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Financial Regulation in Hong Kong: Time for a Change

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Financial Regulation in Hong Kong: Time for a Change

Douglas W. Arner, Berry F.C. Hsu, and Antonio M. Da Roza

Abstract

The global financial system experienced its first systemic crisis since the 1930s in autumn 2008, with the failure of major financial institutions in the United States and Europe and the seizure of global credit markets. Although Hong Kong was not at the epicentre of this crisis, it was nonetheless affected. Following an overview of Hong Kong's existing financial regulatory framework, the article discusses the global financial crisis and its impact in Hong Kong, as well as regulatory responses to date. From this basis, the article discusses recommendations for reforms in Hong Kong to address weaknesses highlighted by the crisis, focusing on issues relating to Lehman Brothers "Minibonds." The article concludes by looking forward, recommending that the crisis be taken not only as the catalyst to resolve existing weaknesses but also to strengthen and enhance Hong Kong's role and competitiveness as China's premier international financial centre.

KEYWORDS: global financial crisis, financial regulation, financial regulatory structure, Hong Kong

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I. INTRODUCTION

The global financial system experienced its first systemic crisis since the 1930s in autumn 2008, with the failure of major financial institutions in the United States and Europe and the seizure of global credit markets. Although Hong Kong was not at the epicentre of this crisis, it was nonetheless affected. While the global financial system did not collapse as the result of a series of significant government interventions, the full extent of the economic impact of the global financial crisis of 2007-2009 was nonetheless severe, resulting in the worst recession since the 1930s. The causes of the global financial crisis are now generally understood, with major initiatives underway around the world to restructure financial systems and economies. Reform of financial regulation has also been initiated, with potentially far-reaching consequences for the future of banking and finance.1 In looking forward, the crisis provides a unique opportunity for Hong Kong not only to address weaknesses highlighted by the crisis, but also to formulate policies in respect of its longer term role and competitiveness in the international financial system and to enhance its financial regulatory system.

In this article, section II provides an overview of Hong Kong’s existing financial regulatory framework. Section III discusses the global financial crisis and its impact in Hong Kong, as well as the regulatory responses to date. Section IV discusses recommendations for reforms in Hong Kong to address weaknesses highlighted by the crisis, focusing on issues relating to Lehman Brothers “Minibonds”. Finally, section V looks forward, recommending that the crisis be taken not only as the catalyst to resolve existing weaknesses but also to strengthen and enhance Hong Kong’s role and competitiveness as China’s premier international financial centre.

II. FINANCIAL REGULATION IN HONG KONG

Like other financial centres, Hong Kong’s financial regulatory system has developed gradually and, with some exceptions, largely in response to a range of financial crises, in particular major international financial crises of 1973, 1987 and 1997. Whilst it is strong in individual sectors, gaps and overlaps remain a factor in Hong Kong’s regulatory system, as shown in clear relief by the fallout from the current global financial crisis.2

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2 For a detailed discussion of Hong Kong’s financial regulatory system, see B. Hsu et al., Financial Markets in Hong Kong: Law and Practice (Oxford University Press, 2006).

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A. Hong Kong’s Financial Regulatory System

Hong Kong’s financial regulatory framework, in general, is a sectoral structure, operating through a “three tier system”. Under the first tier, the Financial Secretary is responsible for overall policy and the Financial Services and the Treasury Bureau (‘FSTB’) is responsible for translating policies into regulation. Under the second tier, specialist regulatory agencies are responsible for regulation and supervision of financial services business. This tier includes the Hong Kong Monetary Authority (‘HKMA’ – regulating banking and banks), the Securities and Futures Commission (‘SFC’ – regulating the securities and futures markets), the Office of the Commissioner of Insurance (‘OCI’ – regulating insurance business), and the Mandatory Provident Fund Schemes Authority (‘MPFA’ – regulating the pensions industry). Under the third tier, self-regulatory organizations are responsible for oversight of the activities of their members, albeit under the supervision of the relevant specialist regulatory agency and, increasingly pursuant to legislation.

In addition, other bodies also play important roles, especially the Financial Reporting Council (FRC – responsible for accounting and auditing standards for listed companies), the Companies Registry (responsible for the Companies Ordinance), the Hong Kong Deposit Protection Board (‘HKDPB’ – responsible for Hong Kong’s deposit insurance scheme), the Independent Commission Against Corruption (‘ICAC’), the Joint Financial Intelligence Unit (‘JFIU’) and the Consumer Council.

1. Hong Kong Government

The Government is not involved in the day-to-day regulation of the financial system. Under Articles 106 to 113 of the Basic Law of Hong Kong, it is responsible for a range of aspects of public finance and monetary and financial affairs. The Financial Secretary is responsible for the monetary system, Exchange Fund, public finance, financial system and status of Hong Kong as an

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4 Financial Reporting Council Ordinance, Cap. 588, Laws of Hong Kong.
6 Deposit Protection Scheme Ordinance, Cap. 581, Laws of Hong Kong.
7 Prevention of Bribery Ordinance, Cap. 201, Laws of Hong Kong.
8 Consumer Council Ordinance, Cap. 216, Laws of Hong Kong.
international financial centre. The FSTB implements the policies set by the Financial Secretary in relation to public finance, the financial system, and Hong Kong’s status as an international financial centre, including ensuring that Hong Kong’s regulatory regime is up-to-date and meets the needs of investors.

2. The HKMA: Central Banking and Banking Regulation

The HKMA performs the functions of both central bank and regulator. In Hong Kong, the legal framework for banking is based on the Banking Ordinance and the Exchange Fund Ordinance, supplemented by the Companies Ordinance, Bills of Exchange Ordinance and common law. This legal framework is further complicated by the division of authority between the HKMA and the Hong Kong Association of Banks (‘HKAB’).

Under the Exchange Fund Ordinance, the HKMA is responsible for administering the official monetary policy in ensuring the stability of the Hong Kong dollar and for managing the Exchange Fund. The HKMA manages the Exchange Fund under powers delegated by the Financial Secretary in accordance with the Exchange Fund Ordinance. Its mandate is to ensure the safety, stability, and effectiveness of the banking system and to maintain the stability of Hong Kong’s currency by regulating the banking business, by supervising banking institutions, and by managing the Exchange Fund. The Exchange Fund forms the basis of Hong Kong’s linked exchange rate mechanism.

The HKMA also regulates all activities of “Authorized Institutions” (i.e., banks, restricted license banks and deposit-taking companies) under the framework of consolidated supervision. Under the Banking Ordinance, the HKMA is responsible for banking business, defined to include only deposit-taking and cheque-related services. As a result, lending business is not addressed by the Banking Ordinance but rather by the common law, the Money

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9 HKSAR Chief Executive, Responsibilities of the Financial Secretary and the Secretary for Financial Services and the Treasury (27 June 2003); Financial Secretary, Policy Objectives in Financial Affairs and Public Finance (27 June 2003).
10 Cap. 155, Laws of Hong Kong.
11 Cap. 66, Laws of Hong Kong.
12 Cap. 19, Laws of Hong Kong.
13 For detailed discussion, see Hsu et al., supra note 2, c. 2.
14 Hong Kong Association of Banks Ordinance, Cap. 364, Laws of Hong Kong.
15 See HKSAR Chief Executive, supra note 9.
16 Banking Ordinance, s. 7(1).
17 Exchange Fund Ordinance, ss. 3(1) & 3(1A).
18 The Exchange Fund was created by the Currency Ordinance of 1935, later renamed as the Exchange Fund Ordinance.
19 Banking Ordinance, s. 2.
Under the HKMA and HKAB, the HKDPB is responsible for the Hong Kong Deposit Protection Scheme (‘DPS’), both established under the Deposit Protection Schemes Ordinance in 2004, with the DPS commencing operations in 2006. Under the DPS, in which all licensed banks are required to participate, deposit insurance of up to HK$100,000 (in HK dollar or foreign currency equivalent) per depositor per member is provided with funding through member contributions.

