

For information  
on 2 November 2009

**Legislative Council  
Panel on Financial Affairs**

**Progress of the Action Plan on Recommendations in the Reports  
Prepared by the Hong Kong Monetary Authority and  
the Securities and Futures Commission  
on the Lehman Brothers Minibonds Incident**

**Purpose**

This paper briefs Members on the progress of the Administration's Action Plan for taking forward the recommendations in the reports prepared by the Hong Kong Monetary Authority (HKMA) and the Securities and Futures Commission (SFC) on the Lehman Brothers Minibonds Incident.

**Background**

2. HKMA and SFC submitted their reports on the Lehman Brothers Minibonds Incident to the Financial Secretary on 31 December 2008. The reports have put forth various recommendations to improve our regulatory framework and enhance investor protection in light of the issues identified during the investigation of complaints regarding the Lehman Brothers Minibonds. The Administration has since formulated an Action Plan in consultation with the two regulators to take forward the various recommendations as set out in their reports, and presented it to the Legislative Council Panel on Financial Affairs on 2 February 2009.

**Progress Update**

3. The Administration has been coordinating efforts by the two regulators and reviewing progress of the implementation of the Action Plan on a regular basis. A progress update as at end October 2009 is at [Annex A](#).

4. A phased approach has been adopted in implementing the Action Plan. The initial phase measures focus on enhancing the selling practice of investment products, business conduct of intermediaries and investor education. After discussion with the Task Force on Sale of Investment Products of the Hong Kong Association of Banks, HKMA has worked out the implementation details that can be taken forward by Registered Institutions (RIs)<sup>1</sup> quickly. For example, HKMA has issued relevant circulars to the RIs to require them to attach “health warnings” to retail derivatives products, to audio-record the sales process of investment products, and to have clear segregation between the general banking business and securities-related activities, etc.

5. In line with established practice, SFC launched a public consultation on 25 September 2009 on proposals to enhance the regulation of intermediaries selling investment products to the public (see summary at **Annex B**). The SFC’s proposals include the requirement of product key facts statements, introduction of cooling-off periods, disclosure of commercial interest involving in the sales process (including commissions and fees), etc. The consultation will end on 31 December 2009.

6. For longer-term measures, we are focussing on proposals to establish an Investor Education Council and a financial dispute resolution scheme (commonly referred to as a Financial Services Ombudsman in overseas jurisdictions), to transfer the public offering regime for structured products in the form of debentures from the Companies Ordinance to the Securities and Futures Ordinance, etc. These are earmarked for public consultation before end 2009.

## **Way Forward**

7. As the Chief Executive has mentioned in the 2009-10 Policy Address, we will seek to further achieve the two main objectives of investor protection and financial security when formulating policies on financial regulation. We aim to strengthen investor protection in every aspect, from investor education, authorisation of investment products, disclosure requirements, sales practices, conduct of intermediaries to financial disputes resolution.

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<sup>1</sup> Registered Institutions (RIs) refer to authorised institutions which are registered under the Securities and Futures Ordinance (SFO) to conduct securities intermediary activities. Under the SFO and the Banking Ordinance, HKMA is the front-line supervisor of registered institutions.

8. We will pay due regard to the views of the markets, the Legislative Council, and various sectors of the community during the consultation exercises, and take account of other factors such as the global financial developments before deciding on how to take the recommendations forward. We look forward to comments from market participants and the public for improving the recommendations for implementation.

9. Members are requested to note the contents of this paper.

Financial Services Branch  
Financial Services and the Treasury Bureau  
October 2009

**Progress Update on the Action Plan for taking forward the  
Recommendations Arising from the Lehman Minibonds Review Reports  
Prepared by the Hong Kong Monetary Authority (HKMA) and the Securities and Futures Commission (SFC)  
(as at end October 2009)**

**Initial Phase**

Improvement measures	Progress			
	Implemented	To be implemented		Further study required
		Under preparation	Consultation required	
<b>I Sale of Investment Products</b>				
1. To require attaching “ <b>health warnings</b> ” to retail derivatives products.	√			
2. To make the SFC website become the repository of information about <b>unlisted investment products</b> authorized by the SFC.	√ <sup>1</sup>			
3. To require investment products to have concise and easily understood product and sales <b>key facts statements</b> .			√ <sup>2</sup>	
4. To establish more detailed principles that assist the market to develop <b>materials that are correct, properly balanced and not misleading</b> .			√ <sup>2</sup>	

<sup>1</sup> A list of unlisted authorised products has been launched on the SFC’s investor education website.

