

## Hong Kong Securities Institute SFC Executive Director Series

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Thank you for inviting me to be here today, the third occasion I have spoken in this series.

The last time was, I think, in September 2009, not long after we secured the 16-bank Minibond resolution. Much water has passed below many bridges since then.

We are not completely over all the consequences that beset Hong Kong when Lehman Brothers failed nor are we through all the regulatory issues that arose from the way in which structured products were being marketed and sold to investors in Hong Kong. But I am sure all of us are much the wiser for the experience.

Some of you may remember, back in late 2008, the Securities and Futures Commission (SFC) was asked by the Financial Secretary to prepare a report on how to improve Hong Kong's regulatory framework in light of the issues raised by the collapse of Lehman Brothers. One of the recommendations made by the SFC was there be established a dispute resolution scheme to resolve disputes between investors and intermediaries.

This recommendation was subsequently taken up by the Government and, in February 2010, the Government published a Consultation Paper on the proposed Investor Education Council and the Financial Dispute Resolution Centre (FDRC).

The FDRC is an important initiative by the Government which the SFC fully endorses and supports and the SFC has recently launched a consultation paper on proposals to amend the Code of Conduct to facilitate the mission of the FDRC.

I want to talk about the FDRC in a moment.

But let me capture some of the issues relating to complaint handling in light of what has happened over the last couple of years.

### **Complaint Handling**

Complaint handling is a touchy subject and one that is attracting more attention from regulators.

Some of the reasons for that I think are related to the increase in complaints around the world and the emergence of social media as a means of organizing and concentrating consumer discontent. But the increased use of social media sites is, I think, a new manifestation of an old truism – bad news travels quickly and widely.



The SFC has had some direct experience with protestors outside our office, at various times.

The protestors were clearly dissatisfied but it wasn't clear what they were dissatisfied with: was it Hong Kong; was it the financial system; was it the SFC or was it everything? And what specifically was or were the issues? Or was it just a general feeling that things aren't right and the system isn't right?

Some wanted specific things – in effect a full indemnity for the collapse of Lehman Brothers rather than the 80% or 90% they had received in our section 201 agreements – but it wasn't clear why or on what basis. Some claimed we had refused to investigate their complaints (some of these, in fact, hadn't made complaints and, when we asked them to make complaints, they didn't).

We invited one group, who paraded life-sized pictures of the then CEO and myself for months on end, into the office to explain what it is they wanted. They said they wanted us to investigate their complaints. When I asked them to tell us what their complaints were, they said they were not the complainants but they were members of their group who had complaints. We then agreed to see these members and so provided this group with dates and times for them to come in and explain their grievance to us. But before any appointments were kept, they were all cancelled without any explanation. No interviews took place. Some of these protestors went away and some later returned. The process left us nonplussed, to say the least.

I am not at all critical of these groups nor resentful of the personal attacks. We need to be sympathetic but our sympathy must be tempered with impartiality. Our responsibilities must be carried out objectively and fairly.

In that light, I think this experience shows up two problems. First, it is hard for many people, especially retail investors, to articulate why they feel let down or aggrieved. At the same time the sense of being let down is very real for them. The second problem is that protest, especially dramatic or noisy protest, is often very inarticulate and so it is hard to provide any meaningful response to it.

I do not mean that a feeling of grievance by itself should justify any regulatory response or intervention by the SFC. But I do think the phenomenon of grievance together with an inability to articulate the problem or the source or nature of discontent leads to an uneasy and unsatisfactory dynamic. In combination, these factors are almost impossible to resolve or reconcile.

### **Complaint Handling: Lehman Brothers**

Some of these issues were alive in the very early days following the collapse of Lehman Brothers.

A good number of complaints which we received did not raise issues that appeared to justify what was being claimed and this was not because the complaints were not legitimate.