3. Securities and Futures: SFC and HKEx

As a result of the 1987 market crisis, the Securities Review Committee was commissioned to develop a plan to upgrade Hong Kong’s securities market infrastructure to international standards in November 1987. This report, known as the “Davison Report”, served as a blueprint for the modernization of capital market regulation in Hong Kong throughout the late 1980s and the 1990s. One fundamental aspect of this transformation has been the establishment of Hong Kong as the preferred market for mainland Chinese enterprises to raise capital.

Following the recommendations of the Davison Report, the SFC was established on 1 May 1989 under the Securities and Futures Commission Ordinance (now consolidated into the Securities and Futures Ordinance [‘SFO’]). Under the SFO, the SFC is the regulator of the securities and futures industry in Hong Kong. The main objectives of the SFC are to maintain and promote the fairness, efficiency, competitiveness, transparency and orderliness of the industry; provide protection to the investing public; minimize crime and misconduct in the industry; and reduce systemic risks in the industry. It has the statutory duties to help maintain Hong Kong’s position as an international

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20 Cap. 163, Laws of Hong Kong.
23 See Hsu et al., supra note 2, c. 1.
24 Cap. 24 (now repealed).
25 Securities and Futures Ordinance, s. 5(1).
26 Securities and Futures Ordinance, s. 4.
financial centre, to facilitate innovation in financial products, and to avoid restrictions on competition.\textsuperscript{27}

In addition to the SFC, Hong Kong Exchanges and Clearing Limited (‘HKEx’) has also been vested with limited regulatory powers under the three-tier system. Under the Securities and Futures (Transfer of Functions – Stock Exchange Company Order),\textsuperscript{28} the SFC’s functions, under the Companies Ordinance and the SFO, of vetting prospectuses relating to listings have been transferred to the HKEx. The HKEx is thus the frontline regulator of all listed and prospective listed companies. The SFC however remains responsible for supervising, monitoring, and regulating the activities of HKEx.\textsuperscript{29}

4. \textbf{Insurance: OCI and HKFI}

The legal and regulatory framework for the insurance market in Hong Kong comprises the Insurance Companies Ordinance,\textsuperscript{30} a statutory body called the OCI headed by the Insurance Authority, and self-regulatory measures. These are supplemented by a large body of common law.

The OCI was established in 1992 and is the regulatory authority responsible for the insurance industry in Hong Kong. The OCI is headed by the Commissioner of Insurance, who has been appointed as the Insurance Authority for administering the Insurance Companies Ordinance. The main functions of the Insurance Authority are to authorize insurers to carry on insurance business in or from Hong Kong and to regulate insurers and intermediaries to ensure the financial soundness and integrity of the insurance market.\textsuperscript{31} While the OCI is responsible for regulation of insurance companies and intermediaries, securities activities of such firms and persons generally fall within the remit of the SFC, unlike the securities activities of banks.\textsuperscript{32}

The Insurance Companies Ordinance does not provide the OCI with statutory power to intervene in cases of disputes between policyholders and insurers or insurance intermediaries. The industry has a self-regulatory system responsible for dispute resolution. Under this system, the Insurance Claims Complaints Bureau (established in 1990) handles disputes involving personal claims against insurers on behalf of policy holders.

\textsuperscript{27} Securities and Futures Ordinance, s. 6.
\textsuperscript{28} Cap. 571AE, Laws of Hong Kong.
\textsuperscript{29} Securities and Futures Ordinance, s. 5(1)(b).
\textsuperscript{30} Cap. 41, Laws of Hong Kong.
\textsuperscript{31} Insurance Companies Ordinance, s. 4A.
\textsuperscript{32} See SFC & Insurance Authority, Memorandum of Understanding between Securities and Futures Commission and Insurance Authority (20 December 2005).
In addition to the OCI, the Hong Kong Federation of Insurers, established in 1988, plays a key self-regulatory role in respect of insurance business in Hong Kong, similar in many ways to that of the HKAB in relation to banking. Most significantly, it is responsible for the Code of Conduct for Insurers, initially adopted in May 1999, which provides standards of insurance conduct enforceable by the HKFI against its membership.

5. **Pensions: The MPFA**

The Mandatory Provident Fund Schemes Authority (‘MPFA’) is responsible for major pension funds regulation under the *Mandatory Provident Fund Schemes Ordinance* \(^{34}\) and the *Occupational Retirement Schemes Ordinance* \(^{35}\) (‘ORSO’). The MPFA was established in September 1998 to regulate and monitor the operation of privately managed provident fund schemes as mandatory retirement savings. The main functions of the MPFA are to ensure compliance with the Ordinance; register provident fund schemes and approve qualified persons as approved trustees; regulate the affairs and activities of approved trustees; and make rules or guidelines for the administration of registered schemes. \(^{36}\)

6. **Cooperation and Coordination between the Regulators**

Although all four regulatory agencies independently supervise their respective sectors, their day-to-day supervisory work is entirely independent, because a large number of the supervised institutions are active in banking, securities, insurance and/or pensions business.

A Cross-Market Surveillance Committee (‘CMSC’), composed of representatives of the FSTB, HKMA, SFC, HKEx, OCI and MPFA, was established to exchange market information and to formulate prompt and appropriate actions where necessary, as well as facilitate supervision of financial groups. The CMSC in 2003 was reconstituted into two separate committees, the Financial Stability Committee and the Council of Financial Regulators. The Council of Financial Regulators comprises the Financial Secretary (as chair) and representatives from the HKMA, SFC, OCI, MPFA and FSTB. It is charged with contributing to the efficiency and supervision of financial institutions, promotion and development of Hong Kong’s financial markets and the maintenance of financial stability. \(^{37}\) In turn, the Financial Stability Committee (‘FSC’) comprises

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\(^{34}\) Cap. 485, Laws of Hong Kong.

\(^{35}\) Cap. 426, Laws of Hong Kong.

\(^{36}\) *Mandatory Provident Fund Schemes Authority Ordinance*, s. 6E.

\(^{37}\) Council of Financial Regulators Terms of Reference.
the Secretary for Financial Services and the Treasury (as chair) and representatives from the HKMA, SFC and OCI. The FSC is charged with monitoring the functioning of the financial system in Hong Kong, deliberating on issues with possible cross-market and systemic implications and formulating and coordinating responses.38

In addition to the FSC and the Council of Financial Regulators, the various agencies and SROs have entered into a series of Memoranda of Understanding (MoUs), which set out the operational framework for cooperation, further delineate roles and responsibilities and set out lines of communication and coordination.39 The presence of so many MoUs addressing the relationships