<sup>2</sup> SFC’s consultation paper was issued on 25 September 2009 as planned.

Improvement measures	Progress			
	Implemented	To be implemented		Further study required
		Under preparation	Consultation required	
5. To consider imposing <b>restrictions on the use of gifts</b> as a marketing tool to promote investment products to investors.			√ <sup>2</sup>	
6. To consider the feasibility of a “ <b>cooling-off</b> ” period to investors for certain investment products.			√ <sup>2</sup>	
7. To consult the market on the definition of <b>Professional Investors</b> .			√ <sup>2</sup>	
8. To explore requiring client agreements to allow clients to have their grievances resolved by a <b>dispute resolution procedure</b> .			√ <sup>3</sup>	
<b>II Business Conduct of Intermediaries</b>				
1. For the assessment of a customer’s risk profile – (a) it should be conducted by qualified staff independent of staff making the sale, and if this is not practicable, an independent review must be performed on the risk	√ (In the case of registered institutions (RIs) <sup>4</sup> )		√ (In the case of brokers <sup>5</sup> )	

<sup>3</sup> The Financial Services and the Treasury Bureau aims to launch a consultation on a proposed dispute resolution by the end of 2009, together with proposals for establishing a financial services ombudsman (please refer to Item 1 of Section II of the “Next Phase”).

<sup>4</sup> Registered Institutions (RIs) refer to authorised institutions which are registered under the Securities and Futures Ordinance (SFO) to conduct securities intermediary activities. Under the SFO and the Banking Ordinance, HKMA is the front-line supervisor of registered institutions.

Improvement measures	Progress			
	Implemented	To be implemented		Further study required
		Under preparation	Consultation required	
<p>assessments conducted by sales staff;</p> <p>(b) the customer should be provided with a copy of the <b>risk profile</b> and asked to confirm his agreement that it is accurate; and</p> <p>(c) mandatory requirements to <b>audio tape</b> the assessment process should be introduced.</p>				
<p>2. To introduce a <b>requirement to audio-record the sales process.</b></p>	<p>√ (In the case of RIs)</p>		<p>√<sup>2</sup> (In the case of brokers)</p>	
<p>3. If there is a risk mismatch between the risk rating applied to the investment products and the customer's risk profile, <b>full and complete documentation</b> should be retained of the reasons. Endorsement of supervisory staff within the institution should also be sought. The above sales process should be <b>audio-recorded.</b></p>	<p>√ (In the case of RIs)</p>		<p>√ (In the case of brokers <sup>6</sup>)</p>	

<sup>5</sup> For items (a) and (b), the SFC's existing Code of Conduct for Persons Licensed by or Registered with the SFC (Code of Conduct), which is principle-based, already provides guidance to intermediaries in these areas. For item (c), SFC's consultation paper was issued on 25 September 2009 as planned.

<sup>6</sup> For the documentation requirement, the SFC's existing Code of Conduct, which is principle-based, already provides guidance to intermediaries in this area. For the audio-recording requirement, SFC's consultation paper was issued on 25 September 2009 as planned.

Improvement measures	Progress			
	Implemented	To be implemented		Further study required
		Under preparation	Consultation required	
<p>4. To require RIs to take steps to ensure <b>clearer differentiation between traditional deposit-taking activities and retail securities business</b>, including –</p> <p>(a) <b>physical segregation</b> of RIs’ retail securities business from their ordinary banking business;</p> <p>(b) <b>staff</b> involved in selling investment products to retail customers should not be involved in ordinary banking business;</p> <p>(c) RIs should make clear, through physical signs and warnings, the distinction between deposits and investments and particularly the risks attached to the latter; and</p> <p>(d) complete information separation between a retail customer’s deposit accounts and his investment accounts and a prohibition on an RI’s making use of deposit-related information to target and channel retail customers into investment activities.</p>	√			
<p>5. To apply the forms of <b>segregation</b> suggested above to <b>RI’s insurance activities and other investment activities</b>.</p>	√			