Let me give you an example. Many complainants said that they were victims of mis-selling because, when they bought their Minibond, they hadn't been told that Lehman Brothers was involved. In most cases, these complainants had invested in a Minibond well before 2008 i.e. before there was any appreciation of the crisis looming in 2008. If it is true that they did not know Lehman Brothers was involved, this fact alone was hardly likely to be a mis-selling issue.

The relatively poor quality of many complaints had a follow on consequence. It was easy for intermediaries to dismiss these complaints almost immediately as having no substance. The dismissal of complaints based only on the issue raised by the complainant, of course, avoided any real internal scrutiny as to what had occurred when the product was actually sold to the customer.

Other problems affected the reliability of complaint handling systems.

Often internal complaints handling processes were aligned very closely to and actually managed by the same business units that were the subject of complaints. This meant whatever inquiries were made were invariably defensive rather than objective. And the process wasn't viewed as a senior management function and so important issues that may have been discovered and brought to senior management attention were not elevated because there was no-one to whom they could be elevated. Finally, there were many instances of poor communication with the complainants with some never spoken to or contacted until they received a letter telling them their complaint had, in effect, been rejected.

The combination of inarticulate complainants and poor complaint handling systems helped fuel the frustration of both customers and the industry in 2008 and 2009.

### **The Enhanced Complaint Handling Process (ECHP)**

In July 2009, we negotiated the Minibond agreement with 16 banks.

As well as the repurchase commitments made by the banks in that agreement, the banks also agreed to undertake overhauls of their complaint handling processes and to implement the ECHP to deal with customers who had complaints that were not covered by the automatic repurchase obligation.

One of the complaints that I have heard when I have ventured outside Chater House at lunchtimes is that the ECHP has not worked.

Based on current figures, the ECHP has assessed over 7,400 complaints with over 3,800 complaints being resolved with an agreed amount of compensation being paid. Over \$874 million has been paid out so far and a further 550 cases are the subject of compensation negotiations at the moment. The process is continuing.

These figures suggest the process has worked. Because it is a merit-based process (i.e. every complaint is investigated and assessed using a common methodology and so only complaints that give rise to a compensatable issue will receive a compensation offer) not everyone will get what they want. But the idea is they ought to get what they deserve.



Under the ECHP, complaint handling is undertaken by a separate business unit with a reporting line to senior management. This ensures there is appropriate oversight and supervision as well as escalation of important issues. Moreover, the investigation unit must be resourced with appropriately skilled and experienced staff.

Secondly, the investigation must be a proper inquiry that includes not only the issue raised by the complainant but a complete review of the entire transaction. This means the inarticulate but legitimate grievance is treated fairly. The investigation is not a paper process and the investigators need to speak to all those involved in the transaction including the complainant. The assessment must be written up and the complainant must be given an opportunity to respond to any issues before the inquiry can be finalized. Finally the outcome must take into account compliance with all regulatory and legal obligations to ensure that if there is a compensatable issue then it is the subject of an express decision by the organization.

As mentioned earlier, before we even got to this point, the SFC recommended to the Financial Secretary back in December 2008 that there be established a dispute resolution process in Hong Kong.

### **Financial Dispute Resolution Centre (FDRC)**

The Government has accepted this recommendation and taken it further by proposing to establish the FDRC which will be a mediation and arbitration process for mostly small retail disputes.

The process of mediation is designed to leverage an agreed outcome and the FDRC will have experienced mediators who will work with banks, brokers and customers to arrive at an agreed resolution quickly and cheaply. If mediation is unsuccessful, the parties have the option of arbitration which will result in an arbitration award which will bind both parties.

We are currently consulting on the changes to the Code of Conduct that will oblige all those licensed by or registered with the SFC to participate and comply with the FDRC scheme. We are keen to get your feedback as to whether the proposed changes will be sufficient to meet the important objectives of the FDRC.