38 Financial Stability Committee Terms of Reference.
39 Financial Secretary, Letter from the Financial Secretary to the Monetary Authority, Functions and Responsibilities in Monetary and Financial Affairs and Monetary Policy Objective (27 June 2003); HKMA & SFC, Memorandum of Understanding on Cooperation in respect of Supervision of Entities in Financial Groups (23 October 1995); SFC & HKMA, Memorandum of Understanding between the Securities and Futures Commission and the Hong Kong Monetary Authority (12 December 2002) [SFC-HKMA MoU]; SFC & HKMA, Memorandum of Understanding between the Securities and Futures Commission and the Hong Kong Monetary Authority (4 November 2005) (concerning the new oversight regime under the Clearing and Settlement Systems Ordinance); HKMA & OCI, Memorandum of Understanding between the Monetary Authority and the Insurance Authority (19 September 2003); HKMA & FRC, Memorandum of Understanding between Hong Kong Monetary Authority and Financial Reporting Council (19 November 2007); HKDPB, SFC & ICC, Memorandum of Understanding between the Hong Kong Deposit Protection Board, Securities and Futures Commission and Investor Compensation Company Limited (8 July 2008); SFC & Insurance Authority, Memorandum of Understanding between Securities and Futures Commission and Insurance Authority (20 December 2005); SFC & MPFA, Memorandum of Understanding concerning the Regulation of Mandatory Provident Fund Products (23 April 2003) (replacing an earlier MoU from June 1999); SFC & FRC, Memorandum of Understanding between the Securities and Futures Commission and the Financial Reporting Council (12 November 2007); SFC & HKEx, Memorandum of Understanding on matters relating to: SFC Oversight, Supervision of Exchange Participants, Market Surveillance (20 February 2001); SFC, HKEx & SEHK, Memorandum of Understanding for the Listing of Hong Kong Exchanges and Clearing Limited on the Stock Exchange of Hong Kong between Securities and Futures Commission, Hong Kong Exchanges and Clearing Limited and the Stock Exchange of Hong Kong (22 August 2001); SFC & SEHK, Memorandum of Understanding Governing Listing Matters (28 January 2003); SFC & HKEx, Agreed Interpretation of Terms in the MoU [22 August 2001] for the Purposes of the Commencement of the SFO (11 April 2003); MPFA & Insurance Authority, Memorandum of Understanding between the Mandatory Provident Fund Schemes Authority and the Insurance Authority (20 April 2004); Insurance Authority & FRC, Memorandum of Understanding between the Insurance Authority and the Financial Reporting Council (19 December 2007); Monetary Authority, Insurance Authority, SFC & MPFA, Memorandum of Understanding concerning the Regulation of MPF Intermediaries (1 January 2004) (replacing an earlier MoU from October 1999); SEHK & FRC, Memorandum of Understanding between the Stock Exchange of Hong Kong and the Financial Reporting Council (27 December 2007); HKICPA & FRC, Memorandum
between regulatory bodies is testimony to the regulatory gaps and overlaps in the roles of each of the regulators and/or that their roles are inadequately delineated in relation to the financial marketplace as a whole. The present arrangements have resulted in a complex statutorily defined architecture and this contributes to a lack of clarity and certainty among both regulators and the financial intermediaries they regulate.

B. Pre-Existing Weaknesses

As can be seen from this brief overview, for a jurisdiction of 7 million people, Hong Kong has a complicated system of financial regulation. In some cases, these complexities stem from piecemeal responses to previous crises and from accommodating (1) local consumers and businesses; (2) Hong Kong’s role as an international financial centre; (3) Hong Kong’s traditional role as an international trading port and entrepôt; and (4) starting from the late 1970s, Hong Kong’s role as the gateway to and from mainland China. At the same time, even before the current financial crisis, a number of weaknesses in Hong Kong’s financial system had been identified in the context of relationships between regulators and activities of a cross-sectoral nature.

1. IMF Review

In 2003, the International Monetary Fund (‘IMF’) published its review of Hong Kong’s financial regulatory system, as part of the Financial Sector Assessment Program (‘FSAP’), a joint IMF/World Bank project directed at improving the soundness of financial systems in member countries. It concluded that Hong Kong largely had an appropriate legal and regulatory framework for financial stability, though with some weaknesses, particularly in relation to accounting practices, financial conglomerates, the relationship between the SFC and HKEx and independence of regulatory agencies. The global financial crisis has brought into clearer focus certain of these issues, as well as others which were not raised by the IMF. Of these issues, the two most significant are the relationship between the HKMA and SFC in relation to the securities activities of banks, and the relationship between the SFC, HKEx and the Listing Rules.
2. **Financial Conglomerates and Securities Activities of Banks: Relationship between the HKMA and SFC**

Although Hong Kong has a primarily sectoral regulatory framework, an important qualification to this structure concerns the activities of banks. While in the context of insurance and pensions activities, the HKMA retains primary authority, in the context of securities activities of banks the role is divided between the SFC as the lead regulator for the securities industry and the HKMA as the main supervisor of banks undertaking securities business. This anomaly has been one of the central points of focus in considering the problems surrounding the sale of Lehman Brothers Minibonds to retail investors in Hong Kong.

3. **Listed Company Matters: Relationship between the SFC and HKEx**

As already mentioned, HKEx, via its wholly owned subsidiary the Stock Exchange of Hong Kong (‘SEHK’), is empowered under the SFO to make rules for, *inter alia*, applications for the listing of securities and the requirements to be met before securities may be listed. The Listing Rules have been made under such provisions and the SEHK is responsible for administering them.

The Listing Rules operate on a contractual basis between the SEHK and the issuer and its related parties. They are not themselves laws and so do not have the force of law. However, the Listing Rules do enjoy a measure of statutory backing by virtue of the *Securities and Futures (Stock Market Listing) Rules* (‘SMLR’) which is subsidiary legislation under the SFO made by the SFC. The SMLR require an applicant for listing to comply with the Listing Rules and is specifically concerned with the quality of information disclosure by listed companies and listing applicants. Under the SMLR, companies that disseminate information to the public have to file a copy of the disclosure materials, including prospectuses and listing documents, with the SFC (the “dual filing” system).

Further, the SMLR provides that a company may simply authorize the SEHK to make the filing on its behalf.

Any person who intentionally or recklessly provides false or misleading information when making a disclosure commits an offence under the SMLR, and is subject to the statutory powers of the SFC. In appropriate cases, the SFC may pursue action or refer to the Department of Justice to prosecute offenders.

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44 *Securities and Futures Ordinance*, s. 23.
45 The *Securities and Futures (Stock Market Listing) Rules* came into effect on 1 April 2003, the same time as the *Securities and Futures Ordinance*.
46 See *Securities and Futures (Stock Market Listing) Rules*, rules 3 & 5, concerning listing applications and other disclosures to the public.
47 *Securities and Futures (Stock Market Listing) Rules*, s. 384.
addition, private individuals (such as shareholders) may bring an action against such persons in respect of false or misleading communications under section 391 of the SFO.

The three-tier structure relating to listing matters was the subject of an external review which led to the publication of a report in March 2003. Although the dual filing regime was introduced as a means to improving the effectiveness of enforcement as regards the disclosures of listed companies by providing for an increased role for the SFC as regards the quality of disclosures, the Expert Report was critical of the dual filing regime as: (1) “inherently inefficient and costly” as a result of work duplication; (2) not dealing adequately with instances of non-disclosure; (3) a complicated delineation of responsibility between the HKEx and the SFC; and (4) giving rise to the possibility of exacerbating frictions between the SFC and HKEx.

The Report recommended these issues be addressed with two primary changes. First, HKEx should be relieved of its listing responsibilities. This should instead be taken up by a new entity which the Report calls the “Hong Kong Listing Authority”, which would operate as part of, or under the auspices of, the SFC. While the Report expresses the hope that this would improve communication between the SFC and the HKEx, such a consequence is obviously far from certain. Second, the Listing Rules should receive further statutory backing than at present under the SMLR in order for a stronger array of statutory sanctions to be available to deal with instances of non-compliance. However, the Report considered that the Listing Rules should retain their present non-statutory status so as to preserve flexibility, for example, to deal with market developments.

At present, a consultation is underway on proposed amendments to the SMLR. Under this proposal, a number of Listing Rules would be removed to form part of the SMLR. Such matters relate to disclosure, namely, as to price sensitive information, annual and periodic reports, and notifiable and connected transactions. While the proposal would make no substantive changes to the provisions, the effect of removing them would be that they cease to be contractual matters between the SEHK and the issuer and its related parties and would instead become statutory requirements. As such, this proposal has the potential to enhance an area of weakness in Hong Kong’s regulation of listing and public offerings of securities. Nonetheless, there remain strong arguments for moving the

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49 Ibid. at 13, 45 and 55.
50 Securities and Futures Commission, “A consultation paper on proposed amendments to the Securities and Futures (Stock Market Listing) Rules” (January 2005); Financial Services and the Treasury Bureau, “Consultation paper on proposed amendments to the Securities and Futures Ordinance to give statutory backing to major listing requirements” (January 2005).
Listing Rules from the SEHK to the SFC, as has been done in the United Kingdom in 2000 through the transfer of authority in this regard from the London Stock Exchange to the Financial Services Authority.

