

## **Prevention of Financial Crime, Management of Risk and Corruption Seminar**

**Mark Steward  
Executive Director of Enforcement  
Securities and Futures Commission**

**29 March 2011**

Thank you for inviting me today.

The weekend's announcements about Lehman Minibonds and the enhanced returns based on the collateral fulfil a long term strategy set in train by the SFC over 18 months ago.

### **September 2008**

Prior to September 2008, about 30,000 Hong Kong investors, most of whom were retail investors, had invested substantial sums of money in Minibonds, a complex structured product, as an alternative to fixed deposit accounts or other simpler and more traditional forms of saving or investment.

Following the collapse of Lehman Brothers, Minibonds were in default, triggering large scale losses of savings and investments.

The size of the losses was difficult to determine. The common view was that all the money was lost. But that was neither entirely true nor accurate because Minibonds were secured, in part, by asset backed securities like collateralised debt obligations (CDOs).

The common view that losses were total and absolute held sway (this view continues to bedevil debate about Minibonds, even amongst sophisticated commentators). In reality, a precise quantification of the losses was not possible. These assets were very hard to value given the collapse of the global markets which meant the market price for such assets was at rock bottom, but that was not necessarily an accurate assessment of their value.

### **The Collateral**

Complicating matters was that the collateral assets were not in Hong Kong. They were held by a custodian bank in London, Bank of New York. Additionally, the Minibonds trustee, HSBC Trustee, was also not in Hong Kong.

Further complications arose in late December 2008 when the lawyers for Lehman in New York issued a 'cease and desist' letter warning the custodian, Bank of New York, that any distribution of the collateral to the Minibond holders would violate US bankruptcy law.

This step meant the custodian was unwilling to distribute the collateral assets to the trustee so as to realise and then distribute the proceeds to the Minibond holders in Hong Kong.



These 'cease and desist' letters, effectively de facto injunctions, were issued to other custodians and trustees leading to litigation in early 2009 in both London and New York in which the 'cease and desist' claim was challenged. Unfortunately for Hong Kong, the litigation led to polarised outcomes with the UK courts siding with investors but the New York bankruptcy court siding with Lehman.

In effect, the Minibond collateral was caught in an insolvency dispute that raised complicated and novel issues of international law, including a conflict between superior courts in both London and New York.

There was a practical side to all of this for retail investors in Hong Kong. To unlock the collateral, someone would have to deal with Lehman Brothers and their lawyers in New York; overturn a ruling made by the Bankruptcy Court that gave priority access to the collateral to Lehman Brothers or resolve the dispute with Lehman Brothers on appropriate terms.

In practical terms, it was most unlikely any of the 30,000 retail investors in Hong Kong would be able to conduct complex commercial litigation and negotiations in New York to resolve any of these complications.

Hong Kong investors, of course, were focused on local targets in Hong Kong, not on how their position reflected complex fault lines across the global financial map.

And no doubt it suited Lehman for the controversy to be localised in Hong Kong against domestic Hong Kong targets because it distracted attention away from Lehman and its de facto injunction over the collateral.

While, on the one hand, Lehman had no incentive to speed up the release of the collateral issue, on the other hand, there was clear prejudice to Minibond holders who were denied a return of the collateral underpinning their investment.

The problem in accessing and pricing the collateral also created a further legal and forensic issue. How much money had the Minibond holders really lost? Many Minibond holders, perhaps egged on by those who wanted to foment local controversy, were forecasting a complete loss so as to justify 100% compensation.

But the position was not nearly as simple as that.

At most the distributors might be made liable for their own mistakes but it was yet to be established how any mis-selling cause 100% of each Minibond holder's loss nor how much of the loss was caused by the collapse of Lehman in New York as opposed to any alleged misconduct in Hong Kong. Clearly there would be strong arguments to say no local distributor should be required to indemnify Hong Kong investors from the consequences of the collapse of Lehman, an event entirely out of the control of anyone in Hong Kong.

## **SFC's Investigations**

Within a few weeks, after the collapse of Lehman, the SFC and the HKMA had received about 15,000 complaints. The level and intensity of dissatisfaction from members of the investing public was unprecedented. Moreover, it was clear that the number of complaints could easily double, creating substantial logistical and administrative pressures.



