK$5.2 billion would be paid to about 24 400 eligible customers and 4 800 customers who had previously settled with the distributing banks.	About 529 customers (for the repurchase offers or the ex gratia payments) with a total investment of HK$264 million. Assuming all eligible customers accept the offers, the total amount payable by DSB and Mevas under the repurchase offers and ex gratia payments is approximately HK$72 million.	About 2 160 accounts of the eligible customers. DBSHK distributed the LB-CLNs to a total of approximately 3 400 customer accounts in approximately 4 380 transactions involving about HK$1,316 million. DBSHK offered to pay approximately HK$651 million to the eligible customers.	Over 95% of the outstanding transactions in LB-ELNs by customers of SCBHK. SCBHK sold over HK$5 billion worth of LB-ELNs between August 2006 and June 2008 of which HK$2.19 billion worth remained outstanding. The 2 515 outstanding LB-ELNs were held by 2 234 customers. The total value of the repurchase offer was estimated to be approximately HK$1.48 billion.	About 92% of CHKL's customers holding outstanding LB-MLNs / LB-ELNs. Between March 2007 and June 2008, CHKL distributed 19 series of LB-MLNs and 52 series of LB-ELNs of which HK$1.6 billion worth remained outstanding. The outstanding LB-MLNs / LB-ELNs were held by more than 1 400 customers. The total value of the repurchase offer was estimated to be approximately HK$1.06 billion.

	Minibonds Repurchase Scheme	**Repurchase for Equity Index-linked Fixed Coupon Principal Protected Notes**	**Resolution Scheme for Constellation Notes**	**Equity Linked Notes Repurchase Scheme**	**Repurchase Scheme for Market Linked Notes and Equity Linked Notes**
Enhanced complaint handling procedures	As part of the Minibonds repurchase agreement, each of the 16 distributing banks agreed to engage a qualified third party to review and enhance complaint handling procedures and to commit to the implementation of all recommendations by such third party. Each distributing bank would immediately implement special enhanced complaint handling procedures to resolve, in a fair and reasonable manner, all complaints in relation to the sale of other structured products. Investors who do not accept the repurchase offers or who are not eligible for the repurchase offers can ask the distributing banks to review their cases under the enhanced complaint handling procedures.	As part of the Minibonds repurchase agreement, distributing banks including DSB and Mevas were required to review and enhance their complaint handling procedures to receive and resolve complaints concerning LB-related structured financial products. The repurchase scheme arose from the enhanced complaint handling procedures under the Minibonds repurchase agreement.	DBSHK was required to review complaints regarding high risk customers under the enhanced complaint handling procedures which is the same as that implemented by the distributing banks under the Minibonds repurchase agreement. Customers who consider that the resolution offer is not acceptable may file complaints under the enhanced complaint handling procedures.	No reference is made to any enhanced complaint handling procedures.	No reference is made to any enhanced complaint handling procedures.
Investigation or enforcement action by SFC and HKMA	SFC will discontinue its investigations into the sale of Minibonds by the distributing banks. Unless dishonesty, fraud or other criminal elements are involved, HKMA does not intend to continue its investigation into the case of any eligible customer who accepts the repurchase offer, but will investigate or continue	SFC will not take any enforcement action against DSB or Mevas, or any of their directors, officers or employees under SFC's Code of Conduct in relation to the sale of the LB-PPNs. HKMA does not intend to take any enforcement action against the executive officers and relevant individuals in connection with the sale of	SFC will not take further enforcement action against DBSHK and its employees in relation to the distribution of the LB-CLNs, save for any acts of dishonesty, fraud, deception or conduct that is criminal in nature. Unless dishonesty, fraud or other criminal elements are involved, the HKMA does not intend to continue its investigation into the case of any eligible customer who	Except for any acts of dishonesty, fraud, deception or conduct that is criminal in nature: - SFC will not take disciplinary action against SCBHK and its current or former officers or employees in relation to the distribution of LB-ELNs; and - HKMA does not intend to take any enforcement action against their executive	Except for any acts of dishonesty, fraud, deception or conduct that is criminal in nature: - SFC will not impose disciplinary sanctions against CHKL and its current or former officers or employees in relation to the distribution of LB-MLNs / LB-ELNs; and - HKMA does not intend to

	Minibonds Repurchase Scheme	Repurchase for Equity Index-linked Fixed Coupon Principal Protected Notes	Resolution Scheme for Constellation Notes	Equity Linked Notes Repurchase Scheme	Repurchase Scheme for Market Linked Notes and Equity Linked Notes
	its investigation into those cases involving customers who do not accept, or are not eligible for, the repurchase offer and whose complaints can not be resolved by the enhanced complaint handling procedures introduced by the distributing banks.	LB-PPNs by them to customers who have accepted the offers. Notwithstanding the above, the resolution does not limit action against any person where there is dishonesty, fraud, deceit or other criminal conduct in connection with the sale of LB-PPNs.	accepts the offer. The HKMA will, however, continue its investigation into those cases involving customers who do not accept, or are not eligible for, the offer.	officers and relevant individuals in connection with the sale of LB-ELNs to customers who have accepted the repurchase offers or the top up payment offers, but will continue to investigate complaints made by customers who reject the offers or who are not eligible for the offers.	take any enforcement action against CHKL's executive officers and relevant individuals in connection with the sale of LB-MLNs / LB-ELNs to customers who have accepted the repurchase offers or the top up payment offers, but will continue to handle complaints made by customers who reject the repurchase offers or who are not eligible for the offers.
Considerations taken into account and concerns raised by the regulators in connection with the repurchase offers	-The repurchase offer by the distributing banks is a reasonable one and is in the public interest. -Customers who accept the repurchase offer will, subject to the recovery and distribution of the underlying collateral, receive a total amount that is equal to or greater than what they would otherwise recover if they were simply paid the current market value of the collateral. -The recoverable value of the collateral was not certain. -The Minibonds repurchase agreement includes a commitment by the distributing banks, as note-holders, to take reasonable steps to expedite the return of the collateral.	- Unlike Minibonds, there is no collateral for the LB-PPNs. The holder of a LB-PPN is an unsecured creditor in LB bankruptcy. Accordingly, there is very little likelihood of any dividend payment to DSB and Mevas. - The repurchase offer enables all individual customers concerned to receive an amount equivalent to 80% of their investment without protracted legal proceedings. - The resolution is a reasonable and practical one and is in the interest of investors and in the public interest.	- There were concerns that DBSHK rated the LB-CLNs as a low to medium risk product and sold them to both high and low risk customers. A different division in DBSHK had assessed the LB-CLNs as having a higher risk level. - The LB-CLNs may not have been suitable for low to medium risk customers whose risk profile favoured the conservative, moderate and balanced end of the investment spectrum. The LB-CLNs were a sound product likely to have been suitable for customers with a higher risk tolerance level and experience in derivatives. - The relevant prospectuses had stated that the prospective investors may lose all or substantially all of their	- There were concerns that SCBHK might have exposed investors of the LB-ELNs to higher levels of risk than were suitable for them by not adequately considering concentration risk [10] when assessing the suitability of the products for the investors. - Unlike Minibonds, there is no distributable collateral for the LB-ELNs. As unsecured creditors, there is little chance LB-ELN holders will receive any substantial payment or dividend in the LB bankruptcy. - Although LB-ELNs were high risk products, they were less complex than Minibonds and likely to have been	- CHKL has comparatively sound and detailed written guidelines and procedures in respect of risk disclosure and suitability assessment; but SFC has concerns regarding the implementation, supervision and controls of those guidelines and procedures. - There were concerns in the adequacy of disclosure of credit risk of LB to customers; the sufficiency of the assessment of customers' experience and some customers' level of tolerance to risk for LB-MLNs / LB-ELNs, including risk profiling procedures before the

	Minibonds Repurchase Scheme	Repurchase for Equity Index-linked Fixed Coupon Principal Protected Notes	Resolution Scheme for Constellation Notes	Equity Linked Notes Repurchase Scheme	Repurchase Scheme for Market Linked Notes and Equity Linked Notes
	-The Minibonds repurchase agreement includes special measures in which the 16 distributing banks will investigate and resolve in a fair and reasonable manner all complaints involving the sale and distribution of other structured products. -The Minibonds repurchase agreement also remediates the distributing banks' systems and processes to meet the highest standards that will provide enhanced protection to the investing public in the future and give the investing public an assurance that the parties are determined to ensure these events are not repeated.		investment in LB-CLNs. - Unlike Minibonds, there is no distributable collateral for the LB-CLNs. There is no chance that holders of the LB-CLNs will receive any additional or top up payment or dividend so the payments from DBSHK will be the only possible return payable to the eligible customers. - The present outcome could not have been achieved through disciplinary action by the SFC against DBSHK and/or its officers and employees, if such action was successful. - The resolution offer will guide other distributors of LB-CLNs in resolving complaints with their customers who purchased such notes.	suitable products for most customers as part of a diversified portfolio. - The offer will enable the majority of the LB-ELN investors of SCBHK to obtain a reasonable recovery without the costs and associated risks of separate litigation. - The present outcome could not have been achieved through disciplinary action by the SFC against SCBHK and/or its officers and employees.	purchase of the products; and the overall monitoring of the sale process of the products. - The repurchase scheme enables the great majority of CHKL's customers for LB-MLNs / LB-ELNs to receive a reasonable portion of what they invested without the costs and risks of separate legal proceedings. - LB-MLNs / LB-ELNs were less complex than credit-linked notes. - Unlike Minibonds, there is no distributable collateral for LB-MLNs / LB-ELNs. There is less chance for customers to receive any substantial payment or dividend in the LB's bankruptcy proceedings. - The present outcome could not have been achieved through disciplinary action by SFC against CHKL and/or its staff, even if such action was successful.

Source: Press releases and relevant Questions and Answers published by SFC and HKMA regarding the various agreements.

Appendix 6(b)
(Paragraph 6.23)

Recovery from the collateral for LB-related Minibonds

On 28 March 2011, the 16 Minibonds-distributing banks and the Receivers[1] of the collateral securing Minibonds Series 10 to 12, 15 to 23 and 25 to 36 (the relevant series) issued announcements concerning a Minibonds collateral recovery agreement. According to the Receivers' estimate, the note-holders would be able to recover from the collateral 70% to 93% of their original investment. The 16 Minibonds-distributing banks also announced that in addition to the amount to be recovered from the collateral, the distributing banks would offer ex gratia payments to the investors who were eligible for the Minibonds repurchase offers announced on 22 July 2009 or those who would have been eligible for such offers had they not previously reached a settlement with the distributing banks on a case-by-case basis. The ex gratia payment to which each eligible investor was entitled was equal to 50% of the shortfall between the amount to be recovered from the collateral and the amount of his or her original investment.

2. The collateral recovery agreement was subject to the following two conditions:

(a) the US Bankruptcy Court confirming that the Derivatives Procedures Order made on 16 December 2008 would apply to the transactions underlying the relevant series; and

(b) the approval by at least 75% of the note-holders for each and every relevant series who cast votes at the special note-holder meetings held on 18, 19 and 20 May 2011.

On 21 May 2011, the Receivers announced that the agreement became effective as the two conditions were met.[2]

---

[1] On 30 June 2009, HSBC Bank USA, National Association, the trustee for the outstanding LB-related Minibonds, appointed Messrs. Ted Osborn, Anthony Boswell and Jan Blaauw, partners of PricewaterhouseCoopers Hong Kong, as the Receivers.

[2] On 14 April 2011, the Receivers announced that the US Bankruptcy Court had confirmed that the Derivatives Procedures Order applied to the transactions underlying the relevant series of the Hong Kong Minibonds programme. On 21 May 2011, the Receivers announced that the note-holders had voted in favour of the collateral recovery agreement at meetings held on 18, 19 and 20 May 2011.

3. On 15 June 2011, the Receivers announced that the value recovered from the collateral of the relevant series was higher than the estimated level of recoveries announced on 28 March 2011. According to the information published by the 16 distributing banks on 15 June 2011, the level of recovery to eligible investors based on the higher level of collateral recovery, together with the ex gratia payments, was in the range of 85.715% to 97.55% of their original investment.

Appendix 7(a)
(Paragraph 7.7)

Examples of investor education work undertaken by SFC

1. SFC made an ongoing effort to educate the public about the risks of investment and related regulations. A variety of investor education work was conducted making use of different channels including website, newspaper and magazine articles, radio and TV programmes, etc. Described below are some examples of these initiatives.

Investor education portal

2. In 2000, SFC started a designated investor education portal, formerly known as the Electronic Investor Resources Centre (www.hkeirc.org) and then renamed in January 2006 to InvestEd (www.InvestEd.hk), to provide investors with educational information on investments and regulations.