4. **Other Issues: Review of Banking Stability**

In July 2008, the HKMA released an external review of its work in the area of banking stability. Overall, echoing the IMF’s conclusion, the Carse Report concluded:

> No fundamental deficiencies in the regulatory and supervisory framework have been identified. But a number of enhancements can be made which will provide an even sounder foundation to cope with the challenges ahead.52

The report was prescient in the context of the need to review deposit protection arrangements and regulatory structure. It is also certainly correct in stating that “priorities over the next few years will be set to a large extent by the lessons learned internationally from the sub-prime crisis” and at the same time that “[t]he future agenda in Hong Kong will also be set by local considerations, including particularly the need to manage the increasing business integration with the Mainland”.

At the same time, the Carse Report did not anticipate the scale of problems which would emerge as the global financial crisis intensified and how these would highlight a range of particular problems beyond the context of banking stability.

III. **THE GLOBAL FINANCIAL CRISIS AND ITS EFFECTS IN HONG KONG**

Although certain problems were known to exist with financial regulation in Hong Kong, the global financial crisis highlighted certain of these and also brought to light new issues.

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52 Ibid. at iv-v.
53 Ibid. at 51.
54 Ibid. at 51.
55 Ibid. at 2.
A. The Global Financial Crisis

In essence, the global financial crisis of 2007-2009 resulted from an unprecedented period of excessive borrowing, excessive lending and excessive investment incentivised by a series of significant economic and regulatory factors. Excesses in borrowing and lending most directly arose in the context of the market for subprime residential mortgages in the United States, especially during 2005 and 2006. However, over-borrowing and lending were prevalent in virtually all asset classes globally, including commercial real estate, corporate lending (especially for mergers and acquisitions and private equity transactions), commodities and international (especially emerging markets) equities. These excesses were not limited to the United States; they were truly global, impacting almost every market and asset class. These broad-based excesses in borrowing and lending were fuelled by over-investment from a wide range of investors around the world.

Such borrowing, lending and investment were inextricably interconnected through a range of transaction structures derived from well understood techniques of securitization – the transmission mechanism between borrowing, lending and investment. Essentially, securitization is a transaction structure in which loans (such as loans secured by residential real estate – i.e., mortgages) are pooled together (“repackaged”) as collateral underlying the issuance of securities, predominantly debt securities. At its simplest, securitization makes a great deal of sense: it allows the distribution of risks to a wider pool of investors, thereby reducing the cost of borrowing for ultimate borrowers and reducing the risk to lenders of defaults on underlying loans. At the same time, however, the structure has the potential to provide significant incentives for abuse, including excessive complexity and financialization (essentially, a disassociation between financial and real economic activity), and this in many ways lies at the heart of the global financial crisis of 2007-2009. Especially in the United States, loans came to be made not by banks with an on-going interest in their repayment but instead by specialists – mortgage brokers for real estate and a range of financial institutions, especially investment banks, for corporate loans – intent on profiting from charging to arrange loans. In the extreme form of the originate and distribute model of finance which became common at the beginning of the 21st century, they had no intention of maintaining an interest in the ability of the borrower to repay in the future.

Securitization was thus the central linkage between over-investment in credit securities and over-borrowing and lending. Excesses in investment were largely the result of two economic factors: first, the period of low interest rates in Japan in the wake of the onset of its banking crisis at the beginning of the 1990s and in the United States following the bursting of the dot.com bubble in 2001; and
second, the imbalances in saving and investment between the Anglo-American economies, especially the United States and United Kingdom, and the rest of the world, especially Japan, China and the major oil-producing countries such as Russia and Saudi Arabia, largely resulting from a build-up of foreign exchange reserves in the wake of experiences during the Asian financial crisis of 1997-1998. The combination of low interest rates and large volumes of investment funds from outside the United States and the United Kingdom supported massive investment in debt securities in New York and London designed to produce an appealing combination of perceived safety and attractive yields.

In addition to issues which arose in the context of relatively simple securitization transactions, the technology of securitization was expanded over the past decade to encompass a range of ever-more complex techniques and structures, including structured investment vehicles (‘SIVs’) and conduits, collateralized debt obligations (‘CDOs’), collateralized loan obligations (‘CLOs’), synthetic securitizations and a range of other exotics such as CDO²s and synthetic CDOs. Many of these took the technology of securitization (pooling of portfolios of risks, off-balance sheet structure and capital markets funding) and combined it with that of over-the-counter (‘OTC’) derivatives, especially credit derivatives such as credit default swaps (‘CDS’). While such transaction structures in hindsight may seem an obvious source of risk, in fact, in the period leading up to the global financial crisis, such techniques received important support and developmental incentives from regulators around the world. This combination of complexity, financialization, regulatory incentives and failures, corporate governance and risk management failures, excessive liquidity and massive global investor demand set the stage for the crisis.

Following interest rate increases in major markets, peaks in the US residential real estate market and resultant shifts in market sentiment, the complex transmission mechanisms at the heart of the financial excesses preceding the onset of the global financial crisis ceased to function. As a result of lack of transparency resulting from complexity and risk distribution, a process of adverse selection, loss of confidence, changes in market psychology and investor preferences amongst wholesale market participants combined to produce a closure of the primary interbank funding mechanisms in the global financial markets, eventually leading to the failure of significant international financial institutions around the world. As complexity and lack of transparency hindered market and regulatory responses, moral hazard and improperly designed financial infrastructure and regulatory systems hindered appropriate responses.

In hindsight, it is now clear that excessive attention was placed on monetary policy rather than balancing monetary policy and financial stability. Regulatory attention focussed excessively on the safety and soundness of individual financial institutions rather than on systemic risks and linkages across
institutions and markets. Prudential regulatory and risk management systems did not take adequate account of market cycles and crises, and that the realities of potential failures of large complex financial institutions had not been adequately addressed in advance.

B. Impact in Hong Kong

Hong Kong has not been immune from the impact of the global financial crisis. On 15 September 2008, Lehman Brothers filed for bankruptcy triggering the highest profile incident in Hong Kong flowing from the global financial crisis, though the insolvency of the firm caused less disruption to the wholesale markets in Hong Kong than in the other major financial centers. The near failure of American International Group (‘AIG’) during this time triggered a rush by insurance policyholders of its subsidiary AIA (HK) to redeem their policies. While the US Government’s effective nationalization of AIG prevented serious consequences in Hong Kong, had AIG actually been allowed to fail like Lehman Brothers, in all likelihood Hong Kong’s financial regulatory system would have been hard pressed to cope.

As a consequence of market turmoil, especially the rapid decline of the Australian dollar against the US dollar in foreign exchange markets, CITIC Pacific, the Hong Kong-listed and incorporated subsidiary of the major state-owned Mainland conglomerate CITIC, disclosed on 20 October 2008 that it had lost approximately HK$15.5 billion (US$2 billion) on long-dated structured foreign exchange option contracts derivatives popularly known as “accumulators”. Following the announcement, the SFC initiated a formal investigation.

The bankruptcy filing of Lehman Brothers produced second order effects on individuals in Hong Kong, which led to popular disquiet and public protests, and produced lessons for effective financial regulation in Hong Kong. Both the SFC\(^{56}\) and the HKMA\(^{57}\) produced reports for the Financial Secretary addressing issues that have arisen out of the incident, which subsequently led to proposals of reform for which public consultation recently ended. However, before turning to those issues it is necessary to provide some understanding of the products

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\(^{56}\) Securities and Futures Commission, Issues Raised by the Lehman Minibonds Crisis: Report to the Financial Secretary (December 2008) [SFC Report].