Hong Kong had not before dealt with a mis-selling controversy of such proportions ever before. The scale and intensity of the reaction was a substantial challenge to the regulatory framework in Hong Kong.

Having experienced mis-selling scandals in other places before coming to Hong Kong, it was apparent the normal tactical tools that are used elsewhere did not exist. In Australia, victims of misconduct can benefit from compensation proceedings commenced by the regulator, such as the proceedings commenced in recent years following the WestPoint collapse in 2005. Moreover, there is provision in Australia for victims to get hold of evidence gathered by ASIC in its investigations so victims can bring their own actions. No such facility exists in Hong Kong. Many complainants still seem to think they can bring their own proceedings based on findings made by the SFC yet there is no provision for this at all in Hong Kong's regulatory system.

Like Australia, the UK has extensive experience in dealing with mis-selling and the FSA has specific compensation powers. The US SEC too is able to distribute disgorged money under the Fair Funds scheme.

No such processes are available in Hong Kong. Disciplinary sanctions provide for a maximum fine of \$10 million, together with licensing suspensions and reprimands. These sanctions are calibrated to a securities market of small brokers rather than a securities market dominated by large banks.

Since the enactment of the Securities and Futures Ordinance (SFO), the growth in securities business conducted by banks has been substantial. The market for investment products, in particular, is dominated by the banks. The crisis brought the framework of securities regulation and enforcement upon banks into the sharpest focus for the first time. A fine against a bank no greater than a banker's bonus would be like throwing marshmallows into a bonfire.

What's more, we knew that if we investigated each complaint separately we would still be investigating the first batch now, more than two years later.

Commencing thousands of cases which cannot be completed within a reasonable period of time is not productive, efficient nor fair to anyone seeking vindication.

### **The Top-down Strategy**

This led to the top-down strategy which we announced in a speech given at a Wealth Management conference on 23 October 2008. Instead of investigating tens of thousands of cases, our plan was to investigate each distributor's sales processes and practices; we would apply the top-down evidence for the benefit of those complainants who had bought Lehman products from that distributor and we would provide incentives, through disciplinary discounts, for distributors to address the financial hardship of their customers by paying compensation. That is what we set out to do.

This approach meant we were able to directly assess the way in which each distributor managed the sales process, including how well the financial circumstances of the customers were understood, how well advisory staff understood and matched the products they were recommending to their customers.



The result was that we found a large number of concerns, all of which are summarised in the announcement we made on 22 July 2009, where we announced that we had entered into a resolution with the 16 distributor banks (the Minibond Agreement).

I will not rehearse the concerns that we identified in our investigations nor will I downplay them. They were all serious matters. Our concerns were important enough to justify the remediation provided by the distributors in the Minibond Agreement. We believed the processes for the sale of structured products required substantial re-engineering. At the same time, it was also clear that the distributors in Hong Kong could not be held liable for all losses consequent to the collapse of Lehman nor was there any clear justification to find that the local distributors had any obligation in law to indemnify their customers for losses flowing from events out of their control.

### **The Minibond Agreement**

Under the Minibond Agreement, all banks agreed to offer to repurchase outstanding Minibonds at 60% of the notional value of over 90% of all customers (70% for those aged over 65). This meant there was an immediate return of most of the lost capital. This represented a substantial first payment because embedded in the agreement was the unlocked potential of the collateral.

The second key component of the Minibond Agreement is that all 16 banks disgorged their commission income from the sale of Minibonds so as to create a fighting fund out of which the Minibond trustee could take up the 'fight' to Lehman in New York through PricewaterhouseCoopers who had been appointed some weeks earlier as receivers. The fighting fund amounted to about \$291 million and permitted the receivers to negotiate from a much stronger position than had been possible beforehand.

For the first time, focused, well funded attention could be turned to Lehman in New York.

Through this initiative, the banks were required to take all reasonable steps to expedite the return of the Minibond collateral out of which additional second tranche payments would be made to each eligible customer who accepted the offer. The other aspect of the 'fight for the collateral' initiative was that if the collateral could be recovered, it would ensure a return of capital for all Minibond holders, including the professional investors who were not eligible for the retail offer.

