SECURITIES AND FUTURES COMMISSION
證券及期貨事務監察委員會

Mis-selling: Consequences at a Glance

Mark Steward
Executive Director, Enforcement

23 October 2008

Last Friday the SFC received the first referrals from the Hong Kong Monetary Authority concerning possible mis-selling by banks of Lehman Brothers-related products. These cases are now added to the investigations already commenced by the SFC into the sale of similar products by three SFC-licensed firms.

We expect to receive more referrals from the HKMA who is continuing to assess individual complaints. As well, the number of new complaints is growing:

- current figures indicate the number of complaints now exceeds 15,000;
- the complaints relate not only to Lehman Brothers Minibond products but also other structured products related to Lehman Brothers, including products that were never the subject of any SFC vetted prospectus or marketing material.

It is too early to tell how many of these complaints have a valid basis.

What is clear is that the matter must be investigated properly, fairly and efficiently.

As to propriety and fairness, we need to remain cool, calm and rational: as to efficiency, the sheer logistics involved in managing up to 15,000 individual cases raises special challenges.

I want to explain how the SFC will be overcoming these challenges and, if we find sufficient evidence to establish misconduct, what is involved in taking enforcement action.

First, let me quickly map the relevant regulatory landscape.

Regulatory landscape

The relevant standards of conduct are contained in the SFC Code of Conduct. The Code applies equally to banks and SFC licensees. The Code sets out nine general principles. These principles underpin the conduct of securities business in Hong Kong. They impose general requirements of honesty, fairness and due diligence. They stress in several places that banks and firms have obligations to act in the best interests of both clients and the market. They make it clear that the primary responsibility to ensure appropriate standards of conduct are maintained lies with senior management.

Under more detailed requirements, the Code obliges firms and banks to ensure staff are fit and proper, properly trained and supervised. The Code also makes it clear that banks and firms are responsible for the acts and omissions of their staff and agents.

The key obligation that relates to the risk of mis-selling is the need for banks and firms to ensure that products are suitable for their clients.

This means banks and firms must know their client's financial situation, investment experience and investment objectives (General Principle 4) and, having regard to that information, "..when making a recommendation or solicitation, ensure the suitability of the recommendation or solicitation for that client is reasonable in all the circumstances" (Para 5.2).

This is the cornerstone obligation for banks and firms engaged in the sale of financial products.

Let me be clear about the requirement of suitability. It does not mean banks and firms must make sure the client has received a copy of the prospectus, or that the client has been given a list of risks attached to the product or signed a form that says they have read the prospectus. These things might be relevant but they do not by themselves satisfy the requirement of suitability.

The onus is on the bank or the firm to ensure the product is an appropriate one for the client given the client's financial situation, investment experience and investment objectives. The Code casts the obligation on the bank or firm to know the product is suitable. The obligation is not on the client.

It goes without saying that the person making the suitability assessment must have appropriate expertise to perform that task; have adequate training and information about the product, understand the product properly and be properly supervised. After all, the client is relying on that expertise and experience when making his investment decision.

The SFC published some helpful guidelines about suitability back in May 2007 advising distributors:

- to make their own inquiries about a product, keeping due diligence updated because market conditions will change;
- to ensure clients understand the prospectus and other relevant documents with plain, simple language explaining the nature of the product, its risks, its advantages and its potential downsides; and
- to document and record contemporaneously the information given to each client and the rationale for recommendations given to the client, including any material queries raised by the client and the responses given.

Finally, the Code requires banks and firms to have in place adequate systems to deal with complaints. In short, complaints must be handled in a timely and appropriate manner; steps must be taken to investigate and respond promptly to the complaint and, if the complaint cannot be remedied, the client needs to be told what to do next, e.g. referring the matter to the SFC or the HKMA (as applicable).

It is clear the Code anticipates that banks and firms have a positive if not primary obligation to investigate client complaints and resolve them if possible. The SFC reminded everyone about this important obligation in a press release and circular issued on 19 September 2008.

Our response to the challenges

We have thought hard about how to manage an efficient investigatory process in the face of what is now 15,000 complaints (and growing) against a large number of banks and firms in Hong Kong.

Our objective is to ensure:

- we are able to respond quickly to the maximum number of complaints in the shortest possible time; and
- we obtain a full and proper understanding of the position of each bank and firm without taking short cuts that will prejudice our assessment or our legal obligations to act fairly.

There are two broad approaches: We investigate each complaint individually or we investigate the selling practices and policies of each bank or firm.

We simply do not think handling every complaint individually, as a starting point, will enable us to respond cogently and credibly to such a large number of complainants in an efficient or expedient way. Assuming evidence of misconduct is found, we would be fighting the same firms and banks in potentially tens, hundreds or thousands of separate proceedings, all commencing and ending at different points in time and potentially with different or inconsistent outcomes.

This sounds neither expedient nor appealing and will likely increase administration costs without securing any commensurate, tangible benefits for complainants, banks, firms or regulators.

Accordingly in the first instance we will deal with each firm and bank scrutinising the selling process within each organisation on a top-down basis examining key issues like:

- the management controls;
- the due diligence process;
- the training and supervision of sale staff;
- the record keeping; and
- the procedures used at point of sale especially the way in which suitability was determined.

This will enable us to form views about the respective positions of the largest number of complainants in the shortest time frame.

It will also enable us to answer the obvious forensic question that arises from so many complaints, namely is there a systemic problem in the sale of these products to be identified and remedied.

