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.