\(^{57}\) Hong Kong Monetary Authority, Report of the Hong Kong Monetary Authority on Issues Concerning the Distribution of Structured Products Connected to Lehman Group Companies (December 2008) [HKMA Report].

http://www.bepress.com/asjcl/vol5/iss1/art8
DOI: 10.2202/1932-0205.1238
themselves and their impact in Hong Kong resulting from Lehman Brothers’ failure.\footnote{For further discussion, see P. Lejot, “Dictum non meum pactum: Lehman’s minibond transactions,” (2009) 38 Hong Kong L.J. 585.}

Lehman Brothers was a leading global dealer and arranger in credit and interest rate products and securities. Structuring securities was important in its activities and the firm’s sales to retail buyers in Asia became prolific. As set out in the SFC’s report, these included sales to Hong Kong retail buyers of complex structured notes. Pacific International Finance Limited (‘PIFL’), a Cayman Islands-incorporated SPV issuer,\footnote{Commonly referred to as an orphan SPV, that is not owned by or legally controlled by the person whose special purpose it has been established – while at the same time, that person should be able to rely upon the fact that, in practice, the SPV will carry out the transaction or transactions into which it is expected to enter in a manner which is predictable.} issued approximately HK$14 billion of structured products (mainly unlisted credit-linked notes) branded “Minibonds”\footnote{“Retail” means buyers of financial instruments who are not professional investors or intermediaries and whose participation in any single issue is modest. They may be intelligent, clear-sighted and accustomed to buying and selling any such instruments but could not reasonably be seen as sophisticated.}, \footnote{SFC report, \textit{supra} note 56, s. 13 (“Impact of failure of Lehman Brothers Holdings Inc. on Hong Kong Investors”); HKMA report, \textit{supra} note 57, s. 2 (“Lehman structured products”).} which were unlisted debt securities arranged by a Hong Kong subsidiary of Lehman Brothers Holdings\footnote{Lehman Brothers subsidiaries were licensed by the SFC in corporate finance and securities advisory, and securities and futures dealing. No Lehman Brothers company has held a Hong Kong banking license. Lehman Brothers did not directly market or sell Minibonds to Hong Kong buyers although members of its staff may have assisted the sales process conducted by distributors.} and sold through 21 licensed bank and securities broker distributors.\footnote{SFC report, \textit{supra} note 56, s. 13 (“Impact of failure of Lehman Brothers Holdings Inc. on Hong Kong Investors”); HKMA report, \textit{supra} note 57, s. 2 (“Lehman structured products”).} The Minibonds were referenced to the credit of companies including HSBC, Hutchison Whampoa, DBS, Swire Pacific, Sun Hung Kai Properties, Goldman Sachs and Morgan Stanley. A total of 32 series of Minibonds were issued. Lehman Brothers’ collapse triggered contractual provisions in the Minibond issues requiring unwinding of the underlying financial structure, resulting in their value falling to no more than a fraction of the amounts paid. This led to the following issues:

1. The effectiveness of the regulation of the marketing and sale of complex financial instruments, particularly requirements for transaction information disclosure in a language clear and simple enough for ordinary retail investors to understand, and which enables them to make informed decisions.

2. The quality of point-of-sale supervision of financial intermediaries serving individual investors in ensuring the understanding of front-line sales staff of products being sold.
3. Whether sales incentives encouraged distributors to mis-sell securities,\textsuperscript{63} in particular inducing sales with incomplete or misleading information.\textsuperscript{64}
4. Whether the law ensures contractual even-handedness in the sale of proprietary complex financial instruments to retail and other investors.

Many types of investors use complex transactions, largely as a result of the utility of securitization, other forms of credit risk transfer, financial derivatives, and a pre-crisis trend for investment barriers to be dismantled. They are legitimate instruments but present problems of disclosure market regulators are usually expected to monitor. This is a problem not only for retail users but for many professional intermediaries, as recent English case law and the global financial crisis both show.\textsuperscript{65} To be considered fair contracts, complex instruments must:

1. Carry warnings that make clear their speculative nature; and
2. Be supported by information sufficiently complete and well-presented to allow the decision of a reasonable buyer to be fairly informed.\textsuperscript{66}

Minibonds targeted retail customers using low nominal purchase prices of around US$5,000 and “gifts” of inexpensive consumer products or supermarket coupons. Most Minibonds were structured with underlying security assets and referenced to credit risks – the return on each issue was a function of yield from the underlying security assets plus the premium earned from time-to-time insuring the credit standing of specified borrowers, all well-known Chinese or international companies, or banks with top credit ratings.\textsuperscript{67}

\textsuperscript{63} Lehman paid its distributors fees of as much as 5\% of Minibond sale proceeds.
\textsuperscript{64} Claims against distributors for mis-selling could also suggest misrepresentation or fraudulent mistake in contract formation, and infractions arising from failure to meet regulatory compliance requirements, e.g. in ensuring that sales staff are properly acquainted with the terms of complex financial products. The HKMA and SFC indicate that over 95\% of complaints together received from Minibond holders allege point of sale mis-selling by distributors. SFC report, \textit{supra} note 56 & later HKMA & SFC notices, available online: <http://www.info.gov.hk/hkma/eng/press/category_f.htm>.
\textsuperscript{65} A leading banking misrepresentation case, \textit{Peekay Intermark Limited & Another v. Australia and New Zealand Banking Group Ltd} [2005] EWHC 830 (Comm), [2006] EWCA Civ 386, showed confusion in both arranger and buyer as to the terms and design of structured notes.
\textsuperscript{66} This concern was raised in the context of other Hong Kong retail-targeted instruments: see P. Lejot, “Cover up! Hong Kong’s Regulation of Exchange-traded Warrants,” (2006) 36 Hong Kong L.J. 277. It would apply also to complex option-based contracts known as accumulators in the context of CITIC Pacific.
\textsuperscript{67} Separate issues arranged by another bank in Hong Kong used Lehman Brothers as a reference entity.
The Minibonds were unlisted, and as such, illiquid. In the prospectus, it was cautioned that the arranger was under no duty to make a market, and there was thus no dealing price. There was also no information as to the underlying security assets purchased with the proceeds of the issues, meaning their value was unknown. The filing for bankruptcy by the holding company of Lehman Brothers led to a payment default of the Minibonds, resulting in acceleration of the notes. The notes thus became repayable in full immediately. This set off a chain of events established in the documentation that were designed to essentially collapse the series. These required the underlying foreign exchange and interest rate swaps as well as credit default swaps to be unwound with the underlying asset securities liquidated. Given the then-prevailing market conditions, the unwinding and liquidation of these instruments resulted in substantial loss compared with their original acquisition price. In at least one of the series, the underlying securities assets were made up of Lehman Brothers’ notes. In some of the other series, one of the referenced entities was Lehman Brothers. Where instruments were connected with Lehman Brothers, there was almost no residual value.

The Minibonds were structured such that the counter-parties of the underlying transactions, being Lehman Brothers subsidiaries, had prior claims, including expenses, over PIFL (the SPV) when it came to the distribution of residual proceeds of the unwound and liquidated instruments. This meant that the retail investors were last in line bar PIFL, which was nominally capitalized and did not have any assets of its own. The substantial loss in value of the underlying transactions, the long liquidation process of Lehman Brothers and the priority standing of the retail investors meant that there would most likely not be any residue value available for distribution to the retail investors. After the conclusion of the whole process of liquidation, clearing out the debris from the underlying transactions, PIFL would turn into the empty shell it originally was before it was used as the conduit to course through the Minibond-related transactions.

As described in the HKMA report, the practices and requirements in a number of overseas jurisdictions for sale of financial products to retail investors are more stringent than those currently in place in Hong Kong. Furthermore, it appears that at least some of the distributor institutions and their staff were engaged in questionable sales practices.