3. A series of articles were published from December 2003 to January 2004 on the portal describing the key features and risks of credit-linked notes and equity-linked notes.

4. Another series of eight feature articles on structured products were published in March 2008 to explain the common features of structured products and information need to know before investing in structured products. From April to June 2008, three articles were published in its monthly e-newsletter to remind investors to understand the risks before investing in structured products.

Dr Wise's column

5. In December 2003, a monthly on-line column written by a fictitious character, namely Dr Wise's column, was introduced on the portal to discuss key issues of investing and to explain regulatory issues. For example, "Investing in Bonds" published in May 2004 explaining the features of bonds and credit-linked notes, "Should you invest in structured notes?" published in July 2005 advising investors of the features and risks of structured notes,

"Retail Structured Notes – Buyer Beware" published in November 2006 advising investors of what they should understand before placing an order for any retail structured note.

Printed media

6. Eight newspapers articles were published from October to December 2001 describing the key features and risks of structured products. From December 2003 to January 2004, a series of five newspaper articles were published describing the key features and risks of credit-linked notes and equity-linked notes. From April to June 2008, eleven newspaper and magazine articles on structured products were published to alert investors to the risks of structured products.

Investor Education Month

7. Starting January 2006, SFC designated each January as Investor Education Month and rolled out a series of activities around a theme. For example, the theme for 2006 was "Before you invest, ask the right questions", the theme for 2007 and 2008 was "Know your risk", and the theme for 2009 was "Be Smart, Ask First".

Source: Evidence of Mr Martin WHEATLEY and Prof CHAN Ka-keung

Appendix 7(b)
(Paragraph 7.8)

Some instances of Mr Joseph YAM's general forewarnings

1. As informed by Mr Joseph YAM, then Monetary Authority, during the period June 2006 to August 2008, he had issued general forewarnings to alert the investing public with regard to developments in the global and local economies, in particular the impacts of the sub-prime problems and the ensuing credit crisis through different channels. Some examples of these general forewarnings are described below.

Briefings at the LegCo Panel on Financial Affairs

2. At the meeting of the Panel on Financial Affairs held on 8 November 2007, Mr YAM said that it was not easy for investors to understand the market risks when making investment in innovative credit and debt instruments, given the complexity of the underlying structure and operations of the assets involved.

3. At another meeting of the Panel held on 29 January 2008, Mr YAM pointed out that all relevant parties including individuals, institutional investors and financial regulators needed to stay alert under the prevailing volatile market environment. He advised that the prices of derivatives were subject to greater fluctuations than equity prices in a volatile market.

Articles in Viewpoint column

4. In his article published on 15 June 2006, Mr YAM wrote that it was not unusual for investors to put their money into investment instruments that promised high rates of return, only to find out later that the risks involved were well beyond their appetite or there was no market for the instruments when they wanted to sell out. He alerted investors to pay attention to the risks and liquidity associated with prospective investments.

5. Mr YAM warned in his article dated 16 August 2007 that financial innovation was so efficient that it had become rather difficult to identify what risks were involved and where they lay, and whether those assuming the risks were aware of them or were in a position to manage them. He advised that there was a need for a lot of vigilance by everyone involved in the financial system.

6. In another article dated 28 February 2008, Mr YAM highlighted that financial innovation created complex risks that might be beyond the capacity of market participants and the regulatory authorities to understand and manage. He warned that investors could find themselves holding assets whose risk-return profile turned out to be different from what they believed.

7. Mr YAM wrote in his article dated 27 March 2008 that inadequate investor due diligence was a common phenomenon that grew along with the intensification of euphoria in the financial markets. He emphasized the importance for investors to exercise due diligence over their investments, particularly when the structures of the financial instruments and the dynamics of the markets were highly complex.

Interviews with the media and media briefings

8. In an interview with the media on 8 August 2007, Mr YAM said that the economy might be adversely affected by subprime jitters. He pointed out that the risks under a globalized financial system would be contagious and more problems might surface in the coming months.

9. On 21 January 2008, Mr YAM said at a media briefing that he would use the word "difficult" to describe the investment outlook for the year and the market sentiment could deteriorate even further due to the deepening concern over subprime woes. He urged investors to be prudent.

Source: Evidence of Mr Joseph YAM

Lists of written evidence/documents

Lists of written evidence/documents

A. Evidence/documents provided by the Administration

B. Evidence/documents provided by the Hong Kong Monetary Authority

C. Evidence/documents provided by the Securities and Futures Commission

D. Evidence/documents provided by DBS Bank (Hong Kong) Limited

E. Evidence/documents provided by Standard Chartered Bank (Hong Kong) Limited

F. Evidence/documents provided by Citibank (Hong Kong) Limited

G. Evidence/documents provided by The Royal Bank of Scotland N.V.

H. Evidence/documents provided by Bank of China (Hong Kong) Limited

I. Evidence/documents provided by Dah Sing Bank, Limited

J. Evidence/documents provided by other witnesses

A. Evidence/documents provided by the Administration

Documents		Subcommittee reference no.
1.	Witness statement from Professor CHAN Ka-keung, SFST	W1(C)
2.	Curriculum vitae, duties and statutory powers of Professor CHAN Ka-keung, SFST	W3(C)
3.	Opening remark by Professor CHAN Ka-keung, SFST, at the hearing on 20 February 2009	W5(C)
4.	Witness statement from Mr John C TSANG, FS	W20(C)
5.	Curriculum Vitae and duties of Mr John C TSANG, FS	W21
6.	Opening statement by Mr John C TSANG, FS at the hearing on 11 December 2009	W22
7.	Information provided by the Financial Services and the Treasury Bureau in response to the Clerk to Subcommittee's letter dated 22 December 2008	A1
8.	Weblinks of statements made by key government officials in relation to subprime loans in the United States and Lehman Brothers-related structured financial products (2006 to 2008)	A2
9.	Motion on "Reforming financial regulators" at the meeting of the Legislative Council on 26 November 2008 – Progress Report (February 2009)	A3
10.	署理財經事務及庫務局局長就「改革金融業監管機構」動議辯論開場發言 (2008 年 11 月 26 日)	A4
11.	財經事務及庫務局局長就「協助雷曼兄弟苦主」動議辯論開場發言 (2008 年 10 月 22 日)	A5
12.	新聞公報--財經事務及庫務局局長談金融市場波動 (2008 年 9 月 30 日)	A6
13.	Speech by SFST at seminar hosted by HSBC USA, Hong Kong Economic and Trade Office in New York and the Hong Kong Association of New York on 13 May 2008	A7

Documents		Subcommittee reference no.
14.	"Hong Kong SAR: Preliminary Conclusions of the IMF Mission" dated 7 November 2007	A8
15.	財經事務及庫務局局長出席香港中華總商會會議講座答問全文（2007 年 8 月 6 日）	A9
16.	Consultation Document on the Securities and Futures Bill (2 April 2000)	A10
17.	Legislative Council Brief on Regulatory Reform for the Securities and Futures Market – Consultation on the Securities and Futures Bill issued by Financial Services Bureau on 2 April 2000	A11
18.	Sections 4, 5 and 6 of the Securities and Futures Ordinance	A12
19.	Paper on "Action Plan on Recommendations in the Reports prepared by HKMA and SFC on the Lehman Brothers Minibonds Incident" issued to the Panel on Financial Affairs for discussion on 2 February 2009	A13
20.	Speech by FS on Motion of Thanks Debate for the Policy Address on 26 October 2007	A14
21.	2008 - 2009 Budget Speech made by FS on 27 February 2008	A15
22.	Exchange of Letters between the FS and the Monetary Authority of 25 June 2003	A16
23.	First Quarter Economic Report 2007 prepared by the Economic Analysis and Business Facilitation Unit (published in May 2007)	A17
24.	Papers submitted by the Economic Analysis and Business Facilitation Unit to the Panel on Financial Affairs since May 2007	A18
25.	Information provided by Professor CHAN Ka-keung, SFST, dated 19 February 2009	A19
26.	Written responses from Professor CHAN Ka-keung, SFST, to follow-up issues arising from the hearing on 20 February 2009	A20

Documents		Subcommittee reference no.
27.	Written responses from Professor CHAN Ka-keung, SFST, to follow-up issues arising from the hearing on 27 February 2009	A21
28.	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	A22
29.	Paragraphs 22 to 26 of 2007 - 2008 Budget Speech made by FS	A23
30.	SFST's written reply to question raised by Hon James TO on "Stock options known as accumulators" at the Legislative Council meeting on 23 April 2008	A24
31.	Paper on "Regulation of sale of structured investment or derivative products" issued by FSTB to the Panel on Financial Affairs in June 2008	A25
32.	Information provided by Professor CHAN Ka-keung, SFST, dated 12 May 2009	A26
33.	Paper on "Policy Objectives in Financial Affairs and Public Finance" issued by FS on 27 June 2003	A27
34.	Paragraphs 12 to 14 of 2009-2010 Policy Address by the Chief Executive	A28
35.	Written responses from Mr John C TSANG, FS, to follow-up issues arising from the hearing on 11 December 2009	A29
36.	Written responses from Mr John C TSANG, FS, to follow-up issues arising from the hearing on 18 December 2009	A30
37.	Written responses from Mr John C TSANG, FS, to follow-up issues arising from the hearing on 8 January 2010 attended by CEO/SFC	A31
38.	Written responses from Mr John C TSANG, FS, in response to the Clerk to Subcommittee's letter dated 24 December 2009	A32
39.	Extracts of agenda and minutes of FSC and CFR	A2(C)**

Documents		Subcommittee reference no.
40.	Comments on relevant extracts of the draft report of the Subcommittee from Prof CHAN Ka-keung, SFST	W102(C)**
41.	Comments on relevant extracts of the draft report of the Subcommittee from Mr John TSANG, FS	W103(C)**

** Documents not available for public inspection

B. Evidence/documents provided by the Hong Kong Monetary Authority

Documents		Subcommittee reference no.
1.	Witness statement of Mr Joseph YAM, MA	W6(C)
2.	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	W6(C) Annex 1
3.	"Policy Objectives in Financial Affairs and Public Finance" issued by the FS on 27 June 2003	W6(C) Annex 2
4.	Exchange of Letters between the FS and the Monetary Authority of 25 June 2003	W6(C) Annex 3
5.	"Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission" dated May 2006	W6(C) Annex 4(A)
6.	"Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the Securities and Futures Commission" dated April 2003	W6(C) Annex 4(B)
7.	A list of circulars issued by the HKMA in relation to the conduct of regulated activities	W6(C) Annex 5
8.	(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	W6(C) Annex 6
9.	Comparison of recommendations made in the HKMA's Review Report and practices of overseas regulators	W6(C) Annex 7
10.	HKMA's Supervisory Policy Manual module OR-1 dated 28 November 2005	W6(C) Annex 8
11.	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	W6(C) Annex 9

	Documents	Subcommittee reference no.
12.	"New securities supervisory regime – register to be maintained by the HKMA and specific guidance in relation to relevant individuals" dated 27 February 2003	W6(C) Annex 10
13.	"New publications of the Securities and Futures Commission and HKMA" dated 21 August 2003	W6(C) Annex 11
14.	"SFC Guidelines for Addressing Analyst Conflicts of Interest" dated 8 November 2004	W6(C) Annex 12
15.	"Register of relevant individuals under section 20(1)(ea) of the Banking Ordinance" dated 21 February 2005	W6(C) Annex 13
16.	"SFC press release – Extracts and Advertisements Concerning Prospectuses under the Companies Ordinance" dated 31 March 2005	W6(C) Annex 14
17.	"Controls to ensure the fitness and propriety of staff of authorized institutions" dated 28 September 2006	W6(C) Annex 15
18.	"Controls to ensure compliance with section 114(3) of the Securities and Futures Ordinance and section 20(4) of the Banking Ordinance" dated 13 June 2007	W6(C) Annex 16
19.	"Thematic examinations on controls to ensure fitness and propriety of relevant individuals" dated 12 March 2008	W6(C) Annex 17
20.	"Access to recordings of telephone conversation and Lehman Minibonds collaterals information" dated 5 November 2008	W6(C) Annex 18
21.	"Despatch of information to investors of retail investment product" dated 10 December 2008	W6(C) Annex 19
22.	"Circular Issued by the Securities and Futures Commission on the Revised Advertising Guidelines Relating to SFC-authorised Collective Investment Schemes" dated 2 January 2009	W6(C) Annex 20
23.	"Report of the HKMA on Issues Concerning the Distribution of Structured Products Connected to Lehman Group Companies" dated 9 January 2009	W6(C) Annex 21