The third component to the Minibond Agreement was that each of the 16 distributing banks had to pay for an independent overhaul of their management systems and processes governing the sale of structured products. This was designed to remediate the concerns that had been identified by the SFC in the top down investigations. Each bank was obliged to adopt all recommendations made by the reviewers who were engaged, briefed by and reported to the regulators. The implementation of the recommendations is being supervised by the HKMA.

The fourth component was that each bank had to undergo an independent overhaul of their complaint-handling processes and institute a bespoke system for dealing with complaints about structured products.



The Enhanced Complaints Handling Process was designed to ensure the banks conducted thorough investigations of each person's complaint. This was important because it was clear that most customers focused on the wrong issue when making a complaint. Their major complaint was that they had lost money which, on its own, is not a sufficient ground for complaint. This made it too easy for many complaints to be dismissed. The Enhanced Complaints Handling Process required each bank to investigate the whole sales process from every regulatory angle in respect to each complaint no matter what issue was raised by the complainant. As well, the process required each bank to explain the outcome to each complainant and, where there was fault, to consider making a compensation offer.

In short, the banks had to remember the complainants are in fact their customers.

### **The Outcome**

The weekend's announcements close the circle on the strategy embedded in the Minibond Agreement.

The deal, which remains conditional, will repatriate the collateral and fund substantial second tranche distributions to all those investors who accepted the repurchase offer as well as ensure returns of over 70% at least to the remaining 10% or so who did not accept the repurchase offers or who were not eligible. All Minibond customers in the relevant series will benefit.

The returns will be enhanced by the additional payments to be made by the distributing banks which are being made voluntarily. These payments reflect the goodwill of the banks towards their customers for the hardships they have endured and signal the banks' determination to form stronger bonds with their customers.

In total, under the Minibond Agreement:

- about 29,300 customers accepted repurchase offers in an amount of approximately \$5.5 billion. This does not include the additional payments that will be made out of the collateral under the weekend's announcements (subject to the conditions being satisfied).
- as at February 2011, an additional \$590 million had been paid out by the banks under the Enhanced Complaints Handling Process.
- every bank has completed an overhaul of its systems and processes over the sale of structured products conducted by independent expert reviewers engaged and directed by the regulators. The banks are required to implement all recommendations and the implementation is being supervised by the HKMA;
- a fighting fund representing the revenue earned by the banks in selling Minibonds was established to recover the collateral and the fighting fund will remain in place to facilitate additional work by the Minibond trustee; and
- subject to conditions, the collateral value of the Minibonds will be repatriated to Hong Kong and will fund substantial payments to all Minibond customers in the relevant



series with returns totalling over 85% for most retail customers and, in many cases over 90%.

Yesterday Bank of China announced that its likely net loss in funding these initiatives under the Minibond Agreement will be in the order of \$1 billion. This is more than three times the revenue earned by all 16 distributing banks let alone three times the profit (if we take the highest fine that could have been imposed by the SFC under the current law).

## **Closing**

There are some who would have preferred all of these outcomes to have been implemented as well as disciplinary actions imposing fines in the order of \$millions. Under the current law, this is impossible. We chose outcomes that provided tangible financial outcomes for each person holding one of these troubled Minibonds in a way that also forced wholesale changes to the way in which the sale of structured products would be conducted in the future.

We chose outcomes that provided tangible financial outcomes for each person holding one of these troubled Minibonds in a way that also forced wholesale changes to the way in which the sale of structured products would be conducted in the future.

Some believe the additional payments to Minibond holders are the result of investor protests. We said in October 2008 that our work will not be dictated by any “any external pressure for a particular desired result.” We have been faithful to that commitment. Our results are a consequence of the strategy we developed, implemented and announced in October 2008 and again in July 2009 in the Minibond Agreement.

There was, without doubt, a very great risk that without these measures, Hong Kong’s regulatory system would have been exposed to greater criticism in failing to ameliorate the devastating impact of the financial crisis on its most vulnerable stakeholders, the investing public.

In the weekend’s announcements, that is one risk I think we have prevented from crystallising.