On 22 January 2009, Sun Hung Kai Investment Services voluntarily offered to repurchase Minibonds from its clients, after the SFC raised a number of

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68 HKMA Report, supra note 57, s. 7 (“Oversea practices”).
69 SFC Report, supra note 56, s. 8 (“Regime for authorising product documentation”) & s. 10 (“Conduct requirements for persons that sell products to the Hong Kong public”); HKMA report, supra note 57, s. 3 (“Policies and regulations governing the sale of Lehman structured products”).
70 SFC, “Sun Hung Kai Investment Services Ltd agrees with SFC to repurchase Minibonds from its clients at original value”, SFC Enforcement News (22 January 2009).
concerns in respect of SHK’s Minibond sales practices – the basis of an SFC reprimand. A similar voluntary repurchase took place after KGI Asia was similarly reprimanded by the SFC. The repurchases were completed on 2 July 2009, with clients of both securities broker distributors having their Minibonds repurchased at a price equal to the principal amount invested by those clients.

By contrast, on 22 July 2009, the SFC and HKMA came to an agreement with 16 banks who had distributed Minibonds to offer to repurchase the Minibonds at a price equal to 60 per cent of the nominal value of the original investment for customers below the age of 65 and at 70 per cent for those above that age. Customers who had reached settlement with the banks earlier would received ex gratia payments if they received settlement amounts less than what they would have received under this agreement. The distributing banks made no admission of liability, and furthermore, the SFC discontinued its investigations into the sale and distribution of Minibonds by the banks. The HKMA informed the banks of its intention not to take any enforcement action in relation to those customers who accept the offer.

An agreement on identical terms for compensation was reached between the SFC and Grand Cathay Securities (Hong Kong) on 17 December 2009, bringing an end to investigations of all 19 Minibond distributors.

On 23 December 2009, the SFC and HKMA also reached a resolution with Dah Sing Bank and Mevas Bank over the sale of Equity Index-linked Fixed Coupon Principal Protected Notes issued by Lehman Brothers. The two banks agreed to repurchase the Notes from eligible customers at 80 per cent of the principal amount, a settlement that includes those customers settling earlier for less than 80 per cent being entitled to be brought to the same position as the customers eligible for repurchase offers. The SFC agreed not to take any enforcement action against the two banks under the Code of Conduct, and the HKMA has similarly agreed not to take any enforcement action.

Finally, an agreement was reached by the SFC with Karl Thomson Investment Consultants on 13 January 2010, which was not a distributor but purchased Minibonds and sold them to 11 clients, to repurchase the Minibonds on the same terms as those offered by the 16 banks under the 22 July 2009 settlement.

In light of settlement being reached with most retail investors, consultations for reform already being carried out and the waning public interest, it is questionable what the ongoing Legislative Council inquiry into the alleged mis-selling of the Minibonds will now add.
The near-concluded saga of the Minibond fiasco highlights include:

1. The legislative, regulatory and supervisory weaknesses in respect of proper and orderly sales of complex investment products aimed at protecting retail investors;
2. The *lacuna* in the current system of dual supervision by the SFC and the HKMA of securities brokers and bank distributors respectively, in respect of the sale of investment products to retail investors; and
3. The lack of a system to quickly and effective bring a resolution to disputes, as is clearly highlighted by the disparities in levels of settlement, the unwillingness of Citibank Hong Kong to come to similar settlement, and the Legislative Council inquiry that continues to drag on despite being unlikely to add anything further to the compensation arrangements already reached.

C. Responses to the Global Financial Crisis

In addressing the financial regulatory reactions to the crisis, the Financial Stability Forum (now renamed and reconstituted as the Financial Stability Board [FSB] – of which Hong Kong is a founding member) and the Group of Twenty (‘G-20’) (of which China is a founding member) have been at the forefront internationally.\(^{71}\) During the initial stages of the crisis in April 2008, the FSF detailed major regulatory reforms to be undertaken.\(^{72}\) Furthermore, during the Group of Seven (‘G-7’) and IMF/World Bank annual meetings in October 2008, the FSF reaffirmed the contents of its April 2008 report and also significantly extended its scope.\(^{73}\) Both of these reports have subsequently been largely integrated in the November 2008 statement of the G-20.

On 15 November 2008, the G-20 addressed the causes of the crisis, committed to supporting an open global economy, and defined the actions to be taken in reforming financial regulation.\(^{74}\) In this statement, subsequently reaffirmed and developed at subsequent G-20 meetings in London in April 2009 and Pittsburgh in September 2009, the G-20 established five main principles to guide reforms, and gave highest priority to six areas: (1) mitigating against pro-cyclicality in regulatory policies; (2) reviewing and aligning global accounting

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\(^{71}\) For detailed discussion, see Arner, *supra* note 1.


standards, particularly for complex securities; (3) strengthening the resilience and transparency of credit derivatives markets and reducing their systemic risks, by measures including the improvement of the infrastructure of OTC markets; (4) reviewing compensation practices as they relate to incentives for risk taking and innovation; (5) reviewing the international financial architecture; and (6) defining the scope of systemically important financial institutions and determining their appropriate regulation and oversight.

D. Responding to the Crisis in Hong Kong

Following the structure outlined by the G-7 in October 2008, Hong Kong focused its efforts in three areas: liquidity (expanding the HKMA’s liquidity mechanisms and most recently swap arrangements with the People’s Bank of China), depositor protection (blanket guarantee of deposits with AIs via the Exchange Fund) and capital injections.

Further, the Chief Executive announced in his 2008-2009 Policy Address the establishment of a new Task Force on Economic Challenges (‘TFEC’) to monitor the impact of the crisis on local and global markets and to identify proposals to deal with long-term issues. In addition, at the request of the Financial Secretary, the SFC and HKMA have produced reports addressing issues arising from the Lehman incident, following which the Financial Secretary announced that Hong Kong would undertake a comprehensive review of the financial regulatory system to address both existing weaknesses and support long-term competitiveness. This was followed by the submission of an Action Plan by the FSTB to the Legislative Council on the recommendations made in the SFC and HKMA’s reports on 2 February 2009. In accordance with the action plan, on 25 September 2009, the SFC published the Consultation Paper on Proposals to Enhance Protection for the Investing Public. The consultation paper dealt with proposals in respect of pre-sale documentation, disclosure and other matters during the sales process, ongoing disclosure post-sale, and a post-sale cooling-off period. Proposals in respect of the creation of an Investor Education Council and a Financial Services Ombudsman are to be separately consulted on by the Government later, whilst amendments to the SFO in respect of all unlisted structured products is to be separately consulted on by the SFC.

76 15 October 2008.
78 FSTB, “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”, CB(1)678/08-09(03) (2 February 2009).
E. Implications for International Finance and International Financial Centres

Preventing and addressing systemic risk is the fundamental aspect of financial regulatory design. Such design requires the following elements to be addressed: first, a robust financial infrastructure (especially payment and settlement systems); second, well managed financial institutions with effective corporate governance and risk management systems; third, disclosure requirements sufficient to support market discipline; fourth, regulatory systems designed to reinforce management and market discipline as well as limiting and monitoring potential risks across all financial institutions; fifth, a lender of last resort to provide liquidity to financial institutions on an appropriate basis; sixth, mechanisms for resolving problem institutions; and seventh, mechanisms to protect financial services consumers in the event of financial institution failure.

First, in relation to infrastructure, the central weakness exposed by the crisis has been in relation to the current bilateral structure of OTC derivatives transactions. In this context, the bilateral structure resulted in counterparty risks which were not adequately addressed either by market participants or regulators. Second, in relation to financial institution corporate governance, in contrast to the expectations of former U.S. Federal Reserve Chairman Alan Greenspan, financial institutions did not manage their own risks or businesses well. This is certainly one of the central failures in the global financial crisis. Third, disclosure requirements were not sufficient to support transparency and market discipline. In fact, systemic risks arose due to asymmetric information and understanding – essentially, weaknesses in transparency and disclosure. Such issues are characteristic of the highly complex structured products which acted as the transmission mechanism of the excesses preceding the crisis and adverse selection issues during the crisis. The activities of rating agencies exacerbated such issues both prior to and during the crisis. Fourth, in relation to prudential regulation, in most cases, systemic risk did not arise from areas which were the subject of regulatory responsibility. Rather, in most cases, risks arose primarily from regulatory arbitrage: exploitation of jurisdictional differences and areas which were largely unregulated. Examples include mortgage broker activities, off-balance sheet activities of banks, thrifts and securities firms, hedge funds, OTC

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79 See Arner, supra note 43.
82 See Arner, Lejot & Schou-Zibell, supra note 1.
derivatives and non-traditional activities of insurance companies. In these cases, risks often arose from regulatory arbitrage: financial firms actively moving activities outside of regulated areas. In addition, such regulatory arbitrage was in many cases made possible by the splintering of financial regulation across a large number of regulators, with individual regulators usually less concerned about activities falling outside of the scope of their major responsibilities – an issue also significant in Hong Kong. Systemic risks also arose due to improperly designed prudential regulatory standards, especially in relation to capital, liquidity and leverage.