	Documents	Subcommittee reference no.
24.	"Circular Issued by the Securities and Futures Commission Regarding Self-Examination of Controls and Procedures on Suitability Obligations" dated 26 February 2009	W6(C) Annex 22
25.	"Fair and reasonable arrangements for settling complaints related to the selling of investment products" dated 5 March 2009	W6(C) Annex 23
26.	"Circular Issued by the Securities and Futures Commission on Suspension of the Closing Auction Session" dated 20 March 2009	W6(C) Annex 24
27.	"Implementation of recommendations in the HKMA's Report on Issues Concerning the Distribution of Structured Products Connected to Lehman Brothers" dated 25 March 2009	W6(C) Annex 25
28.	Curriculum Vitae of Mr Joseph YAM, MA	W7**
29.	List of duties and responsibilities of the MA	W8
30.	Opening remark by Mr Joseph YAM Chi-kwong, MA, at the hearing on 14 April 2009	W9
31.	The remark delivered by Mr Joseph YAM, MA, at the hearing on 28 April 2009 on the Subcommittee's decision to decline his request for confidentiality of the excised parts of the "Report of the Hong Kong Monetary Authority on Issues Concerning the Distribution of Structured Products Connected to Lehman Group Companies" as submitted to the Financial Secretary on 31 December 2008	W10
32.	Witness statement of Mr Y K CHOI, Deputy Chief Executive of HKMA	W11(C)
33.	Curriculum Vitae of Mr Y K CHOI, Deputy Chief Executive of HKMA	W12**
34.	Supervisory Policy Manual module SB-1: Supervision of regulated activities of SFC-registered authorized institutions	M1
35.	Circular issued by HKMA dated 1 March 2005: The Securities and Futures Commission's Report on Selling Practices of Licensed Investment Advisers	M2

Documents		Subcommittee reference no.
36.	Circular issued by HKMA dated 3 March 2006: Retail Wealth Management (RWM) Business	M3
37.	Circular issued by HKMA dated 7 May 2007: Questions and Answers on Suitability Obligations Published by the Securities and Futures Commission	M4
38.	Circular issued by HKMA dated 23 September 2008: Investment products related to Lehman Brothers	M5
39.	Circular issued by HKMA dated 23 October 2008: Selling of investment products to retail customers	M6
40.	HKMA's response to the Clerk to Subcommittee's letter dated 22 December 2008	M7
41.	Frequently asked questions issued by Lehman Brothers Asia Limited, the arranger of the Minibonds, to distributors and noteholders dated 17 September 2008; Frequently asked questions issued by Lehman Brothers Asia Limited, the arranger of the ProFund Notes, to distributors and noteholders dated 18 September 2008; and Frequently asked questions issued by Lehman Brothers Asia Limited, the arranger of the Pyxis Notes, to distributors and noteholders dated 18 September 2008	M7 Appendix 1
42.	Securities and Futures Commission's Licensing information booklet	M7 Appendix 2
43.	SFC's application forms for new registration and addition of regulated activities and the related supplements	M7 Appendix 3
44.	HKMA's application forms for approval to become and Executive Officer and change of regulated activities for an Executive Officer and the related supplements	M7 Appendix 4
45.	Relevant extracts of BO and SFO	M7 Appendix 5
46.	SFC's Fit and Proper Guidelines	M7 Appendix 6
47.	SFC's Guidelines on Competence and the revised Appendix C	M7 Appendix 7

Documents		Subcommittee reference no.
48.	SFC's Guidelines on Continuous Professional Training	M7 Appendix 8
49.	SFC's frequently asked questions on responsible officers	M7 Appendix 9
50.	Section 193 of SFO	M7 Appendix 10
51.	Circular issued by HKMA dated 24 March 2003: Executive officers of registered institutions	M7 Appendix 11
52.	HKMA's response to the Clerk to Subcommittee's letter dated 30 December 2008	M8
53.	HKMA's response to the Clerk to Subcommittee's letter dated 22 December 2008	M9
54.	"Plan for 2008 and Beyond" in the Annual Report 2007 of HKMA	M10
55.	Circular issued by HKMA dated 13 January 2003: Calls in Relation to Securities or Futures Products and Services	M11
56.	Circular issued by HKMA dated 1 March 2007: Thematic Examinations on Investment Advisory Activities	M12
57.	Circular issued by HKMA dated 1 June 2007: SFC's Report on Findings of Second Round of Thematic Inspection of Licensed Investment Advisers	M13
58.	Information provided by HKMA in March 2009 to the Financial Affairs Panel on Lehman Brothers-related Minibonds and Structured Financial Products	M14
59.	Written responses from Mr Joseph YAM, MA, to follow-up issues arising from the hearing on 14 April 2009	M15
60.	Report of Hong Kong Monetary Authority on Issues Concerning the Distribution of Structured Products Connected to Lehman Group Companies	M16
61.	Written responses from Mr Joseph YAM, MA, to follow-up issues arising from the hearing on 17 April 2009	M17

Documents		Subcommittee reference no.
62.	Written responses from Mr Joseph YAM, MA, to follow-up issues arising from the hearing on 28 April 2009	M18
63.	Written responses from Mr Joseph YAM, MA, to follow-up issues arising from the hearing on 8 May 2009	M19
64.	Written responses from Mr Joseph YAM, MA, to follow-up issues arising from the hearing on 14 April 2009	M20
65.	Written responses from Mr Joseph YAM, MA, to follow-up issues arising from the hearing on 15 May 2009	M21
66.	Written responses from Mr Joseph YAM, MA, to the follow-up issue arising from the hearing on 22 May 2009	M22
67.	Written responses from Mr Y K CHOI, Deputy Chief Executive of HKMA, to follow-up issues arising from the hearing on 26 May 2009	M23
68.	Supervisory Policy Manual CR-G-12: Credit Derivatives	M24
69.	Written responses from Mr Joseph YAM, MA, to follow-up issues arising from the hearing on 22 May 2009	M25
70.	Written responses from Mr Y K CHOI, Deputy Chief Executive of HKMA, to follow-up issues arising from the hearing on 2 June 2009	M26
71.	Written responses from Mr Y K CHOI, Deputy Chief Executive of HKMA, to follow-up issues arising from the hearing on 5 June 2009	M27
72.	Written responses from Mr Y K CHOI, Deputy Chief Executive of HKMA, to follow-up issues arising from the hearing on 2 June 2009	M28
73.	Further information provided by Mr Joseph YAM, MA, dated 15 June 2009	M29

Documents		Subcommittee reference no.
74.	Written responses from Mr Y K CHOI, Deputy Chief Executive of HKMA, to follow-up issues arising from the hearing on 12 June 2009	M30
75.	Written responses from Mr Y K CHOI, Deputy Chief Executive of HKMA, to follow-up issues arising from the hearing on 5 June 2009	M31
76.	Information provided by Mr Y K CHOI, Deputy Chief Executive of HKMA, dated 2 July 2009	M32
77.	Written responses from Mr Y K CHOI, Deputy Chief Executive of HKMA, to the Clerk to Subcommittee's letter dated 8 October 2009	M33
78.	"Questions and answers about Lehman Brothers Minibonds Repurchase Scheme by Distributing Banks" issued by HKMA dated 19 August 2009	M34
79.	Written responses to range of issues for the hearing on 10 November 2009 from Mr Y K CHOI, Deputy Chief Executive of HKMA	M35
80.	Written responses from Mr Y K CHOI, Deputy Chief Executive of HKMA, to follow-up issues arising from the hearing on 10 November 2009	M36
81.	Written responses from Mr Y K CHOI, Deputy Chief Executive of HKMA, to follow-up issues arising from the hearing on 10 November 2009	M37
82.	Written responses from Mr Y K CHOI, Deputy Chief Executive of HKMA, to follow-up issues arising from the hearing on 17 November 2009	M38
83.	Written responses from Mr Y K CHOI, Deputy Chief Executive of HKMA, to follow-up issues arising from the hearing on 17 November 2009	M39
84.	Written responses from Mr Y K CHOI, Deputy Chief Executive of HKMA, to follow-up issues arising from the hearing on 17 November 2009	M40
85.	Information provided by Mr Arthur K H YUEN, Deputy Chief Executive of HKMA, in response to the Clerk to Subcommittee's letter dated 4 January 2010	M41

Documents		Subcommittee reference no.
86.	Information provided by Mr Arthur K H YUEN, Deputy Chief Executive of HKMA, in response to the Clerk to Subcommittee's letter dated 11 February 2010	M42
87.	Further information provided by Mr Arthur K H YUEN, Deputy Chief Executive of HKMA dated 24 May 2010	M43
88.	Further information provided by Mr Arthur K H YUEN, Deputy Chief Executive of HKMA dated 5 August 2010	M44
89.	Sample checklists for on-site examinations of banks provided by Mr Joseph YAM, MA, in response to members' requests at the hearing on 22 May 2009	M2(C)
90.	Comments on relevant extracts of the draft report of the Subcommittee from HKMA	W100(C)**
91.	Comments on relevant extracts of the draft report of the Subcommittee from Mr Joseph YAM, then MA	W101(C)**

** Documents not available for public inspection

C. Evidence/documents provided by the Securities and Futures Commission

Documents		Subcommittee reference no.
1.	Witness statement of Mr Martin WHEATLEY, Chief Executive Officer of SFC	W13(C)
2.	Glossary of Terms	W13(C) Appendix 1
3.	Regulatory Objectives and Functions of the SFC under the SFO	W13(C) Appendix 2
4.	Seventeenth and Eighteenth Schedule to the Companies Ordinance	W13(C) Appendix 3
5.	Procedure for Registration of Prospectuses	W13(C) Appendix 4
6.	Procedure for Seeking Authorization of Marketing Material relating to Debentures (including Structured Notes)	W13(C) Appendix 5
7.	Table of Licensed and Registered Persons	W13(C) Appendix 6
8.	Table of Investor Education Work on Retail Structured Products and Investment Advisers	W13(C) Appendix 7
9.	SFC Press Release dated 22 January 2009	W13(C) Appendix 8
10.	Comments from HKMA on Various Codes and Guidelines published by the SFC	W13(C) Appendix 9
11.	Curriculum Vitae of Mr Martin WHEATLEY, Chief Executive Officer of SFC	W14**
12.	Role and responsibilities of the Chief Executive Officer of SFC	W15
13.	Opening statement by Mr Martin WHEATLEY, Chief Executive Officer of SFC, at the hearing on 23 June 2009	W16
14.	Witness statement of Mr Brian HO, Executive Director (Corporate Finance Division) of SFC	W17(C)

Documents		Subcommittee reference no.
15.	CO Compliance Checklist	W17(C) Appendix A
16.	CO Marketing Guidelines	W17(C) Appendix B
17.	Summary of points to note when reviewing prospectuses and marketing materials	W17(C) Appendix C
18.	Key Disclosures in Issue Prospectuses of Outstanding Minibond Series	W17(C) Appendix D
19.	Examples of Comments raised by SFC on Draft Prospectuses and Marketing Leaflets of Certain Series of Minibonds and Constellation Notes	W17(C) Appendix E
20.	Brief Comparison between the Contents of the Prospectuses for Minibond Series 1, 27, 34 & 35	W17(C) Appendix F
21.	Brief Comparison between the Contents of the Marketing Leaflets for Minibond Series 16, 27, 34 & 35	W17(C) Appendix G
22.	Brief Comparison between the Contents of the Prospectuses for Constellation Notes Series 1, 44, 56 and 58	W17(C) Appendix H
23.	Brief Comparison between the Contents of the Marketing Leaflets for Constellation Notes Series 10, 11, 44, 56 & 58	W17(C) Appendix I
24.	Risk Disclosures in the Prospectuses and Marketing Leaflets of Minibond Series 27, 34 and 35 and Constellation Notes Series 44, 56 & 58	W17(C) Appendix J
25.	Curriculum Vitae of Mr Brian HO, Executive Director (Corporate Finance Division) of SFC	W18**
26.	Opening statement by Mr Martin WHEATLEY, Chief Executive Officer of SFC, at the hearing on 3 August 2009	W19
27.	Opening statement by Mr Martin WHEATLEY, Chief Executive Officer of SFC, at the hearing on 9 February 2010	W25
28.	Information provided by SFC in response to Clerk to Subcommittee's letter dated 22 December 2008	S1