Improvement measures	Progress			
	Implemented	To be implemented		Further study required
		Under preparation	Consultation required	
6. A <b>mystery shopper programme</b> to be instituted periodically by the regulatory authorities (as well as by RIs themselves) to test sales processes, and a pilot programme of customer surveys be commissioned to gauge whether such surveys can provide information useful for the examination of specific issues in the context of the longer-term customer relationship.	√ (For the internal mystery shopper programme of the RIs)	√ (For the external mystery shopper programme of HKMA and SFC <sup>7</sup> )		
7. <b>To place greater focus on remuneration structures for staff engaged in RIs' securities business</b> in the HKMA's on-site examinations and off-site surveillance of RIs' securities business.	√			
8. To examine a <b>pre-sale disclosure requirement</b> for commissions and fees that the intermediary would receive for products being offered or sold.			√ <sup>2</sup>	
9. To determine what changes are appropriate to <b>existing inspection regime</b> in light of findings from the investigations	√			

<sup>7</sup> HKMA and SFC will jointly develop an external mystery shopper programme by the end of 2009. They have jointly commissioned a market professional to prepare a mystery shopping plan for the two regulators.

Improvement measures	Progress			
	Implemented	To be implemented		Further study required
		Under preparation	Consultation required	
currently underway.				
<p>10. Intermediaries to conduct a <b>formal self examination</b> of their controls and procedures to ensure that –</p> <p>(a) sales staff are <b>trained</b>;</p> <p>(b) products are sold by staff who have a sufficient <b>understanding of the product</b>;</p> <p>(c) they document and provide a copy to each client of the <b>rationale underlying the recommendations</b> or solicitation made to the client; and</p> <p>(d) <b>product due diligence</b> is carried out on a continuous basis.</p>	√			
<p>11. To explore requiring intermediaries to <b>adopt suitable criteria</b> for characterising investors to help ensure that investment advice and products offered are suitable for investors.</p>			√ <sup>2</sup>	

Improvement measures	Progress			
	Implemented	To be implemented		Further study required
		Under preparation	Consultation required	
<b>III Investor Education</b>				
1. To clarify through investor education what is meant by “ <b>SFC authorization of a product</b> ”.	√ (Ongoing)			
2. To emphasize the principles underlying the disclosure-based regime, focusing particularly on the responsibilities of investors, intermediaries and regulators in public education campaigns to be launched during 2009.	√ (Ongoing)			

### Next Phase

Improvement measures	Progress			
	Implemented	To be implemented		Further study required
		Under preparation	Consultation required	
<b>I Enhancing the Structure of the Regulatory Framework</b>				
1. To consider whether it is necessary to adjust the framework for regulating the securities business of banks.				√

Improvement measures	Progress			Further study required
	Implemented	To be implemented		
		Under preparation	Consultation required	
2. To place all aspects of RIs' securities business (including registration, standard setting, supervision, investigation and sanction) under the HKMA, and to strengthen coordination between the HKMA and the SFC, with the aim of setting broadly consistent standards of conduct.				√
3. To (a) revisit whether Hong Kong should retain two public offering regimes for investment products and (b) consider whether the existing exemptions from the requirement for SFC authorisation of offering documents (i.e. the scope of private placement) are too broad.			√ <sup>8</sup>	

<sup>8</sup> SFC aims to issue a consultation paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance and the Offers of Investment Regime in the Securities and Futures Ordinance shortly. It would cover proposals to enhance the regulatory regime governing offers of structured products to the public in Hong Kong by transferring the regulation of public offers of structured products in the form of debentures from the Companies Ordinance to the Securities and Futures Ordinance so that the regulation of the public offering of structured products (irrespective of their legal form) will be aligned.