We are also proposing to add to the Code of Conduct an obligation that banks and brokers act in good faith when engaged with the FDRC process. This is an important obligation because the success of mediation and arbitration depends very much on the mediators and arbitrators having access to the relevant documents and, potentially, the staff that explains what happened with the customer. Without access to the right material, the mediation and arbitration process may result in unfair outcomes which will trigger successive waves of discontent and cynicism. This obligation is mirrored in other jurisdictions with financial services ombudsman or dispute resolution schemes and it is an important feature. Your comments on this obligation are also keenly sought.

Finally, we do not expect the FDRC to be used to handle many complaints. We have an expectation and a strong preference for internal complaint handling which we expect will be sufficient to deal with most complaints. For this reason, the internal complaint handling process will be supplemented with an obligation upon each institution to examine the subject matter of the complaint. This is designed to help ensure the inarticulate complainant with a



genuine grievance is treated fairly and also to oblige institutions to have a concern for what may be behind or on the horizon. One complaint may raise issues that affect other customers i.e. knock-on or cross-over consequences. The earlier these risks can be identified and managed, the better.

There are also new obligations to notify and report certain matters to the SFC when the FRDC is engaged. These obligations are set out in our consultation document. I expect to get strong responses to these new obligations.

### **Additional Changes**

We are also making a number of additional changes to the Code of Conduct. These are for the most part updates with some important implications.

First, we are proposing to extend the time period for the retention of telephone recordings from three months to six months. The proposal, back in 2000, was originally six months but it was reduced, I believe, because of costs concerns. Technology has moved forward and we think new digital recording systems makes the cost issue less of a problem. The overall purpose is for firms to be in a better position to resolve disputes with customers and to monitor compliance. These aims, we think, are important enough to justify the period of time being extended. We welcome your views.

Secondly, we are proposing to cease the exemption for mobile phones from compliance with the recording obligation. We have always discouraged order taking on mobile phones but reluctantly granted the exemption because of convenience concerns. Our understanding was always that firms themselves discouraged the use of mobiles and that the policy to use recorded landlines was one that was shared across the industry.

The proliferation of mobiles has become an issue. We have seen many cases of mobile phones being used in trading rooms where recorded landlines are installed. We have seen cases where recorded landlines are diverted to mobiles so as to avoid the recording system. This is a concern that ought to be shared by the industry.

We are proposing to end the exemption but we are also asking the industry whether there are other ways to deal with the potential for abuse.

Thirdly, we are proposing to require firms to retain IP address records for six months. This will align with the telephone recording retention period and recognizes the proliferation of online orders. I hope this is acceptable and your feedback is welcomed.

Fourthly, we are seeking to build into the Code a practice that is already common among many firms which is to ensure there is written authorization for designated third parties of a client account. We expect this to be uncontroversial.

Fifthly, we are proposing to impose an obligation on firms to report actual or suspected misconduct by clients. Firms already have self-reporting obligations under other legislation. There is a gap in relation to the SFC and market misconduct especially. We have already warned the industry that firms who execute self-evidently suspicious or manipulative orders will be disciplined. Some people have been the subject of enforcement action because they have allowed their systems to be exploited by manipulators in circumstances where



manipulation was obvious. We think it is a short but necessary step to require firms who receive a manipulative order which they may decline to execute to report to us. The reporting will obviously be confidential.

Finally, we are continuing to seek assistance from the market for expert witnesses. Time and again we receive offers to assist or individuals agree to assist us in our cases only for permission to do so be refused by employers. This is increasingly frustrating. It is important that the industry assists us in the fight against market misconduct. We will make better decisions if we have better access to key market participants. We think it is in everyone's interests for the industry – and it is mainly banks – to loosen up on this issue.

### **Conclusion**

The major changes we are proposing relate to the relationship between intermediaries and their customers when their interests are not aligned and they are in dispute. The process of complaint handling, mediation and arbitration should not be a process that engenders fear and loathing. The necessity of strong processes and disciplines to handle complaints is enormously important for the well-being of the market.

Unfortunately, if the processes are not sufficiently robust, what we have seen over the past two to three years will become business as usual. I hope the industry embraces and supports these changes to avoid that from happening.