Report on certain issues related to the distribution of Lehman Brothers-related Minibonds and structured financial products

June 2012

**Report by Dr Hon Philip WONG Yu-hong,
Hon Abraham SHEK Lai-him and Hon Jeffrey LAM Kin-fung
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Introduction

1. The Subcommittee to Study Issues Arising from Lehman Brothers-related Minibonds and Structured Financial Products (the Subcommittee) has produced a substantial report setting out its findings, observations and recommendations (the Subcommittee's Report). In this report, we would like to:

(a) present our observations on certain issues which differ from those of the majority of members as set out in the Subcommittee's Report; and
(b) explain why we have made such observations.

Overall remarks

2. The Subcommittee's Report is organized in eight chapters each dealing with a specific subject relevant to the Subcommittee's scope of study. We agree with the analytical framework in the Subcommittee's Report, and consider that the relevant evidence and information obtained by the Subcommittee has been presented succinctly and analyzed thoroughly. While we have no objection to most of the findings and observations set out in the Subcommittee's Report, we would like to state our views on a number of issues in order to provide a more balanced perspective for consideration of the impact of the LB incident on Hong Kong's regulatory system and the investing public. These will be explained in the ensuing paragraphs.

Retail banks that distributed Lehman Brothers-related structured financial products (LB structured products)

3. In order to ascertain how banks conducted the sale of LB structured products to their customers, the Subcommittee has summoned 13

witnesses from the top/senior management of six banks [1] and 26 witnesses[2] from the frontline staff of these six banks. The written and oral testimonies of these 39 witnesses have facilitated the Subcommittee in acquiring a solid understanding of the policies, practices and processes implemented by retail banks in selling LB structured products to their customers. The relevant evidence and observations are set out in Chapter 5 of the Subcommittee's Report. Pursuant to the Subcommittee's decision, the banks referred to are identified by way of footnotes in the chapter.

4. We are concerned that naming individual banks in Chapter 5 is not conducive to the Subcommittee's impartiality and fairness. Paragraph 1.17 of the Subcommittee's Report has made it clear that in summoning witnesses from banks, the Subcommittee has no intention to investigate into the performance of individual banks or their staff in specific cases, or to follow up the complaints of individual investors. Hence, when dealing with the evidence from banks, it is necessary to avoid giving the impression that individual banks are being singled out for criticism or being targeted at. In our view, naming the banks is neither necessary nor illustrative. To the contrary, the Subcommittee will risk being perceived as being selective and biased, and having departed from the principle stated in Chapter 1 that it would not investigate into specific cases and institutions. We consider that the objective of analyzing how retail banks had distributed various LB structured products could have been well achieved without having to name the banks concerned.

The responsibility of investors in protecting their own interest

5. In order to understand what had typically transpired in the selling process, the Subcommittee has taken evidence from 16 investors who had purchased LB structured products from the six distributing banks. We have found that most of the investors appearing before the Subcommittee were unsuitable for acquiring the LB structured products in question and should not have been sold such products under normal circumstances. However, we have noted with grave concern that as testified by some investors who alleged that they had been mis-sold LB structured products by the banks, they had signed on transaction

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[1] The six banks are DBS Bank (Hong Kong) Limited, Standard Chartered Bank (Hong Kong) Limited, Citibank (Hong Kong) Limited, The Royal Bank of Scotland N.V., Bank of China (Hong Kong) Limited and Dah Sing Bank, Limited.

[2] The 26 frontline bank staff testified to the Subcommittee in closed hearings.

documents the purpose and contents of which were not known or explained to them.

6. It has been precisely pointed out in paragraph 5.81 of the Subcommittee's Report that trust in the banks or their staff was no substitute for healthy scepticism and vigilance on the part of the investors. We consider it of paramount importance for the investors to understand that they should not sign transaction documents if they do not understand their contents or purpose. By signing on the transaction document, the investors had in fact assumed their share of responsibility in the transaction, and such responsibility could not easily be avoided or diminished on the grounds that they had been misled or that they were not aware of the contents of the documents.

7. We concur with the need to enhance investor education from all fronts and cannot agree more with the recommendation in paragraph 8.58(e) of the Subcommittee's Report that any investor education initiatives must unequivocally convey the message that investors should not invest in products that they do not know or understand. Paragraph 7.27 of the Subcommittee's Report has rightly pointed out that one should not expect the Administration and the regulators to provide a risk-free investment environment for investors. In our view, one important lesson learned from the LB incident is that investors should realize their share of responsibility in protecting themselves. Any decision to make an investment is ultimately that of the investor on his/her own volition.

Settlement agreements entered into by the Securities and Futures Commission (SFC), Monetary Authority (MA) and distributing banks of LB structured products

8. A total of five broad-based settlement agreements have been entered into between SFC, MA and most of the distributing banks pursuant to section 201 of the Securities and Futures Ordinance (Cap. 571) (SFO) under which the banks had offered to repurchase outstanding LB structured products from eligible customers without admission of liability[3]. We appreciate that these repurchase offers are the compromise reached after long-drawn negotiation between the regulators and the distributing banks, and consider that they are reasonable outcomes in the interest of the investors. As noted in paragraph 6.31 of the Subcommittee's Report, these agreements had

[3] Details of the various settlement agreements are set out in Appendix 6(a) and Appendix 6(b) of the Subcommittee's Report.

been instrumental in bringing about the resolution of outstanding LB-related complaints.