	Documents	Subcommittee reference no.
29.	Guidelines on use of offer awareness and summary disclosure materials in offerings of shares and debentures under CO (March 2003)	S1 Appendix 1
30.	Guidelines on using a "dual prospectus" structure to conduct programme offers of shares or debentures requiring a prospectus under CO (21 February 2003)	S1 Appendix 2
31.	Guidelines on applying for a relaxation from the procedural formalities to be fulfilled upon registration of a prospectus under CO (21 February 2003)	S1 Appendix 3
32.	Companies Ordinance (Exemption of Companies and Prospectuses form Compliance with Provisions) Notice (Cap. 32 sections 38A and 342A)	S1 Appendix 4
33.	CO Parts II and XII	S1 Appendix 5
34.	CO (Seventeenth Schedule and Twenty First Schedule)	S1 Appendix 6
35.	Consultation Paper on Possible Reforms to the Prospectus Regime in CO (August 2005)	S1 Appendix 7
36.	Written responses from FSTB, HKMA and SFC to the questions raised by members for the House Committee meeting in October 2008	S1 Appendix 8
37.	SFO Parts V to IX	S1 Appendix 9
38.	Memorandum of Understanding between SFC and HKMA (12 December 2002) and the addendum thereto of 1 March 2004	S1 Appendix 10
39.	Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (May 2006)	S1 Appendix 11
40.	Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the Securities and Futures Commission (April 2003)	S1 Appendix 12
41.	Written responses from FSTB, HKMA and SFC to the questions raised by Hon KAM Nai-wai in October 2008	S1 Appendix 13

Documents		Subcommittee reference no.
42.	Speech – "Systematic Risk: Who's Watching the Baby?" presented by Mr Martin WHEATLEY at the Asia Pacific Capital Markets Congress [5 July 2007]	S2
43.	Speech – "Transmission of Global Financial Risks" presented by Mr Martin WHEATLEY at the Lujiazui Forum in Shanghai [9 May 2008]	S3
44.	Speech – "Recent developments in Global Financial Markets" presented by Mr Eddy FONG at the Annual Dinner of the Toy Manufacturers of Hong Kong [11 September 2007]	S4
45.	Speech – "Challenges and Opportunities for Asia Pacific after Subprime - 'A Regulatory Perspective'" presented by Mr Eddy FONG at the Asia Securities Forum 2008 [5 September 2008]	S5
46.	Speech – "Challenges and Opportunities for Asia Pacific after Subprime – 'Issues, Lessons and the Global Regulatory Response'" presented by Mr Martin WHEATLEY at the Asia Securities Forum 2008 [6 September 2008]	S6
47.	Keynote address – "Mis-selling: Consequences at a Glance" presented by Mr Mark STEWARD at the 4th Annual Wealth Management Conference [23 October 2008]	S7
48.	Speech – "From Wall Street to High Street – the Implications for China" presented by Mr Eddy FONG at the State-owned Assets Supervision and Administration Commission [23 October 2008]	S8
49.	Comments – "Risks and exposures of structured products" made by Mr Martin WHEATLEY [24 October 2008]	S9
50.	Keynote address – "SEC Regulation Outside the United States" presented by Ms Alexa LAM at the 7th Annual SEC Regulation Outside the United States Conference [29 October 2008]	S10
51.	Welcoming address presented by Ms Alexa LAM at the 4th Annual Real Estate Investment 1Q 2008 [4 November 2008]	S11

Documents		Subcommittee reference no.
52.	Keynote address – "Road Ahead for Risk Management in the Greater China Market" presented by Mr Alexa LAM at the Annual Symposium on Risk Management [7 November 2008]	S12
53.	Main points of the Opening Statement made by Mr Martin WHEATLEY at the Meeting of the Special House Committee of the Legislative Council [13 October 2008]	S13
54.	Press releases issued by SFC on issues relating to the financial crisis and Lehman Brothers-related Minibonds and structured financial products [September – October 2008]	S14
55.	Speech - "Market Volatility - Challenges for the SFC and its Regulatory Approaches" presented by Mr Eddy FONG at the Hong Kong Stockbrokers Association Luncheon Seminar [15 July 2008]	S15
56.	Information provided by SFC dated 26 March 2009	S16
57.	Consultation Conclusions on the Consultation Paper on Possible Reforms to the Prospectus Regime in CO issued by SFC in September 2006	S17
58.	SFC's Advertising Guidelines Applicable to Collective Investment Schemes Authorized under the Product Codes [July 2008]	S18
59.	SFC's Budget of Income & Expenditure for the financial year 2009/2010 [18 February 2009]	S19
60.	Report on Selling Practices of Licensed Investment Advisers issued by SFC on 23 February 2005	S20
61.	Press Release issued by SFC on "Sun Hung Kai Investment Services Ltd agrees with SFC to repurchase Minibonds from its clients at original value" [22 January 2009]	S21
62.	Press Release issued by SFC on "KGI Asia Ltd agrees with SFC to repurchase Minibonds from its clients at original value" [5 April 2009]	S22
63.	Regulatory Challenges and Responses issued by SFC in March 2006	S23

Documents		Subcommittee reference no.
64.	Retail Investor Survey 2005 issued by SFC in March 2006	S24
65.	Structured Product Investor Survey issued by SFC in November 2006	S25
66.	Survey on Engagement of Investment Advisers issued by SFC in September 2006	S26
67.	Report on Findings of Second Round of Thematic Inspection of Licensed Investment Advisers issued by SFC in May 2007	S27
68.	SFC's article entitled "Should you invest in structured notes" [July 2005]	S28
69.	SFC's article entitled "Retail Structured Notes – Buyer Beware" [November 2006]	S29
70.	Circular entitled "Enhanced prospective investors' understanding of structured products" issued by SFC in November 2006	S30
71.	Information provided by SFC dated 10 June 2009	S31
72.	Leaflets of Minibonds series 27, 34 and 35	S32
73.	Leaflets of Constellation Notes series 44, 56 and 58	S33
74.	Written responses from Mr Martin WHEATLEY, Chief Executive Officer of SFC, to follow-up issues arising from the hearing on 23 June 2009	S34
75.	Written responses from Mr Martin WHEATLEY, Chief Executive Officer of SFC, to follow-up issues arising from the hearing on 26 June 2009	S35
76.	Written responses from Mr Martin WHEATLEY, Chief Executive Officer of SFC, to follow-up issues arising from the hearing on 26 June 2009	S37
77.	Written responses from Mr Martin WHEATLEY, Chief Executive Officer of SFC, to follow-up issues arising from the hearing on 3 July 2009	S38
78.	Key Findings of Retail Investor Survey issued by SFC in December 2008	S39

Documents		Subcommittee reference no.
79.	Written responses from Mr Martin WHEATLEY, Chief Executive Officer of SFC, to follow-up issues arising from the hearing on 23 June 2009	S40
80.	Written responses from Mr Martin WHEATLEY, Chief Executive Officer of SFC, to follow-up issues arising from the hearing on 26 June 2009	S41
81.	Written responses from Mr Martin WHEATLEY, Chief Executive Officer of SFC, to follow-up issues arising from the hearing on 3 July 2009	S42
82.	Written responses from Mr Martin WHEATLEY, Chief Executive Officer of SFC, to follow-up issues arising from the hearing on 7 July 2009	S43
83.	Pages 6 to 7 of the issue prospectus of Minibonds series 35	S44
84.	Pages 14 to 17 of the issue prospectus of Constellation Notes series 56 and 58	S45
85.	Sample checklist provided by Mr Martin WHEATLEY, Chief Executive Officer of SFC, in response to follow-up issues arising from the hearing on 26 June 2009	S46
86.	Written responses from Mr Brian HO, Executive Director (Corporate Finance Division) of SFC, to follow-up issues arising from the hearing on 21 July 2009	S47
87.	Press release issued by SFC on 22 July 2009 on the 16 distributing banks' repurchase scheme on Minibonds	S48
88.	Written responses from Mr Martin WHEATLEY, Chief Executive Officer of SFC, to follow-up issues arising from the hearing on 3 August 2009	S49
89.	Written responses from Mr Martin WHEATLEY, Chief Executive Officer of SFC, to follow-up issues arising from the hearing on 3 August 2009 attaching copy of a letter from HSBC Bank USA, National Association	S50

Documents		Subcommittee reference no.
90.	Press release issued by SFC on 17 December 2009 on its completion of investigations of all 19 Minibond distributors and agreement with Grand Cathay Securities (Hong Kong) Ltd on the repurchase of Minibond	S51
91.	Press release issued by SFC on 23 December 2009 on the resolution reached by SFC and HKMA with DSB and Mevas concerning their sale of certain Equity Index-linked Fixed Coupon Principal Protected Notes issued by Lehman Brothers	S52
92.	Press release issued by SFC on 13 January 2010 on its agreement with Karl Thomson Investment Consultants Ltd concerning sale of Lehman Brothers Minibonds	S53
93.	Written responses from Mr Martin WHEATLEY, Chief Executive Officer of SFC, to follow-up issues arising from the hearing on 8 January 2010	S54
94.	Written responses from Mr Martin WHEATLEY, Chief Executive Officer of SFC, to follow-up issues arising from the hearing on 8 January 2010	S55
95.	Written responses from Mr Martin WHEATLEY, Chief Executive Officer of SFC, to follow-up issues arising from the hearings on 26 and 29 January 2010 attended by Mr Harold KO	S56
96.	Witness statement dated 8 March 2010 from Mr Martin WHEATLEY, Chief Executive Officer of SFC	S57
97.	Written responses from Mr Martin WHEATLEY, Chief Executive Officer of SFC, to follow-up issues arising from the hearings on 26 and 29 January 2010 attended by Mr Harold KO	S58
98.	Written responses from Mr Martin WHEATLEY, Chief Executive Officer of SFC, to follow-up issues arising from the hearing on 9 February 2010	S59
99.	Written responses from Mr Martin WHEATLEY, Chief Executive Officer of SFC, to written questions raised by Mr LEUNG Kwok-hung on 28 January 2010	S60

Documents		Subcommittee reference no.
100.	A bundle of documents provided by Mr Martin WHEATLEY, Chief Executive Officer of SFC, relating to the hearings on 26 and 29 January and 9 February 2010	S61
101.	"Internal Guidelines – Equity-linked Deposits offered by Authorized Institution" issued by SFC	S62
102.	An email titled "Re: Phase 3 CO Prospectus Regime Reforms – Draft Consultation Paper for your comments" on 10 November 2004 from Stephen PO, Senior Director of IIP, to William Pearson, Director of CFD, and others	S63
103.	"Memorandum decision of Judge Peck of the United States Bankruptcy Court for the Southern District of New York, in Lehman Brothers Special Financing, Inc. v. BNY Corporate Trustee Services, Ltd., Case No. 08-13555, Adv. No. 09-01242 (25 January 2010)" provided by CEO/SFC in connection with paragraphs 81 and 82 of S57	S64
104.	"England and Wales Court of Appeal (Civil Division) decision in Perpetual Trustee Company Ltd & Anor v BNY Corporate Trustee Services Ltd & Ors [2009] EWCA Civ 1160 (6 November 2009)" provided by CEO/SFC in connection with paragraphs 81 and 82 of S57	S65
105.	Written responses from Mr Martin WHEATLEY, CEO/SFC, to follow-up issues arising from the hearing on 26 March 2010	S66
106.	Written responses from Mr Martin WHEATLEY, CEO/SFC, to follow-up issues arising from the hearing on 26 March 2010	S67
107.	Information provided by Mr Martin WHEATLEY, CEO/SFC, dated 24 May 2010	S68
108.	Issues raised by the Lehmans Minibonds crisis – Report to the Financial Secretary	S2(C)

Documents		Subcommittee reference no.
109.	Written exchanges between the Chief Executive Officer of SFC, HKMA and the Government from 7 to 22 July 2009 relating to the agreement on the repurchase of Lehman Brothers-related Minibonds by the 16 distributing banks	S3(C)
110.	Agreement reached by SFC, HKMA and the 16 distributing banks in relation to the repurchase of Minibonds from eligible customers as announced on 22 July 2009	S4(C)
111.	SFC's document entitled "A Thematic Analysis of the Sale of Minibonds"	S5(C)
112.	Letter dated 14 February 2006 from Mr Martin WHEATLEY, CEO/SFC to Mr Henry TANG, FS, attaching a paper on "Regulation of Registered Institutions and Relevant Individuals", provided by CEO/SFC in response to the follow-up issues arising from the hearing on 8 January 2010	S7(C) (in connection with paragraph 2.3 of S55)
113.	Draft Notice of Proposed Disciplinary Action	S8(C)**
114.	Draft Notice of Proposed Disciplinary Action	S9(C)**
115.	Comments on relevant extracts of the draft report of the Subcommittee from SFC	W98(C)**
116.	Comments on relevant extracts of the draft report of the Subcommittee from Mr Martin WHEATLEY, then Chief Executive Officer of SFC	W99(C)**