Fifth, systemic risk arose due to the lack of appropriate mechanisms to deal with problems that arose from unregulated and/or unexpected sources. Examples include the necessity of rescuing AIG and also the lack of a mechanism for appropriately resolving Lehman Brothers. In particular, systems are required to deal not only with banks, especially those of systemic significance, but also mechanisms capable of dealing with non-banks and/or financial conglomerates. Finally, consumer protection mechanisms, such as deposit insurance, did not meet the realities of the domestic financial systems and had to be extended to new areas such as businesses and money markets, in order to prevent new forms of bank run-like withdrawals from core funding sources of the financial system. As noted in the first section, preventing and addressing systemic risk is the fundamental aspect of financial regulatory design. However, financial regulatory design should extend beyond addressing systemic risk to broader concerns of financial stability.83

In looking forward, the current global financial crisis highlights the urgent requirement to redesign the both global and domestic financial regulatory systems not only to properly address systemic risk but also to support its proper functioning, i.e. financial stability. The plan outlined by the G-20 and being implemented by the FSB and others provides a significant comprehensive outline of the major issues which are to be addressed in this respect. At the same time, the plan advanced by the G-20 and being implemented by the FSB does not provide a significant amount of guidance in respect of the future of finance.

IV. CURRENT PROBLEMS AND EXISTING WEAKNESSES

In addressing problems and weaknesses, the first step is an analysis of the performance of the financial, legal and regulatory system in Hong Kong in the context of the global financial crisis. From this basis, it will then be possible to discuss consequent recommendations.

83 See Arner, supra note 43.
A. Evaluating the Performance of Financial Regulation in Hong Kong

During the financial crisis, in the context of financial stability provided through prudential supervision and mechanisms to address systemic risk, Hong Kong’s financial regulatory system has been acknowledged as having performed better than most. Yet, weaknesses in relation to deposit insurance and lack of compensation mechanisms for customers of failed insurance companies are now evident. However, financial stability, including prudential regulation, is not the only objective of financial regulation; market conduct (including disclosure and consumer protection) and competition are essential objectives. In these, especially market conduct, the weaknesses of Hong Kong’s regulatory system are clear. Disclosure issues surrounding CITIC Pacific, whilst currently unresolved, suggest Hong Kong’s most high profile weakness – the relationship between the SFC, HKEx and the Listing Rules – has, as a result of recent modifications, perhaps not been as problematic as many suspected. The availability of investor actions under the SFO and the implementation of the dual-filing regime appear to have resulted in an adequate system, albeit one that could be improved and strengthened. The most significant aspect is thus the performance of the regulatory system in the context of the Lehman Brothers Minibonds.

B. Evaluating Performance in the Context of Lehman Brothers Minibonds

Two separate, related performance issues are highlighted by the Minibonds. The first concerns the regulation and oversight of complex transactions in terms of contract design, approvals for public issuance and transaction disclosure requirements. Second, regulatory supervision of the behaviour of intermediaries in point of sale matters, notably towards retail clients in the selling of products and aspects of mis-selling. Due to the high level of direct participation in financial trading of individual consumers and investors, both of these problems are of wider importance to the territory’s financial system.

1. Approvals for Issuance of Complex Products

In most jurisdictions, the offer and sale of complex structured financial products to retail investors was limited by disclosure and liability frameworks. However, while the authorization framework in Hong Kong is also disclosure-based, it was insufficient – especially in potential liability for mis-selling – to prevent sales of complex products such as Minibonds to retail investors. The existing framework could arguably have been applied more rigorously to better protect the investing

public’s interests. Transparency could have been improved through compliance with the normally applicable disclosure requirements. The information exemptions granted by the SFC give rise to concerns that the quality of disclosure was insufficient, for example, as regards Lehman Brothers as the beneficiary of the transactions and their primary credit risk.

2. Regulatory Supervision of Intermediary Behaviour

How selling practices of intermediaries are regulated and supervised leads to a similar question – how the existing regulatory system operates, or should or could have operated.

Once Minibonds were approved, the manner they were sold into the retail market has been criticized, particularly as regards: (1) the activities of banks and other financial intermediaries acting as distributors of the products, including possibly inappropriate use of customer or banking information for securities business and (2) the suitability of the products for particular customers. Both securities firms and banks are subject to the rules, codes and guidelines published by the SFC. The centrepiece of the codes regulating business practices is the SFC’s Code of Conduct. General Principle 4 requires intermediaries to “seek from its clients information about their financial situation, investment experience and investment objectives relevant to the services to be provided” and that “[h]aving regard to information about the client of which the licensed or registered person is or should be aware through the exercise of due diligence, the licensed or registered person should, when making a recommendation or solicitation, ensure the suitability of the recommendation or solicitation for that client is reasonable in all the circumstances” (emphasis added).

3. Regulatory Performance

The regulatory requirements, if complied with, could have pre-empted many of the Minibond complaints. However, procuring compliance is not straightforward, and in this regard it is necessary to consider: (1) the adequacy of powers given to the SFC and HKMA to regulate; (2) the steps actually taken to regulate; and (3) effectiveness in procuring compliance.

The SFC’s powers to approve offering documents for financial products being offered to the public are clear under both the SFO and the Companies Ordinance (under which the Minibonds were approved) and provide for an effective gate-keeping mechanism. How those powers were actually exercised in the context of Minibonds has been discussed.

85 SFC, Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (May 2006).
Both the SFC and HKMA have clear powers over intermediaries to supervise and enforce;\(^86\) in particular, the SFC has extensive powers\(^87\) to conduct investigations. In the case of banks, it is required to consult with the HKMA before exercising those powers. The SFC and HKMA have exercised their incumbent powers in issuing various codes and circulars concerning mis-selling and engaged in various forms of supervision. The effectiveness of such actions, and what hurdles or obstacles may have arisen, deserves further consideration, as does the effectiveness of the current means by which securities activities of banks are regulated.

Reviewing the performance of the regulatory system implies an examination of the effectiveness of regulators and identifying problems in that regard. Such examination is central to the accountability mechanisms embedded in the regulatory architecture.

One point arguably has not yet been fully appreciated – the fact that the concerns raised over the authorization and selling of Minibonds only came to light upon Lehman Brothers becoming insolvent, despite the large retail market for Minibonds. This seems to imply that it is likely other nascent product or mis-selling issues exist in the market but which are as yet unidentified, and are thus problems waiting to happen. If a core feature of the regulatory model is the identification of problems before they materialize to prevent or mitigate them, then the extent to which this may not be happening reflects a clear gap in the regulatory net.

C. Resolving Current Problems and Addressing Existing Weaknesses: Lehman Brothers Minibonds

As noted above, both the SFC\(^88\) and HKMA\(^89\) have produced reports identifying and addressing issues raised by the Minibonds incident. The recommendations made by the SFC and the HKMA may broadly be divided into five categories: (1) the regulatory regime; (2) conduct of business; (3) information and disclosure; (4) risk assessment in the context of both customer suitability and products; and (5) dispute resolution and compensation. These recommendations have been the basis of the recently ended public consultations by the SFC on the reforms to enhance investor protection and the prospectus regime. Furthermore, the issue of the accountability framework is also discussed.