9. Having read the terms of the various settlement agreements as announced by the regulators, we recognize that there are certain limitations as not all investors of LB structured products are able to recoup the full amount of their investments. Nevertheless, according to the evidence received by the Subcommittee, there is no doubt that these agreements have enabled the vast majority of investors to recover a reasonable amount of their original investment without incurring the costs and risks of litigation. Had there been no such settlement agreements, the predicament of many aggrieved investors would have subsisted and the efficacy of Hong Kong's regulatory system to resolve complaints would be called into question.

10. We are pleased to note the various settlement agreements which resulted in reasonable and practicable outcomes to the benefit of many investors affected by the collapse of LB. In this regard, we consider that due recognition should be given to the efforts of the regulators and to the cooperation of the participating banks over the past three years or so in bringing to fruition these agreements.

Power of the regulators to compel payment of compensation

11. A related subject of concern is the fact that under existing legislation, neither SFC nor MA has the power to order a regulated person to pay compensation to aggrieved investors even if an adverse disciplinary decision has been made against that person. Hence, in the absence of a voluntary compromise, the regulators are not in a position to compel any payment of compensation. In principle, we see merits in providing the regulator(s) with powers to order regulated persons to pay compensation where the findings so justify. However, it is only prudent for the Administration/regulators to conduct studies into overseas regulatory regimes before making a firm decision to take forward the matter.

Responsibility of key witnesses

12. The regulatory regime governing the securities business of banks rested on the twin pillars of "disclosure" and "regulation of conduct at the point of sale". The "disclosure" regime was administered by SFC while HKMA was the frontline regulator of banks overseeing their regulated

activities according to the requirements and standards set by SFC. Chapters 3 and 4 of the Subcommittee's Report provide a detailed account and discussion of the regulatory arrangement that prevailed during the period when LB structured products were distributed by retail banks in Hong Kong. The LB incident has no doubt exposed the inadequacies of the regulatory arrangement which had been in place since April 2003. We support the Subcommittee's study focusing on issues of regulatory concern and identifying room for improvement.

13. We are fully sympathetic with the investors who were adversely affected by the collapse of LB. Nevertheless, it should be noted that the losses suffered by those who had invested in LB structured products were a consequence of the unpredictable or unexpected collapse of LB in the United States, rather than the direct result of any ineffective supervision of banks' regulated activities by the regulators. The conclusions of the Subcommittee must not send a wrong message to the community that the losses suffered by investors of LB structured products were attributable to the performance of the Administration or regulators. The investors themselves and the banks which distributed LB structured products had their parts to play.

14. Before LB filed for bankruptcy protection in the United States on 15 September 2008, the prevailing market expectation was that some form of rescue or bail-out would take place, as in the case of Bear Stearns and subsequently with AIG. Unfortunately, this did not turn out to be the case with LB. The collapse of LB not only had a damaging effect on the world's financial markets, but also resulted in the financial loss of many local investors who had assumed the credit risks of LB through their investment in various LB structured products. These circumstances have been described in Chapter 2 of the Subcommittee's Report.

15. In view of the above, we find it difficult to support paragraphs 8.13 to 8.22 of the Subcommittee's Report (under the heading of "Accountability") in which the Subcommittee made certain adverse comments against Mr Joseph YAM, then MA, Mr Martin WHEATLEY, then Chief Executive Officer of SFC, Mr John TSANG, Financial Secretary and Prof CHAN Ka-keung, Secretary for Financial Services and the Treasury. With the benefit of hindsight, we agree that these officers could have taken greater initiative to improve the regulatory regime governing the securities business conducted by banks, but it is not fair that they should share the blame for the damaging consequences arising from a global financial crisis which was beyond their control. We consider that it would suffice to point out areas in which the Administration and regulators

could have performed better, as already discussed in Chapters 3 and 4 of the Subcommittee's Report. We do not find it entirely justified to single out Mr Joseph YAM and make a determination to reprove him, or to express disappointment at individual witnesses. We are also very concerned that such adverse comments would be interpreted as tantamount to the Subcommittee's adjudication on the liabilities of these persons, which the Subcommittee should refrain from doing under its Practice and Procedure[4].

The way forward

16. Notwithstanding our observations in the foregoing paragraphs, we have found the Subcommittee's study fruitful and timely as it has put forward over 50 items of recommendations, most of which are well-conceived. We would urge the Administration and regulators to seriously consider the Subcommittee's recommendations detailed in Chapter 8 of the Subcommittee's Report.

June 2012

[4] Please see Paragraph 2(c) of the Subcommittee's Practice and Procedure.

Signatures of Members

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