Improvement measures	Progress			
	Implemented	To be implemented		Further study required
		Under preparation	Consultation required	
<b>II Others</b>				
1 To consider the need for a <b>financial services ombudsman</b> with statutory powers to order compensation.			√ <sup>9</sup>	
2 To consider establishing an <b>Investor Education Council</b> .			√ <sup>9</sup>	
3 To amend the Securities and Futures Ordinance (SFO) so that (i) the SFC's power to seek injunction and other orders and to issue restriction notices <b>can be delegable to prevent undue delays</b> ; and (ii) SFC is allowed to seek orders under s.213 for a breach of the Code of Conduct.				√
4. To amend the SFO so that SFC has the power <b>to impose compensation order</b> as a disciplinary sanction.			√ <sup>10</sup>	

<sup>9</sup> Consultation will be conducted by the Financial Services and the Treasury Bureau by the end of 2009.

<sup>10</sup> The Financial Services and the Treasury Bureau aims to conduct consultation by the end of 2009, together with proposals for establishing a financial services ombudsman (please refer to Item 1 of Section II of the "Next Phase").

Improvement measures	Progress			Further study required
	Implemented	To be implemented		
		Under preparation	Consultation required	
5 To introduce amendments to the SFO for requiring issuers and intermediaries to disclose <b>price information</b> and <b>changes in circumstances</b> that may have a <b>significant effect on the value</b> of the investment to investors.			√ <sup>11</sup>	

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Financial Services and the Treasury Bureau  
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<sup>11</sup> A proposal on the ongoing disclosure requirements with respect to unlisted structured products has been set out in the SFC's consultation paper issued on 25 September 2009.

**Summary of Proposals to  
Enhance Protection for the Investing Public  
Put Forward by the Securities and Futures Commission**

**Background**

The Securities and Futures Commission (SFC) released the “Consultation Paper on the Proposals to Enhance Protection for the Investing Public” (consultation paper) on 25 September 2009 to solicit views from the public on proposals to fine-tune existing regulations governing the sale of unlisted securities and futures products to the public. The proposals of the consultation paper flow directly from the recommendations made in the regulators’ reports to the Financial Secretary on the Lehman Brothers Minibonds Incident.

2. A concise summary of the rationale and regulatory philosophy underlying the SFC’s proposals is as follows.

**Documentation**

3. In order to improve the effectiveness of documentation in communicating key issues to investors, the SFC has set out the following three key proposals in the consultation paper.

*1. Standardisation*

4. The criteria that the SFC will normally consider in authorising offering documentation and advertisements will be consolidated into a single SFC handbook covering Unit Trusts and Mutual Funds (UT), Investment-Linked Assurance Schemes (ILAS) and Unlisted Structured Products (issued under the Securities and Futures Ordinance (SFO)). This will include a new Code on Unlisted Structured Products as well as some updating of the existing Code on Unit Trusts and Mutual Funds and Code on Investment-Linked Assurance Schemes, and codify existing practice. The SFC considers that this will clarify documentation standards and also allow certain guiding principles to be applied to all of these products.

## *II. Transfer of Public Offering Regime*

5. At present, there are two separate regimes under which the SFC authorises the documents of products sold to the Hong Kong public, i.e. the Companies Ordinance (CO) prospectus regime, and the Offers of Investments regime in Part IV of the SFO. The SFC will release a separate consultation shortly on the legislative amendments to transfer the authorisation of offering documentation in relation to structured products that are in the form of debentures out of the CO prospectus regime. Public offers of unlisted structured products, irrespective of their legal form, will then be regulated under Part IV SFO Offers of Investments regime. Through the use of powers to publish the new Code on Unlisted Structured Products under the SFO, this would allow the SFC greater scope and flexibility in setting out the appropriate standards of disclosure in offering documents and advertisements, as well as setting out requirements on unlisted structured products in terms of eligibility of issuers and guarantors, obligations of the issuers or (if applicable) arrangers, relationships between key parties, reference assets, guarantees, collateral, valuation, provision of liquidity and continuing disclosure requirements.

## *III. Simplification*

6. In order to improve the communication of key issues to investors, the SFC has proposed that all offer documents should include concise and easily-understood summaries, or product Key Facts Statements (Product KFS). These should be user friendly, standardized to the extent possible (to facilitate comparison between products), and be kept concise. While they cannot be a substitute for the full information contained in an offer document, the SFC believes that these Product KFS will prove to be effective in ensuring that a product's key features and risks are communicated to investors.