** Documents not available for public inspection

D. Evidence/documents provided by DBS Bank (Hong Kong) Limited

Documents		Subcommittee reference no.
1.	Witness statement of Ms Amy YIP, Chief Executive Officer of DBSHK	W26(C)
2.	Curriculum Vitae and job description of Ms Amy YIP, Chief Executive Officer of DBSHK	W27**
3.	Curriculum Vitae and job description of Ms Linda WONG, Managing Director and Head of Consumer Banking of DBSHK	W28**
4.	Curriculum Vitae and job description of Ms CHONG Hey, Senior Vice President, Consumer Investment & Insurance Products of DBSHK	W29**
5.	Written responses from Ms Amy YIP, Chief Executive Officer of DBSHK, to follow-up issues arising from the hearing on 16 April 2010	F(DBS)1
6.	Written responses from Ms Amy YIP, Chief Executive Officer of DBSHK, to follow-up issues arising from the hearing on 16 April 2010	F(DBS)2
7.	Written responses from Ms Amy YIP, Chief Executive Officer of DBSHK, to follow-up issues arising from the hearing on 20 April 2010	F(DBS)3
8.	Written responses from Ms Amy YIP, Chief Executive Officer of DBSHK, to follow-up issues arising from the hearing on 16 April 2010	F(DBS)4
9.	Written responses from Ms Amy YIP, Chief Executive Officer of DBSHK, to follow-up issues arising from the hearing on 23 April 2010	F(DBS)5
10.	Written responses from Ms Linda WONG, Managing Director and Head of Consumer Bank of DBSHK, to follow-up issues arising from the hearing on 23 April 2010	F(DBS)6
11.	Written responses from Ms Janet CHONG, Senior Vice President, Consumer Investment & Insurance Products of DBSHK, to follow-up issues arising from the hearing on 23 April 2010	F(DBS)7

	Documents	Subcommittee reference no.
12.	Written responses from Ms Amy YIP, Chief Executive Officer of DBSHK, to follow-up issues arising from the hearing on 30 April 2010	F(DBS)8
13.	Information provided by Ms Amy YIP, Chief Executive Officer of DBSHK, dated 4 June 2010	F(DBS)9
14.	Written responses from Ms Amy YIP, Chief Executive Officer of DBSHK, to follow-up issues arising from the hearing on 30 April 2010	F(DBS)10
15.	Written responses from Ms Amy YIP, Chief Executive Officer of DBSHK, to follow-up issues arising from the hearing on 29 June 2010	F(DBS)11
16.	Comments on relevant extracts of the draft report of the Subcommittee from DBSHK	W92(C)**

** Documents not available for public inspection

E. Evidence/documents provided by Standard Chartered Bank (Hong Kong) Limited

Documents		Subcommittee reference no.
1.	Witness statement of Mr HUNG Pi-cheng, Benjamin, Executive Director & Chief Executive Officer of SCBHK	W30(C)
2.	Supplement to witness statement of Mr HUNG Pi-cheng, Benjamin, Executive Director & Chief Executive Officer of SCBHK	W33(C)
3.	Curriculum Vitae and job description of Mr HUNG Pi-cheng, Benjamin, Executive Director & Chief Executive Officer of SCBHK	W31**
4.	Curriculum Vitae and job description of Ms HUEN Wai-yi, Mary, Head of Consumer Banking of SCBHK	W32**
5.	Written responses from Mr HUNG Pi-cheng, Benjamin, Executive Director & Chief Executive Officer of SCBHK, to follow-up issues arising from the hearing on 7 May 2010	F(SCB)1
6.	Written responses from Mr HUNG Pi-cheng, Benjamin, Executive Director & Chief Executive Officer of SCBHK, to follow-up issues arising from the hearing on 11 May 2010	F(SCB)2
7.	Information provided by Mr HUNG Pi-cheng, Benjamin, Executive Director & Chief Executive Officer of SCBHK, dated 19 May 2010	F(SCB)3
8.	Written responses from Mr HUNG Pi-cheng, Benjamin, Executive Director & Chief Executive Officer of SCBHK, to follow-up issues arising from the hearing on 11 May 2010	F(SCB)4
9.	Written responses from Mr HUNG Pi-cheng, Benjamin, Executive Director & Chief Executive Officer of SCBHK, to follow-up issues arising from the hearing on 14 May 2010	F(SCB)5
10.	Information provided by Mr HUNG Pi-cheng, Benjamin, Executive Director & Chief Executive Officer of SCBHK, dated 27 May 2010	F(SCB)6

	Documents	Subcommittee reference no.
11.	Written responses from Mr HUNG Pi-cheng, Benjamin, Executive Director & Chief Executive Officer of SCBHK, to follow-up issues arising from the hearing on 4 June 2010	F(SCB)7
12.	Written responses from Mr HUNG Pi-cheng, Benjamin, Executive Director & Chief Executive Officer of SCBHK, to follow-up issues arising from the hearing on 4 June 2010	F(SCB)8
13.	Comments on relevant extracts of the draft report of the Subcommittee from SCBHK	W93(C)**

** Documents not available for public inspection

F. Evidence/documents provided by Citibank (Hong Kong) Limited

	Documents	Subcommittee reference no.
1.	Witness statement of Mr LO Wai-pak, Weber, Chief Executive Officer & Country Business Manager of CHKL	W34(C)
2.	Curriculum Vitae and job description of Mr LO Wai-pak, Weber, Chief Executive Officer & Country Business Manager of CHKL	W35**
3.	Curriculum Vitae and job description of Ms LUM So-fun, Fanny, Director of Wealth Management of CHKL	W36**
4.	Information provided by Mr LO Wai-pak, Weber, Chief Executive Officer & Country Business Manager of CHKL, dated 28 May 2010	F(CHKL)1
5.	Written responses from Mr LO Wai-pak, Weber, Chief Executive Officer & Country Business Manager of CHKL, to follow-up issues arising from the hearing on 25 May 2010	F(CHKL)2
6.	Written responses from Mr LO Wai-pak, Weber, Chief Executive Officer & Country Business Manager of CHKL, to follow-up issues arising from the hearing on 28 May 2010	F(CHKL)3
7.	Written responses from Mr LO Wai-pak, Weber, Chief Executive Officer & Country Business Manager of CHKL, to follow-up issues arising from the hearing on 1 June 2010	F(CHKL)4
8.	Written responses from Mr LO Wai-pak, Weber, Chief Executive Officer & Country Business Manager of CHKL, to follow-up issues arising from the hearing on 28 May 2010	F(CHKL)5
9.	Written responses from Mr LO Wai-pak, Weber, Chief Executive Officer & Country Business Manager of CHKL, to follow-up issues arising from the hearing on 28 May 2010	F(CHKL)6
10.	Comments on relevant extracts of the draft report of the Subcommittee from CHKL	W94(C)**

** Documents not available for public inspection

G. Evidence/documents provided by The Royal Bank of Scotland N.V.

Documents		Subcommittee reference no.
1.	Witness statement of Mr CHU Ren-yee, Alexander, Country Executive, Hong Kong of RBS	W37(C)
2.	Supplementary witness statement of Mr CHU Ren-yee, Alexander, Country Executive, Hong Kong of RBS	W37A(C)
3.	Curriculum Vitae and job description of Mr CHU Ren-yee, Alexander, Country Executive, Hong Kong of RBS	W38**
4.	Curriculum Vitae and job description of Mr John SHELLEY, Chief Operating Officer, Retail & Commercial Asia of RBS	W39**
5.	Information provided by Mr CHU Ren-yee, Alexander, Country Executive, RBS, dated 28 June 2010	F(RBS)1
6.	Written responses from Mr CHU Ren-yee, Alexander, Country Executive, RBS, dated 12 July 2010 to follow-up issues arising from the hearing on 6 July 2010	F(RBS)2
7.	Written responses from Mr CHU Ren-yee, Alexander, Country Executive, RBS, dated 12 July 2010 to follow-up issues arising from the hearing on 9 July 2010	F(RBS)3
8.	Written responses from Mr CHU Ren-yee, Alexander, Country Executive, RBS, dated 23 July 2010 to follow-up issues arising from the hearing on 6 July 2010	F(RBS)4
9.	Written responses from Mr CHU Ren-yee, Alexander, Country Executive, RBS, dated 23 July 2010 to follow-up issues arising from the hearing on 9 July 2010	F(RBS)5
10.	Written responses from Mr CHU Ren-yee, Alexander, Country Executive, RBS, dated 5 August 2010 to follow-up issues arising from the hearing on 13 July 2010	F(RBS)6
11.	Written responses from Mr CHU Ren-yee, Alexander, Country Executive, RBS, dated 5 August 2010 to follow-up issues arising from the hearing on 9 July 2010	F(RBS)7

	Documents	Subcommittee reference no.
12.	Written responses from Mr CHU Ren-yee, Alexander, Country Executive, RBS, dated 6 October 2010 to follow-up issues arising from the hearing on 21 September 2010	F(RBS)8
13.	Written responses from Mr CHU Ren-yee, Alexander, Country Executive, RBS, dated 19 November 2010 to follow-up issue arising from the hearing on 21 September 2010	F(RBS)9
14.	Comments on relevant extracts of the draft report of the Subcommittee from RBS	W97(C)**

** Documents not available for public inspection

H. Evidence/documents provided by Bank of China (Hong Kong) Limited

Documents		Subcommittee reference no.
1.	Witness statement of Mr HE Guangbei, Vice Chairman and Chief Executive, BOCHK	W40(C)
2.	Curriculum Vitae and job description of Mr HE Guangbei, Vice Chairman and Chief Executive, BOCHK	W41**
3.	Curriculum Vitae and job description of Mr LAM Yim-nam, Deputy Chief Executive, BOCHK	W42**
4.	Information provided by Mr HE Guangbei, Vice Chairman and Chief Executive of BOCHK, dated 28 September 2010	F(BOC)1
5.	Written responses from Mr HE Guangbei, Vice Chairman and Chief Executive of BOCHK, dated 11 October 2010 to follow-up issues arising from the hearing on 5 October 2010	F(BOC)2
6.	Written responses from Mr HE Guangbei, Vice Chairman and Chief Executive of BOCHK, dated 14 October 2010 to follow-up issues arising from the hearing on 5 October 2010	F(BOC)3
7.	Written responses from Mr HE Guangbei, Vice Chairman and Chief Executive of BOCHK, dated 14 October 2010 to follow-up issues arising from the hearing on 5 October 2010	F(BOC)4
8.	Written responses from Mr LAM Yim-nam, Deputy Chief Executive of BOCHK, dated 14 October 2010 to follow-up issues arising from the hearing on 8 October 2010	F(BOC)5
9.	Written responses from Mr HE Guangbei, Vice Chairman and Chief Executive of BOCHK, dated 28 October 2010 to follow-up issues arising from the hearing on 8 October 2010	F(BOC)6
10.	Written responses from Mr LAM Yim-nam, Deputy Chief Executive of BOCHK, dated 29 October 2010 to follow-up issues arising from the hearing on 19 October 2010	F(BOC)7

	Documents	Subcommittee reference no.
11.	Written responses from Mr LAM Yim-nam, Deputy Chief Executive of BOCHK, dated 3 December 2010 to follow-up issues arising from the hearing held in the morning of 23 October 2010	F(BOC)8
12.	Written responses from Mr LAM Yim-nam, Deputy Chief Executive of BOCHK, dated 3 December 2010 to follow-up issues arising from the hearing held in the afternoon of 23 October 2010	F(BOC)9
13.	Written responses from Mr HE Guangbei, Vice Chairman and Chief Executive of BOCHK, dated 9 December 2010 to follow-up issues arising from the hearing held on 19 October 2010	F(BOC)10
14.	Written responses from Mr HE Guangbei, Vice Chairman and Chief Executive of BOCHK, dated 10 February 2011 to follow-up issues arising from the hearing held in the morning of 23 October 2010	F(BOC)11
15.	Written responses from Mr HE Guangbei, Vice Chairman and Chief Executive of BOCHK, dated 10 February 2011 to follow-up issues arising from the hearing held in the afternoon of 23 October 2010	F(BOC)12
16.	Comments on relevant extracts of the draft report of the Subcommittee from BOCHK	W95(C)**