This approach is also consistent with our published guidelines on how we calculate fines (see the SFC's Disciplinary Fining Guidelines, 23 February 2003). The guidelines make it clear that the SFC's assessment of the amount of a penalty involve an assessment of *the whole of the conduct* in question. For example, relevant factors identified in the guidelines include:

- the impact of the conduct on the integrity of the market;
- whether significant losses have been incurred by clients or the investing public generally;
- whether the conduct is widespread;
- whether the conduct was engaged in by the whole firm or only by an individual; and
- whether the conduct reveals serious or systemic weaknesses in respect to management systems or internal controls.

Given that the SFC is able to impose a fine of up to three times the amount of profit made or loss avoided by the misconduct, an assessment of the whole of the conduct of a bank or firm means the outcome, in a case of systemic mis-selling involving a large number of customers, would be a material one for any bank or firm.

We have been discussing this approach with the HKMA and have established a system for the efficient referral of bank cases to enable this process to work expediently. Our investigation process with banks will include regular consultation with HKMA staff to ensure our respective work is part of a seamless process and that we are able to leverage one another's resources including skills and experiences.

The investigation and disciplinary process

The SFC must act fairly and in accordance with legal process. This means we are obliged to gather all relevant evidence and pursue all relevant lines of inquiry so we can be sure our decision is the right one and we can support our case all the way through the review and court process, if required.

There is no shortcut to ensuring we have a fair and balanced view of all the material facts.

It goes without saying that no outcome will be pre-judged and our conclusions will be based on evidence, taking into account each bank or firm's point of view, not on supposition, speculation or any external pressure for a particular desired result.

Once we think we understand what has happened, we are under additional obligations imposed by the Securities and Futures Ordinance to give a firm or a bank a reasonable opportunity to be heard before we make a final decision. We give banks and firms a minimum period of 30 days and in complex cases it is normal for this period to be extended to allow the bank or firm sufficient time to obtain legal advice.

During this period we are not allowed to comment publicly on the case even to complainants.

I want to emphasise one aspect of our process that is highly relevant once we have formed a good view of what has happened in each case. We will often sit down together with a bank or firm and discuss whether we can resolve the case other than through formal disciplinary proceedings. The provisions of section 201 of the Securities and Futures Ordinance specifically permit the SFC to consider and, if appropriate, to agree other means of resolution.

The SFC is and will remain very interested to find ways to remediate misconduct by firms and banks:

- to ensure problems do not arise again;
- to mitigate the financial consequences of misconduct on the investing public; and
- to increase confidence in the capacity of Hong Kong's regulatory systems to solve problems beneficially.

We have entered into remediation agreements involving financial redress and compensation on several occasions. We think these types of resolutions may have a very important role to play in these cases assuming evidence of misconduct is found.

For example, this was how the SFC resolved allegations of mis-selling by representatives of Towry Law. In that case, the SFC was able to secure financial redress of more than $670 million for over 2,000 clients.

There is also a number of cases in both Australia and the UK where regulators have secured similar results for large numbers of customers, including, for example:

- the FSA's investigations into the mis-selling of endowment mortgages in the UK which led to redress and compensation of over £600 million to over 400,000 clients; and
- ASIC's investigation into superannuation switching advice in 2006 which led to a comprehensive scheme between the advisory firm and ASIC to redress identified problems and their consequences (including financial redress) for over 30,000 retail customers.

Let me touch on how we think we can accelerate this process.

Under the Code of Conduct, banks and firms are required to conduct their own inquiries in relation to complaints they receive.

Our view is that banks and firms should not wait for us to complete our investigations before discussing any potential misconduct issues with us. We encourage banks and firms to undertake their own internal inquiries into their selling practices, to speak to us about the scope of these inquiries and, if necessary, engage external consultants to conduct reviews.

We think this is the best way to reduce overall costs and expenses for banks and firms and to mitigate the risk of a multitude of separate and competing legal claims.

We have already discussed this process as a means of accelerating a resolution of regulatory issues with some banks.

We know one or two banks are already embarking on this kind of process.

We will be asking all banks and firms to take steps to advance as quickly as possible their own internal investigations and reviews and to report progress and outcomes to us. This will avoid delays and help us resolve the difficult issues and challenges we are all facing at the moment.

I do not want to make it sound like this will necessarily be an instant panacea. There are no "just add water" solutions in these types of cases. So I want to mention some important qualifications and conditions. Banks and firms setting out to compensate affected clients must make sure:

- the population of affected clients is clearly defined;
- the identification of affected clients is sound and covers the field of potential liability; and
- the payment of financial redress, including any terms and conditions that may be imposed, is both fair and reasonable.

The SFC will not stand in the way of payments being made quickly. We want the process to move ahead immediately. But the SFC will want to make sure nothing has been left out. We are happy to speak to all firms and banks who are thinking about embarking on this process.

We will continue with our own investigations in the normal course to ensure the process and any potential outcomes are justified given the SFC's public charter and obligations to the investing public.

Of course the disciplinary process is one that the SFC will invoke where there is sufficient evidence to do so. The SFC is able to revoke or suspend licences as well as impose fines of up to $10 million or three times the total profit or loss avoided by the misconduct.

It goes without saying that systemic failures are at the high end of the spectrum and, in the absence of a fair and reasonable outcome resolving the underlying causes, the SFC is prepared to prosecute robustly all appropriate cases.