## **Disclosure**

7. The SFC considers that the current disclosure regime could be enhanced in the following areas –

- (a) investors are not aware of the commercial interest of intermediaries selling the investment product to them, i.e. the commission or benefits earned on the sale; and
- (b) there may have been occasions when little information was readily

available to investors in the period between the completion of the sale and the maturity of the investment product.

The SFC has included three items in its consultation proposals to deal with these issues.

(i) *Monetary and non-monetary benefits*

8. In reviewing the selling practice, SFC considers that the level of commission (or benefits) earned is an important factor that should be disclosed by the intermediaries to investors. Concerns have been expressed about the possibility that the level of commissions may have been a factor which encouraged institutions to develop business strategies that inappropriately incentivised their sales staff to sell investment products. This in turn may have created potential conflicts of interest.

9. Requirements already exist in the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (Code of Conduct) to make adequate disclosure of relevant material information and to avoid conflicts of interest and ensure that clients are fairly treated. In order to further mitigate against conflicts of interest and to enhance transparency, the SFC proposes to require disclosure to clients at the pre-sale stage of commissions, fees and other benefits receivable from product issuers for the sale of the products.

10. The SFC noted that overseas jurisdictions already require varying degrees of disclosure. While the SFC considers that additional disclosure will benefit investors, the Commission also recognises that there are different ways in which this can be achieved. The SFC also accepts that there are some circumstances in which establishing the level of commission or benefit is complex.

(ii) *Ongoing disclosure requirements*

11. The SFC believes that it would be helpful to make material information available to investors on an ongoing basis to enable them to better monitor their investments in a volatile market. The single SFC handbook requires ongoing disclosure to investors of material information in relation to unlisted structured products in addition to the existing on-going disclosure requirements already imposed on unit trusts and mutual funds and ILAS products.

12. Distributors of these products are also reminded of their obligations to pass on to ultimate investors the information that they receive from the issuers.

*(iii) Sales disclosure document*

13. In its report to the Financial Secretary, the Hong Kong Monetary Authority (HKMA) recommended that consideration be given to providing a uniform statement of key facts to investors at the point of sale. This would include, inter alia, information about the capacity in which the intermediary was acting, e.g. agent or principal and also any commission earned. The SFC proposes to specify the minimum content to be provided in a sales disclosure document.

## **Sales Process**

14. The sale of investment products is covered by requirements set out in the Code of Conduct. Having reviewed these requirements and with the benefit of the information provided by the many complaints received regarding the sale of Lehman Brothers Minibonds, the SFC believes that these requirements are still appropriate. However, concerns exist about the extent to which some intermediaries complied with these requirements in the sale of investment products to the public.

15. Based on the SFC's review, the Commission does not propose any substantive changes to the Code of Conduct and its core requirement to ensure the suitability of the recommendation or solicitation for that client is reasonable in all the circumstances. However, the Commission has proposed changes in the following areas.

### *Gifts*

16. The HKMA noted that gifts were offered to investors in the marketing of some Lehman retail products and suggested that consideration be given to restricting the use of gifts as a marketing tool to promote a specific investment product. Accordingly the SFC seeks views as to whether an intermediary should not act in a way that should distract the client's attention from the features of the products by offering certain types of gifts as a marketing tool.

### *Audio recording of sales process*

17. The SFC Internal Control Guidelines and FAQs (Internal Control Guidelines) contain requirements that intermediaries document and record contemporaneously the information given to each client and the rationale for recommendations given to the client. The HKMA has already imposed an audio recording requirement on banks selling investments to the public to ensure that full and complete records of the sales process are kept.

18. The SFC understands the rationale for the HKMA's requirement but is equally aware of the concerns expressed by some intermediaries regarding both the practicality of making audio recordings in all circumstances and the difficulty that some smaller intermediaries may experience in establishing the appropriate infrastructure.

19. Given that several months experience has now been gained by banks operating this system, the SFC wishes to consult on whether or not this audio recording requirement should be extended to cover all intermediaries selling investments to the public or if alternative methods of compliance with the Internal Control Guidelines remain acceptable.