** Documents not available for public inspection

I. Evidence/documents provided by Dah Sing Bank, Limited

Documents		Subcommittee reference no.
1.	Witness statement of Mr Derek WONG Hon-hing, Managing Director and Chief Executive, DSB	W44(C)
2.	Curriculum Vitae and job description of Mr Derek WONG Hon-hing, Managing Director and Chief Executive, DSB	W45**
3.	Curriculum Vitae and job description of Mr John LAM Cheung-wah, Alternate Chief Executive and Executive Director, DSB	W46**
4.	Information provided by Mr Derek WONG Hon-hing, Managing Director and Chief Executive of DSB, dated 27 October 2010	F(DSB)1
5.	Written responses from Mr Derek WONG Hon-hing, Managing Director and Chief Executive of DSB, dated 8 November 2010 to follow-up issues arising from the hearing on 2 November 2010	F(DSB)2
6.	Written responses from Mr Derek WONG Hon-hing, Managing Director and Chief Executive of DSB, dated 12 November 2010 to follow-up issues arising from the hearing on 5 November 2010	F(DSB)3
7.	Written responses from Mr John LAM Cheung-wah, Executive Director and Head of Retail Banking Division of DSB, dated 12 November 2010 to follow-up issues arising from the hearing on 5 November 2010	F(DSB)4
8.	Written responses from Mr John LAM Cheung-wah, Executive Director and Head of Retail Banking Division of DSB, dated 15 November 2010 to follow-up issues arising from the hearing on 9 November 2010	F(DSB)5
9.	Written responses from Mr Derek WONG Hon-hing, Managing Director and Chief Executive of DSB, dated 17 November 2010 to follow-up issues arising from the hearing on 9 November 2010	F(DSB)6
10.	Comments on relevant extracts of the draft report of the Subcommittee from DSB	W96(C)**

** Documents not available for public inspection

J. Evidence/documents provided by other witnesses

Documents		Subcommittee reference no.
1.	Witness statement of Mr Harold KO	W23(C)^^
2	Brief personal details of Mr Harold KO	W24**
3.	Written responses from Mr Harold KO to follow-up issues arising from the hearing on 26 January 2010	G1
4.	Written responses from Mr Harold KO to follow-up issues arising from the hearing on 29 January 2010	G2
5.	Witness statements of 26 frontline staff from the six banks produced at closed hearings	W47(C) to W72(C)**
6	Written responses from two frontline staff to follow-up issues arising from closed hearings	W53A(C) and W65A(C)**
7.	Witness statement of Ms IP Chun	W73(C)
8.	Witness statement of Mr NG Joong-yee	W74(C)
9.	Witness statement of Ms HO Lai-yuet	W75(C)^^
10.	Witness statement of Ms TAM Sui-lin	W76(C)^^
11.	Witness statement of Ms KO Yuk-ha	W78(C)
12.	Witness statement of Ms CHUNG Kit-chu	W79(C)^^
13.	Witness statement of Mr KAN Bing-kwong	W80(C)^^
14.	Witness statement of Mr TSE Chin-to	W81(C)
15.	Witness statement of Ms FUNG Kit-mui	W82(C)
16.	Witness statement of Ms LAW Siu-luen	W83(C)^^
17.	Witness statement of Mr KWOK Ming-sum	W84(C)^^
18.	Witness statement of Ms FUNG King-cheung, Vency	W85(C)^^
19.	Witness statement of Ms CHAN King-hing	W86(C)^^
20.	Witness statement of Mr YIP Kai-chiu	W88(C)
21.	Witness statement of Ms LI Yuk-mui	W89(C)^^
22.	Witness statement of Mr YEE Heung-ming	W91(C)^^
23.	Written responses from Ms TAM Sui-lin to follow-up issues arising from the hearing at 9:30 am on 18 March 2011	H1^^

Documents		Subcommittee reference no.
24.	Written responses from Ms KO Yuk-ha to follow-up issues arising from the hearing at 10:15 am on 18 March 2011	H2^^
25.	Written responses from Ms LI Yuk-mui to follow-up issues arising from the hearing at 9:30 am on 19 April 2011	H3^^
26.	Written responses from Ms FUNG Kit-mui to follow-up issues arising from the hearing at 10:15 am on 25 March 2011	H4

** Documents not available for public inspection

^^ Attachments to these documents not available for public inspection

Minutes of proceedings

Ref : CB1/HS/1/08/1

Subcommittee to Study Issues Arising from Lehman Brothers-related Minibonds and Structured Financial Products

Extract from the minutes of the 162nd meeting (closed) which contains the proceedings on consideration of the report of the Subcommittee held on Tuesday, 24 April 2012, at 8:30 am in Conference Room 4 of the Legislative Council Complex

Members present	:	Ir Dr Hon Raymond HO Chung-tai, SBS, S.B.St.J., JP (Chairman) Dr Hon Philip WONG Yu-hong, GBS (Deputy Chairman) Hon James TO Kun-sun Hon Abraham SHEK Lai-him, SBS, JP Hon Audrey EU Yuet-mee, SC, JP Hon Jeffrey LAM Kin-fung, GBS, JP Hon WONG Ting-kwong, BBS, JP Hon CHIM Pui-chung Hon KAM Nai-wai, MH Hon CHAN Kin-por, JP Dr Hon Priscilla LEUNG Mei-fun, JP Hon Mrs Regina IP LAU Suk-yee, GBS, JP Hon LEUNG Kwok-hung
Members absent	:	Hon Ronny TONG Ka-wah, SC Hon Starry LEE Wai-king, JP Hon IP Wai-ming, MH
Clerk in attendance	:	Miss Polly YEUNG Principal Council Secretary (SC)1
Staff in attendance	:	Mrs Constance LI Assistant Secretary General 1 Mr KAU Kin-wah Senior Assistant Legal Adviser 3

Ms Clara TAM
Assistant Legal Adviser 9

Ms Angel SHEK
Senior Council Secretary (SC)1

Mr KWONG Kam-fai
Senior Council Secretary (SC)2

Mr Fred PANG
Council Secretary (SC)

Ms Linda MA
Legislative Assistant (SC)1

X X X X X X X

I Consideration and endorsement of the report of the Subcommittee paragraph by paragraph
(LC Paper Nos. CB(1)1550/11-12(01) to (02) and CB(1)1558/11-12(01) to (06))

X X X X X X X

The Chairman informed members that the latest revised draft of the English version of the Subcommittee's report had incorporated comments made by members at previous meetings. Members agreed that the Chinese text of the report would be considered at another meeting after the Subcommittee had considered and endorsed the English version of the report paragraph by paragraph.

2. The question that the English version of the draft report (issued vide LC Paper Nos. CB(1)1550/11-12(01) to (02) and CB(1)1558/11-12(01) to (06)) be adopted as the Chairman's report to form the basis for discussion, and be read a second time paragraph by paragraph, was proposed, put and agreed to. Members also agreed to consider the Executive Summary after considering Chapters 1 to 8 of the report.

Chapter 1

3. Paragraphs 1.1 to 1.4 read and agreed to.

4. Paragraph 1.5 read and agreed to.

5. Paragraphs 1.6 to 1.7 read and agreed to.

6. Paragraphs 1.8 to 1.13 read and agreed to.

7. Paragraph 1.14 read and agreed to.

8. Paragraph 1.15 read and agreed to.

9. Paragraphs 1.16 to 1.17 read and agreed to.

10. Paragraph 1.18 read and agreed to.

11. Paragraph 1.19 read and agreed to.

12. Paragraphs 1.20 to 1.21 read and agreed to.

13. Paragraphs 1.22 to 1.25 read and agreed to.

14. Paragraph 1.26 read and agreed to.

15. Paragraphs 1.27 to 1.31 read and agreed to.

16. Paragraphs 1.32 to 1.34 read and agreed to.

17. Paragraphs 1.35 to 1.36 read and agreed to.

18. Paragraphs 1.37 to 1.38 read and agreed to.

19. Paragraphs 1.39 to 1.40 read and agreed to.

20. Paragraph 1.41 read and agreed to.

21. Paragraphs 1.42 to 1.43 read and agreed to.

22. Paragraph 1.44 read and agreed to.

23. Paragraph 1.45 read and agreed to.

24. Paragraphs 1.46 to 1.48 read and agreed to.

25. Appendix 1(a) read and agreed to.

26. Appendix 1(b) read and agreed to.

27. Appendix 1(c) read and agreed to.

28. Appendix 1(d) read and agreed to.

Chapter 2

29. Paragraph 2.1 read and agreed to.

30. Paragraphs 2.2 to 2.3 read and agreed to.

31. Paragraph 2.4 read, amended and agreed to.

32. Paragraph 2.5 read and agreed to.

33. Paragraphs 2.6 to 2.10 read and agreed to.

34. Paragraph 2.11 read and agreed to.

35. Paragraphs 2.12 to 2.15 read and agreed to.

36. Paragraph 2.16 read and agreed to.

37. Paragraph 2.17 read and agreed to.

38. Paragraphs 2.18 to 2.20 read and agreed to.

39. Appendix 2(a) read, amended and agreed to.

40. Appendix 2(b) read and agreed to.

41. Appendix 2(c) read and agreed to.

Chapter 3

42. Paragraph 3.1 read and agreed to.

43. Paragraph 3.2 read and agreed to.

44. Paragraphs 3.3 to 3.5 read and agreed to.

45. Paragraphs 3.6 to 3.8 read and agreed to.

46. Paragraphs 3.9 to 3.10 read and agreed to.

47. Paragraph 3.11 read and agreed to.

48. Paragraph 3.12 read and agreed to.

49. Paragraphs 3.13 to 3.17 read and agreed to.

50. Paragraphs 3.18 to 3.19 read and agreed to.

51. Paragraphs 3.20 to 3.22 read and agreed to.

52. Paragraphs 3.23 to 3.24 read and agreed to.

53. Paragraph 3.25 read and agreed to.

54. Paragraph 3.26 read and agreed to.

55. Paragraphs 3.27 to 3.30 read and agreed to.

56. Paragraphs 3.31 to 3.33 read and agreed to.

57. Paragraph 3.34 read and agreed to.

58. Paragraphs 3.35 to 3.36 read and agreed to.

59. Appendix 3(a) read and agreed to.

Chapter 4

60. Paragraph 4.1 read and agreed to.

61. Paragraphs 4.2 to 4.3 read and agreed to.

62. Paragraph 4.4 read and agreed to.

63. Paragraphs 4.5 to 4.15 read and agreed to.

64. Paragraphs 4.16 to 4.17 read and agreed to.

65. Paragraph 4.18 read and agreed to.

66. Paragraphs 4.19 to 4.21 read and agreed to.

67. Paragraphs 4.22 to 4.25 read and agreed to.

68. Paragraphs 4.26 to 4.30 read and agreed to.

69. Paragraph 4.31 read and agreed to.

70. Paragraph 4.32 read and agreed to.

71. Paragraphs 4.33 to 4.34 read and agreed to.

72. Paragraph 4.35 read and agreed to.

73. Paragraphs 4.36 to 4.40 read and agreed to.

74. Paragraph 4.41 read and agreed to.

75. Paragraphs 4.42 to 4.44 read and agreed to.

76. Paragraphs 4.45 to 4.49 read and agreed to.

77. Appendix 4(a) read and agreed to.

78. Appendix 4(b) read and agreed to.

79. Appendix 4(c) read and agreed to.

80. Appendix 4(d) read and agreed to.

Chapter 5

81. Paragraph 5.1 read and agreed to.

82. Paragraphs 5.2 to 5.5 read and agreed to.

83. Paragraph 5.6 read and agreed to.

84. Paragraph 5.7 read and agreed to.

85. Paragraphs 5.8 to 5.10 read and agreed to.

86. Paragraphs 5.11 to 5.13 read and agreed to.

87. Paragraphs 5.14 to 5.17 read and agreed to.

88. Paragraphs 5.18 to 5.22 read and agreed to.

89. Paragraphs 5.23 to 5.24 read and agreed to.

90. Paragraph 5.25 read and agreed to.

91. Paragraphs 5.26 to 5.31 read and agreed to.

92. Paragraphs 5.32 to 5.34 read and agreed to.

93. Paragraphs 5.35 to 5.36 read and agreed to.

94. Paragraphs 5.37 to 5.40 read and agreed to.

95. Paragraph 5.41 read and agreed to.

96. Paragraphs 5.42 to 5.45 read and agreed to.

97. Paragraph 5.46 read and agreed to.

98. Paragraph 5.47 read and agreed to.

99. Paragraph 5.48 read and agreed to.

100. Paragraphs 5.49 to 5.50 read and agreed to.

101. Paragraphs 5.51 to 5.54 read and agreed to.

102. Paragraphs 5.55 to 5.56 read and agreed to.

103. Paragraph 5.57 read and agreed to.

104. Paragraph 5.58 read and agreed to.

105. Paragraphs 5.59 to 5.64 read and agreed to.

106. Paragraphs 5.65 to 5.66 read and agreed to.

107. Paragraphs 5.67 to 5.69 read and agreed to.

108. Paragraphs 5.70 to 5.71 read and agreed to.

109. Paragraph 5.72 read and agreed to.

110. Paragraphs 5.73 to 5.74 read and agreed to.

111. Paragraph 5.75 read and agreed to.

112. Paragraph 5.76 read and agreed to.

113. Paragraphs 5.77 to 5.81 read and agreed to.

114. Paragraph 5.82 read and agreed to.

115. Paragraphs 5.83 to 5.84 read and agreed to.

116. Paragraphs 5.85 to 5.88 read and agreed to.

117. Paragraphs 5.89 to 5.90 read and agreed to.

118. Paragraphs 5.91 to 5.92 read and agreed to.

119. Paragraph 5.93 read and agreed to.

120. Paragraphs 5.94 to 5.98 read and agreed to.

121. Paragraphs 5.99 to 5.100 read and agreed to.

122. Paragraph 5.101 read and agreed to.

123. Paragraph 5.102 read and agreed to.

124. Paragraphs 5.103 to 5.105 read and agreed to.

125. Paragraphs 5.106 to 5.107 read and agreed to.

126. Paragraph 5.108 read and agreed to.

127. Paragraph 5.109 read and agreed to.

128. Paragraph 5.110 read and agreed to.

129. Paragraph 5.111 read and agreed to.

130. Paragraphs 5.112 to 5.114 read and agreed to.

131. Appendix 5(a) read and agreed to.

Chapter 6

132. Paragraph 6.1 read and agreed to.

133. Paragraphs 6.2 to 6.5 read and agreed to.

134. Paragraphs 6.6 to 6.11 read and agreed to.

135. Paragraphs 6.12 to 6.17 read and agreed to.

136. Paragraphs 6.18 to 6.20 read and agreed to.

137. Paragraphs 6.21 to 6.22 read and agreed to.

138. Paragraphs 6.23 to 6.26 read and agreed to.

139. Paragraph 6.27 read and agreed to.

140. Paragraph 6.28 read and agreed to.

141. Paragraphs 6.29 to 6.31 read and agreed to.

142. Paragraphs 6.32 to 6.33 read and agreed to.

143. Paragraphs 6.34 to 6.36 read and agreed to.

144. Paragraph 6.37 read and agreed to.

145. Paragraphs 6.38 to 6.39 read and agreed to.

146. Paragraphs 6.40 to 6.41 read and agreed to.

147. Paragraphs 6.42 to 6.45 read and agreed to.

148. Appendix 6(a) read and agreed to.

149. Appendix 6(b) read and agreed to.

Chapter 7

150. Paragraph 7.1 read and agreed to

151. Paragraph 7.2 read and agreed to.

152. Paragraphs 7.3 to 7.4 read and agreed to.

153. Paragraphs 7.5 to 7.9 read and agreed to.

154. Paragraphs 7.10 to 7.11 read and agreed to.

155. Paragraphs 7.12 to 7.14 read and agreed to.

156. Paragraph 7.15 read and agreed to.

157. Paragraphs 7.16 to 7.19 read and agreed to.

158. Paragraphs 7.20 to 7.22 read and agreed to.

159. Paragraphs 7.23 to 7.24 read and agreed to.

160. Paragraphs 7.25 to 7.26 read and agreed to.

161. Paragraphs 7.27 to 7.28 read and agreed to.

162. Paragraphs 7.29 to 7.31 read and agreed to.

163. Paragraphs 7.32 to 7.34 read and agreed to.

164. Appendix 7(a) read and agreed to.

165. Appendix 7(b) read and agreed to.

Chapter 8

166. Paragraph 8.1 read and agreed to.

167. Paragraph 8.2 read and agreed to.

168. Paragraph 8.3 read and agreed to.

169. Paragraph 8.4 read and agreed to.

170. Paragraphs 8.4(a) to 8.4(c) read and agreed to.

171. Paragraphs 8.4(d) to 8.4(f) read and agreed to.

172. Paragraph 8.5 read and agreed to.

173. Paragraphs 8.5(a) to 8.5(c) read and agreed to.

174. Paragraphs 8.5(d) to 8.5(e) read and agreed to.

175. Paragraphs 8.5(f) to 8.5(g) read and agreed to.

176. Paragraphs 8.5(h) to 8.5(k) read and agreed to.

177. Paragraph 8.5(l) read and agreed to.

178. Paragraph 8.5(m) read and agreed to.

179. Paragraph 8.6 read and agreed to.

180. Paragraph 8.7 read and agreed to.

181. Paragraph 8.8 read and agreed to.

182. Paragraph 8.9 read and agreed to.

183. Paragraphs 8.10 to 8.11 read and agreed to.

184. Paragraph 8.12 read and agreed to.

185. Question on an amendment to paragraph 8.14 proposed, put and negatived.

186. Paragraphs 8.13 to 8.15 read and agreed to.

187. Paragraphs 8.16 to 8.18 read and agreed to.

188. Paragraphs 8.19 to 8.22 read and agreed to.

189. Paragraph 8.23 read and agreed to.

190. Paragraphs 8.24 to 8.25 read and agreed to.

191. Paragraphs 8.26 to 8.28 read and agreed to.

192. Paragraphs 8.29 to 8.30 read and agreed to.

193. Paragraph 8.31 read and agreed to.

194. Paragraphs 8.32 to 8.34 read and agreed to.

195. Paragraphs 8.35 to 8.36 read and agreed to.

196. Paragraph 8.37 read and agreed to.

197. Paragraphs 8.38 to 8.43 read and agreed to.

198. Paragraphs 8.44 to 8.45 read and agreed to.

199. Paragraphs 8.46 to 8.47 read and agreed to.

200. Paragraph 8.48 read and agreed to.

201. Paragraphs 8.49 to 8.50 read and agreed to.

202. Question on an amendment to add a new paragraph 8.51 proposed, put and agreed to, subject to certain textual amendments to be made. Consequential amendments were made to re-number ensuing paragraphs.

203. Paragraphs 8.51 to 8.55 (re-numbered as paragraphs 8.52 to 8.56) read and agreed to.

204. Paragraphs 8.56 to 8.57 (re-numbered as paragraphs 8.57 to 8.58) read and agreed to.

205. Question on an amendment to add a new paragraph 8.61(b) proposed, put and negatived.

206. Paragraphs 8.58 to 8.61 (re-numbered as paragraphs 8.59 to 8.62) read and agreed to.

207. Question on an amendment to add a new paragraph 8.62 proposed, put and negatived.

208. Paragraphs 8.62 to 8.63 (re-numbered as paragraphs 8.63 to 8.64) read and agreed to.

Acknowledgement

209. The Acknowledgement read and agreed to.

Abbreviations

210. The Abbreviations read and agreed to.

211. The question that the English text of the report (except the Executive Summary), as amended, be adopted as the report of the Subcommittee was put and agreed to. Members noted that the Subcommittee would consider and endorse the Executive Summary of the report at the next meeting.

X X X X X X X

III Any other business

Date of next meeting

212. The Chairman advised that the next meeting would be held at 8:30 am on Friday, 27 April 2012 to consider and endorse the Chinese text of the report of the Subcommittee paragraph by paragraph.

213. There being no other business, the meeting ended at 10:44 am.

Council Business Division 1
Legislative Council Secretariat
15 May 2012

Ref : CB1/HS/1/08/1

Subcommittee to Study Issues Arising from Lehman Brothers-related Minibonds and Structured Financial Products

Extract from the minutes of the 163rd meeting (closed) which contains the proceedings on consideration of the report of the Subcommittee held on Friday, 27 April 2012, at 8:30 am and continued on Wednesday, 2 May 2012, at 11:30 am in Conference Room 4 of the Legislative Council Complex

Members present	:	Ir Dr Hon Raymond HO Chung-tai, SBS, S.B.St.J., JP (Chairman) Hon Audrey EU Yuet-mee, SC, JP Hon Jeffrey LAM Kin-fung, GBS, JP Hon WONG Ting-kwong, BBS, JP Hon Ronny TONG Ka-wah, SC Hon CHIM Pui-chung Hon KAM Nai-wai, MH Hon CHAN Kin-por, JP Dr Hon Priscilla LEUNG Mei-fun, JP Hon IP Wai-ming, MH Hon Mrs Regina IP LAU Suk-yee, GBS, JP Hon LEUNG Kwok-hung
Members absent	:	Dr Hon Philip WONG Yu-hong, GBS (Deputy Chairman) Hon James TO Kun-sun Hon Abraham SHEK Lai-him, SBS, JP Hon Starry LEE Wai-king, JP
Clerk in attendance	:	Miss Polly YEUNG Principal Council Secretary (SC)1
Staff in attendance	:	Mr KAU Kin-wah Senior Assistant Legal Adviser 3

Ms Clara TAM
Assistant Legal Adviser 9

Ms Angel SHEK
Senior Council Secretary (SC)1

Mr KWONG Kam-fai
Senior Council Secretary (SC)2

Mr Fred PANG
Council Secretary (SC)

Ms Sharon CHAN
Senior Legislative Assistant (SC)1

X X X X X X X

(The meeting was suspended at 8:50 am on Friday, 27 April 2012 and resumed at 11:30 am on Wednesday, 2 May 2012, in Conference Room 4 of the Legislative Council Complex.)

I Matters arising from the meeting held on 24 April 2012

(LC Paper No. CB(1)1693/11-12(01))

Members noted that at the meeting held on 24 April 2012, the Subcommittee had agreed to an amendment to add a new paragraph 8.51 to the Subcommittee's report, subject to the necessary textual amendments. Members endorsed the newly added paragraph (issued vide LC Paper No. CB(1)1693/11-12(01)) for incorporation in the Subcommittee's report.

II Consideration and endorsement of the report of the Subcommittee paragraph by paragraph

(LC Paper Nos. CB(1)1695/11-12(01) to (02) and CB(1)1702/11-12(01) to (08))

X X X X X X X

2. Following the endorsement of the English text of the report of the Subcommittee at the meeting on 24 April 2012, the Subcommittee proceeded to examine the Chinese text of the draft report paragraph by paragraph. The Chairman advised members that the draft Chinese text (issued vide LC Paper Nos. CB(1)1695/11-12(01) to (02) and CB(1)1702/11-12(01) to (08)) had been updated by the amendments made to the English text agreed to by members at the meeting held on 24 April 2012.

3. The question that the aforesaid Chinese version of the draft report be adopted as the Chairman's report to form the basis for discussion, and be read a second time paragraph by paragraph, was proposed, put and agreed to.