### *Investor characterisation*

20. A general concern has been expressed about the difficulty experienced by average investors in understanding the complex nature and features of some unlisted structured products, which generally have embedded derivative elements. Having reviewed overseas regulations and having regard to the structure of such products, the SFC considers investors' knowledge of derivatives to be a crucial factor.

21. The SFC therefore proposes that it be explicitly required that intermediaries should seek, as part of the "know your client" process, client information including knowledge of derivatives. Intermediaries should then characterise those clients (other than professional investors) who have derivative knowledge as "clients with derivative knowledge". If a client is not characterised as a "client with derivative knowledge", the intermediary should not promote any unlisted derivative products to such a client in all circumstances. An intermediary can promote unlisted derivative products to a "client with derivative knowledge" provided that it complies with paragraphs 5.2 (reasonable advice) and 5.3 (derivative products) of the Code of Conduct and that the recommendation is suitable for the client.

### *Professional investors*

22. The SFC has previously committed to review the definition of “professional investor” in response to concerns expressed regarding the purchase of “accumulators” by individuals who had been classified as such. This was also included as a recommendation in the Commission’s subsequent report to the Financial Secretary.

23. In the public debate on this issue, there has been considerable focus on the minimum portfolio requirement (asset test), set out in subsidiary legislation, which requires that an investor has a minimum portfolio of HK\$8 million. The SFC considers that there is a general market misconception that investors with a portfolio of this size will automatically be treated as professional investors under the Code of Conduct. In fact, the intermediary must establish that the investor has sufficient knowledge and experience in the relevant products and markets. Even then an investor cannot be treated as a professional investor unless he formally agrees, in writing, that he wishes to be classified as such.

24. The SFC believes that this test, as set out in the Code of Conduct, is the key test of whether or not an investor can be considered to be a “professional investor”, and that this is where the Commission needs to take the most care to ensure that its criteria remain appropriate.

25. In considering the questions posed regarding the appropriate definition of professional investor it will be tempting to focus on the simple asset test and to suggest that the current hurdle is too low. However, consideration should also be given to legitimate concerns that if the asset hurdle is set too high this may adversely affect private placement activities in Hong Kong.

### **Post-sale arrangements – cooling-off period**

26. The SFC’s examination of Lehman Brothers Minibonds highlighted that a number of investment products have the effect of locking investors in for a considerable period of time. This is not only because of the maturity period of the investment but also because of the absence of a liquid secondary market in which they can sell their investment.

27. Overseas markets the SFC has examined have various forms of “cooling-off” periods where an investor can exit a transaction within a limited period after initially committing to it. In Hong Kong, such a

cooling-off period already exists for ILAS products.

28. In considering the possibility of cooling-off periods for other investment products, the SFC has considered carefully where a cooling-off period could be said to be really needed and have also been conscious of the need to avoid the impression that, where investors do not need to take any responsibility for their decisions.

29. The SFC's proposal is that a cooling-off period should only be considered for products where the investment is long-term, and where there is no ready (and realistic) secondary market. If an investor buys a product which has a liquid secondary market, e.g. most mutual funds, then if they decide that this was not an appropriate investment decision they can immediately exit by selling the product. In these circumstances a cooling-off period may not be appropriate.

30. However, where there is no ready secondary market for a long-term investment, the SFC believes that it would be reasonable to allow an investor to change their mind, within a short period after the initial investment decision, rather than lock them into a long-term investment which, they have determined is not appropriate. In these circumstances, the SFC believes that the appropriate response would be to refund their investment capital and the corresponding sales commission less a reasonable administration charge and less any legitimate market value adjustment.

31. The SFC believes that cooling off periods determined in this way would be a win-win arrangement for both the investor and the intermediary who would not want to have a disgruntled customer for the entire period of the investment. Equally, under the SFC's proposals, the Commission does not believe that an investor would change their mind lightly since they would be required to settle the legitimate costs of their decision.

## **Way Forward**

32. The consultation will last for three months until 31 December 2009. After the end of the consultation period, the SFC will analyse the comments carefully and aim to adopt a balanced and pragmatic approach for the purposes of enhancing investor protection in Hong Kong.