Chapter 1

4. Paragraphs 1.1 to 1.4 read and agreed to.

5. Paragraph 1.5 read and agreed to.

6. Paragraphs 1.6 to 1.7 read and agreed to.

7. Paragraphs 1.8 to 1.13 read and agreed to.

8. Paragraph 1.14 read and agreed to.

9. Paragraph 1.15 read and agreed to.

10. Paragraphs 1.16 to 1.17 read and agreed to.

11. Paragraph 1.18 read and agreed to.

12. Paragraph 1.19 read and agreed to.

13. Paragraphs 1.20 to 1.21 read and agreed to.

14. Paragraphs 1.22 to 1.25 read and agreed to.

15. Paragraph 1.26 read and agreed to.

16. Paragraphs 1.27 to 1.31 read and agreed to.

17. Paragraphs 1.32 to 1.34 read and agreed to.

18. Paragraphs 1.35 to 1.36 read and agreed to.

19. Paragraphs 1.37 to 1.38 read and agreed to.

20. Paragraphs 1.39 to 1.40 read and agreed to.

21. Paragraph 1.41 read and agreed to.

22. Paragraphs 1.42 to 1.43 read and agreed to.

23. Paragraph 1.44 read and agreed to.

24. Paragraph 1.45 read and agreed to.

25. Paragraphs 1.46 to 1.48 read and agreed to.

26. Appendix 1(a) read and agreed to.

27. Appendix 1(b) read and agreed to.

28. Appendix 1(c) read and agreed to.

29. Appendix 1(d) read and agreed to.

Chapter 2

30. Paragraph 2.1 read and agreed to.

31. Paragraphs 2.2 to 2.3 read and agreed to.

32. Paragraphs 2.4 to 2.5 read and agreed to.

33. Paragraphs 2.6 to 2.10 read and agreed to.

34. Paragraph 2.11 read and agreed to.

35. Paragraphs 2.12 to 2.15 read and agreed to.

36. Paragraph 2.16 read and agreed to.

37. Paragraph 2.17 read and agreed to.

38. Paragraphs 2.18 to 2.20 read and agreed to.

39. Appendix 2(a) read and agreed to.

40. Appendix 2(b) read and agreed to.

41. Appendix 2(c) read and agreed to.

Chapter 3

42. Paragraph 3.1 read and agreed to.

43. Paragraph 3.2 read and agreed to.

44. Paragraphs 3.3 to 3.5 read and agreed to.

45. Paragraphs 3.6 to 3.8 read and agreed to.

46. Paragraphs 3.9 to 3.10 read and agreed to.

47. Paragraph 3.11 read and agreed to.

48. Paragraph 3.12 read and agreed to.

49. Paragraphs 3.13 to 3.17 read and agreed to.

50. Paragraphs 3.18 to 3.19 read and agreed to.

51. Paragraphs 3.20 to 3.22 read and agreed to.

52. Paragraphs 3.23 to 3.24 read and agreed to.

53. Paragraph 3.25 read and agreed to.

54. Paragraph 3.26 read and agreed to.

55. Paragraphs 3.27 to 3.30 read and agreed to.

56. Paragraphs 3.31 to 3.33 read and agreed to.

57. Paragraph 3.34 read and agreed to.

58. Paragraphs 3.35 to 3.36 read and agreed to.

59. Appendix 3(a) read and agreed to.

Chapter 4

60. Paragraph 4.1 read and agreed to.

61. Paragraphs 4.2 to 4.3 read and agreed to.

62. Paragraph 4.4 read and agreed to.

63. Paragraphs 4.5 to 4.15 read and agreed to.

64. Paragraphs 4.16 to 4.17 read and agreed to.

65. Paragraph 4.18 read and agreed to.

66. Paragraphs 4.19 to 4.21 read and agreed to.

67. Paragraphs 4.22 to 4.25 read and agreed to.

68. Paragraphs 4.26 to 4.30 read and agreed to.

69. Paragraph 4.31 read and agreed to.

70. Paragraph 4.32 read and agreed to.

71. Paragraphs 4.33 to 4.34 read and agreed to.

72. Paragraph 4.35 read and agreed to.

73. Paragraphs 4.36 to 4.40 read and agreed to.

74. Paragraph 4.41 read and agreed to.

75. Paragraphs 4.42 to 4.44 read and agreed to.

76. Paragraphs 4.45 to 4.49 read and agreed to.

77. Appendix 4(a) read and agreed to.

78. Appendix 4(b) read and agreed to.

79. Appendix 4(c) read and agreed to.

80. Appendix 4(d) read and agreed to.

Chapter 5

81. Paragraph 5.1 read and agreed to.

82. Paragraphs 5.2 to 5.5 read and agreed to.

83. Paragraph 5.6 read and agreed to.

84. Paragraph 5.7 read and agreed to.

85. Paragraphs 5.8 to 5.10 read and agreed to.

86. Paragraphs 5.11 to 5.13 read and agreed to.

87. Paragraphs 5.14 to 5.17 read and agreed to.

88. Paragraphs 5.18 to 5.22 read and agreed to.

89. Paragraphs 5.23 to 5.24 read and agreed to.

90. Paragraph 5.25 read and agreed to.

91. Paragraphs 5.26 to 5.31 read and agreed to.

92. Paragraphs 5.32 to 5.34 read and agreed to.

93. Paragraphs 5.35 to 5.36 read and agreed to.

94. Paragraphs 5.37 to 5.40 read and agreed to.

95. Paragraph 5.41 read and agreed to.

96. Paragraphs 5.42 to 5.45 read and agreed to.

97. Paragraph 5.46 read and agreed to.

98. Paragraph 5.47 read and agreed to.

99. Paragraph 5.48 read and agreed to.

100. Paragraphs 5.49 to 5.50 read and agreed to.

101. Paragraphs 5.51 to 5.54 read and agreed to.

102. Paragraphs 5.55 to 5.56 read and agreed to.

103. Paragraph 5.57 read and agreed to.

104. Paragraph 5.58 read and agreed to.

105. Paragraphs 5.59 to 5.64 read and agreed to.

106. Paragraphs 5.65 to 5.66 read and agreed to.

107. Paragraphs 5.67 to 5.69 read and agreed to.

108. Paragraphs 5.70 to 5.71 read and agreed to.

109. Paragraph 5.72 read and agreed to.

110. Paragraphs 5.73 to 5.74 read and agreed to.

111. Paragraph 5.75 read and agreed to.

112. Paragraph 5.76 read and agreed to.

113. Paragraphs 5.77 to 5.81 read and agreed to.

114. Paragraph 5.82 read and agreed to.

115. Paragraphs 5.83 to 5.84 read and agreed to.

116. Paragraphs 5.85 to 5.88 read and agreed to.

117. Paragraphs 5.89 to 5.90 read and agreed to.

118. Paragraphs 5.91 to 5.92 read and agreed to.

119. Paragraph 5.93 read and agreed to.

120. Paragraphs 5.94 to 5.98 read and agreed to.

121. Paragraphs 5.99 to 5.100 read and agreed to.

122. Paragraph 5.101 read and agreed to.

123. Paragraph 5.102 read and agreed to.

124. Paragraphs 5.103 to 5.105 read and agreed to.

125. Paragraphs 5.106 to 5.107 read and agreed to.

126. Paragraph 5.108 read and agreed to.

127. Paragraph 5.109 read and agreed to.

128. Paragraph 5.110 read and agreed to.

129. Paragraph 5.111 read and agreed to.

130. Paragraphs 5.112 to 5.114 read and agreed to.

131. Appendix 5(a) read and agreed to.

Chapter 6

132. Paragraph 6.1 read and agreed to.

133. Paragraphs 6.2 to 6.5 read and agreed to.

134. Paragraphs 6.6 to 6.11 read and agreed to.

135. Paragraphs 6.12 to 6.17 read and agreed to.

136. Paragraphs 6.18 to 6.20 read and agreed to.

137. Paragraphs 6.21 to 6.22 read and agreed to.

138. Paragraphs 6.23 to 6.26 read and agreed to.

139. Paragraph 6.27 read and agreed to.

140. Paragraph 6.28 read and agreed to.

141. Paragraphs 6.29 to 6.31 read and agreed to.

142. Paragraphs 6.32 to 6.33 read and agreed to.

143. Paragraphs 6.34 to 6.36 read and agreed to.

144. Paragraph 6.37 read and agreed to.

145. Paragraphs 6.38 to 6.39 read and agreed to.

146. Paragraphs 6.40 to 6.41 read and agreed to.

147. Paragraphs 6.42 to 6.45 read and agreed to.

148. Appendix 6(a) read and agreed to.

149. Appendix 6(b) read and agreed to.

Chapter 7

150. Paragraph 7.1 read and agreed to.

151. Paragraph 7.2 read and agreed to.

152. Paragraphs 7.3 to 7.4 read and agreed to.

153. Paragraphs 7.5 to 7.9 read and agreed to.

154. Paragraphs 7.10 to 7.11 read and agreed to.

155. Paragraphs 7.12 to 7.14 read and agreed to.

156. Paragraph 7.15 read and agreed to.

157. Paragraphs 7.16 to 7.19 read and agreed to.

158. Paragraphs 7.20 to 7.22 read and agreed to.

159. Paragraphs 7.23 to 7.24 read and agreed to.

160. Paragraphs 7.25 to 7.26 read and agreed to.

161. Paragraphs 7.27 to 7.28 read and agreed to.

162. Paragraphs 7.29 to 7.31 read and agreed to.

163. Paragraphs 7.32 to 7.34 read and agreed to.

164. Appendix 7(a) read and agreed to.

165. Appendix 7(b) read and agreed to.

Chapter 8

166. Paragraph 8.1 read and agreed to.

167. Paragraph 8.2 read and agreed to.

168. Paragraph 8.3 read and agreed to.

169. Paragraph 8.4 read and agreed to.

170. Paragraphs 8.4(a) to 8.4(c) read and agreed to.

171. Paragraphs 8.4(d) to 8.4(f) read and agreed to.

172. Paragraph 8.5 read and agreed to.

173. Paragraphs 8.5(a) to 8.5(c) read and agreed to.

174. Paragraphs 8.5(d) to 8.5(e) read and agreed to.

175. Paragraphs 8.5(f) to 8.5(g) read and agreed to.

176. Paragraphs 8.5(h) to 8.5(k) read and agreed to.

177. Paragraph 8.5(l) read and agreed to.

178. Paragraph 8.5(m) read and agreed to.

179. Paragraph 8.6 read and agreed to.

180. Paragraph 8.7 read and agreed to.

181. Paragraph 8.8 read and agreed to.

182. Paragraph 8.9 read and agreed to.

183. Paragraphs 8.10 to 8.11 read and agreed to.

184. Paragraph 8.12 read and agreed to.

185. Paragraphs 8.13 to 8.15 read and agreed to.

186. Paragraphs 8.16 to 8.18 read and agreed to.

187. Paragraphs 8.19 to 8.22 read and agreed to.

188. Paragraph 8.23 read and agreed to.

189. Paragraphs 8.24 to 8.25 read and agreed to.

190. Paragraphs 8.26 to 8.28 read and agreed to.

191. Paragraphs 8.29 to 8.30 read and agreed to.

192. Paragraph 8.31 read and agreed to.

193. Paragraphs 8.32 to 8.34 read and agreed to.

194. Paragraphs 8.35 to 8.36 read and agreed to.

195. Paragraph 8.37 read and agreed to.

196. Paragraphs 8.38 to 8.43 read and agreed to.

197. Paragraphs 8.44 to 8.45 read and agreed to.

198. Paragraphs 8.46 to 8.47 read and agreed to.

199. Paragraph 8.48 read and agreed to.

200. Paragraphs 8.49 to 8.50 read and agreed to.

201. Paragraphs 8.51 to 8.56 read and agreed to.

202. Paragraphs 8.57 to 8.58 read and agreed to.

203. Paragraphs 8.59 to 8.64 read and agreed to.

Acknowledgement

204. The Acknowledgement read and agreed to.

Abbreviations

205. The Abbreviations read and agreed to.

III Consideration and endorsement of the English and Chinese versions of the Executive Summary of the Subcommittee's report paragraph by paragraph

(LC Paper Nos. CB(1)1695/11-12(03))

206. The Chairman invited members to consider the English and Chinese versions of the Executive Summary (issued vide LC Paper No. CB(1)1695/11-12(03)) of the Subcommittee's report paragraph by paragraph.

English version of the Executive Summary

207. Paragraphs 1 to 3 read and agreed to.

208. Paragraph 4 read and agreed to.

209. Paragraphs 4(a) to 4(b) read and agreed to.

210. Paragraph 4(c) read and agreed to.

211. Paragraphs 4(d) to 4(f) read and agreed to.

212. Paragraph 4(g) read and agreed to.

213. Paragraph 4(h) read and agreed to.

214. Paragraphs 4(i) to 4(j) read and agreed to.

215. Paragraph 5 read and agreed to.

216. Paragraphs 5(a) to 5(b) read and agreed to.

217. Paragraphs 5(c) to 5(g) read and agreed to.

218. Paragraphs 5(h) to 5(l) read and agreed to.

219. Paragraphs 5(m) to 5(o) read and agreed to.

220. Paragraphs 5(p) to 5(q) read and agreed to.

221. Paragraphs 5(r) to 5(v) read and agreed to.

Chinese version of the Executive Summary

222. Paragraphs 1 to 3 read and agreed to.

223. Paragraph 4 read and agreed to.

224. Paragraphs 4(a) to 4(b) read and agreed to.

225. Paragraph 4(c) read and agreed to.

226. Paragraphs 4(d) to 4(f) read and agreed to.

227. Paragraph 4(g) read and agreed to.

228. Paragraph 4(h) read and agreed to.

229. Paragraphs 4(i) to 4(j) read and agreed to.

230. Paragraph 5 read and agreed to.

231. Paragraphs 5(a) to 5(b) read and agreed to.

232. Paragraphs 5(c) to 5(g) read and agreed to.

233. Paragraphs 5(h) to 5(l) read and agreed to.

234. Paragraphs 5(m) to 5(o) read and agreed to.

235. Paragraphs 5(p) to 5(q) read and agreed to.

236. Paragraphs 5(r) to 5(v) read and agreed to.

237. The Chairman advised that the Subcommittee had completed the consideration and endorsement of the Chinese version of the Subcommittee's report paragraph by paragraph. The question that the English and Chinese texts of the Chairman's report, as amended, be adopted as the Subcommittee's report was proposed, put and agreed to.

238. The Subcommittee authorized the Chairman and the Secretariat to update and make textual and editorial amendments to both the English and Chinese texts of the report, if necessary.

X X X X X X X

Council Business Division 1
Legislative Council Secretariat
15 May 2012