\(^86\) The SFC under Securities and Futures Ordinance, Parts VIII & IX, SFO; the HKMA under the Banking Ordinance. See also SFC-HKMA MoU, supra note 39.
\(^87\) Under Securities and Futures Ordinance, s. 180.
\(^88\) SFC Report, supra note 56.
\(^89\) HKMA Report, supra note 57.
1. The Regulatory Regime

The HKMA recommended that the regulatory framework should be strengthened to take into account the growth in the volume and complexity of investment products sold to the retail public by banks and the change in public expectations and risk tolerance by investors in light of the Minibonds incident. It further recommended that all aspects of banks’ securities business (including registration, standard-setting, supervision, investigation and sanction) should be placed under the HKMA, and coordination between the HKMA and SFC be strengthened, to set broadly consistent standards of conduct. By contrast, the SFC observed that institutional regulation is now considered suboptimal, whilst the “Twin Peaks” approach separating safety and soundness from conduct of business is attracting more consideration. The SFC thus recommends the Government consider whether Hong Kong’s current regulatory structure is best suited to facilitate its further development as an international financial centre.

The SFC’s recommendation, already initiated by the Financial Secretary, for a full regulatory review is clearly necessary (an issue discussed further below). It no longer makes sense in light of experience to separate securities regulation into two regulatory authorities: responsibility for regulation of banks’ securities activities should be transferred to the SFC, with the HKMA remaining as the prudential regulator of banks. However, the SFC has declined to address the broader questions raised about the regulatory regime, distinguishing between the debate taking place across the globe over the structural changes needed to prevent future financial crises and short-term steps to strengthen the regulatory regime for retail products. As noted above, the regulatory supervision of intermediary behaviour raises questions as to whether or not the regulatory system works as it should have, and in turn, if it had not, how it could be improved.

2. Conduct of Business

The HKMA recommended that banks should be permitted to undertake securities business, but clearer differentiation between traditional deposit-taking activities and retail securities business should be ensured. Recommended measures include: (1) the physical segregation of banks’ retail securities business from ordinary banking business; (2) staff selling investment products to retail customers not be involved in banking business; (3) that banks make clear through signs and warnings the distinction between deposits and investments, particularly the risks

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90 Ibid., Recommendation 4.
91 Ibid., Recommendation 9.
92 See section V infra. for a full discussion of issues relating to regulatory structure.
93 SFC Report, supra note 56 at para. 21.3.
attached to the latter; (4) complete information separation between retail customers’ deposit and investment accounts; and (5) a prohibition on banks making use of deposit-related information to target and channel retail customers into investment activities.\(^94\) It further recommended that this segregation should apply to banks’ insurance and other investment activities.\(^95\) The recommendations are similar to the SFC’s, that the structure of banks’ securities operations should be reviewed to provide clear differentiation of banking from securities services.\(^96\)

Segregation should only be the starting point; ensuring that there is no undue reliance or influence arising out of a pre-existing bank-customer relationship will be difficult. Along with segregation should go strengthened training requirements for selling staff and liability frameworks in the legal and regulatory system against individuals, management and institutions to secure compliance and incentivize appropriate customer treatment.

The issue remains how the apparent conflict of interest between the commercial/remunerative benefits paid to banks and their staff in selling securities and the risks assumed by investors in purchasing such securities is to be resolved. In its consultation paper, the SFC has put forward a proposal that these commercial/remunerative benefits be disclosed during the sales process.\(^97\) The SFC has further proposed new eligibility criteria in respect of Issuers, Guarantors and as well as the collateral for structured products, and has also proposed that investors’ claims to collateral proceeds be accorded priority over claims of the counterparty. The interaction between the regulatory regime and private rights of action, however, appears to remain weak, as is the link between the various Codes administered by the SFC and private rights of action. Whether or not this issue will be addressed by the proposals for a Financial Services Ombudsman remains to be seen. Certainly, it is arguable that such a private right would enable a better recovery return than rights over collateral that may have fall in value.

Further measures that have been put forward for consultation by the SFC include the restriction of the use of gifts as incentives during the sales process, the audio recording of the sales process, and providing investors with a post-sale cooling-off period.

3. **Information and Disclosure**

Appropriate market disclosure for proper risk assessment will always be the central consideration in public securities offerings. The appropriate level of
disclosure must be transparency to the degree that the buyer is a true willing buyer.

The HKMA recommended that the policy objectives on which the disclosure-based system rests remain appropriate for Hong Kong, and the Government should reaffirm those objectives. 98 Similarly, the SFC recommended that Hong Kong maintain the regulatory philosophy of disclosure coupled with conduct regulation of intermediaries, and through investor education, advise investors what SFC authorization of a product means.99

While disclosure is the most appropriate basis for investor protection, its effectiveness is questionable – disclosure ensures neither understanding nor appreciation of the risk investment products represent. In respect of the Minibonds, the prospectuses were not helpful in the sense of disclosure that enabled proper assessment of risk. Even the extent of understanding of the staff of the distributors is questionable.

Recommendations for reform of disclosure requirements include setting a single overall disclosure standard for all offering documents, enforceable against the persons responsible for the documents,100 reconsidering whether the two public offering regimes for investment products should be retained and considering whether existing exemptions from SFC authorization of offering documents are too broad.101 These recommendations have now been incorporated in the SFC’s consultation on possible reforms to the prospectus regime in the Companies Ordinance and the offers of investments regime in the SFO.

Further recommendations in respect of disclosure and investor education were made, such as “health warnings” attached to retail structured products with embedded derivatives or to retail derivative products generally,102 and uniform disclosure formats such as simple “product key facts statements” and “sales key facts statements” in respect of such products and other retail investment products. 103 The SFC makes a similar recommendation of summaries for structured products in no more than four pages of plain, concise, easily understood language, augmented by charts and diagrams,104 which should include key information and facilitate comparisons with other products.105 The SFC put forward this measure, in the form of Key Facts Statements in offering documents, for consultation.106 Further disclosure enhancements proposed include the

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98 Ibid., Recommendations 1 & 2.
99 SFC Report, supra note 56 at paras. 24.9.1 and 24.9.2.
100 Ibid. at paras. 25.5.1 and 25.5.2.
101 Ibid. at paras. 25.6.1 and 25.6.2.
102 HKMA Report, supra note 57, Recommendation 5.
103 Ibid., Recommendation 6.
105 Ibid. at paras. 26.6.1 and 26.6.2.
106 SFC Consultation Paper, supra note 97, Part II.
enhancement of the information in offering documents and advertising guidelines, and ongoing disclosure requirements.

Other disclosure recommendations included the review of the private placement regime,\(^\text{107}\) and the revision of the SFC’s published guidance on marketing materials to ensure the materials are correct, properly balanced and not misleading.\(^\text{108}\)

The HKMA also recommended that public education campaigns should periodically be undertaken, with an emphasis on the responsibilities of investors, intermediaries and regulators,\(^\text{109}\) whilst the SFC recommended an Investor Education Council be set up for the purposes of enhancing financial literacy.\(^\text{110}\)

As a counterpart to disclosure, education is a necessary component for promoting greater understanding of financial services. It remains questionable how receptive the public may be to such education. Academic understanding should not be equated with appreciation of risk. The expectation of reward, as surveyed, must be tempered by the fostering of public understanding that risk needs to be actively managed, and the importance of independent financial advice should be emphasized in investment and risk strategy. Proposals for the creation of an investor education body were put forward by the FSTB in February 2010.\(^\text{111}\)

One recommendation in respect of disclosure that does not push the onus back upon the investor comes from the SFC, which recommended requirements to ensure issuers provide relevant information for investors including changes in circumstances that may have a significant effect on the value of the investment,\(^\text{112}\) and requiring intermediaries take appropriate steps to ensure this information is brought to the attention of investors.\(^\text{113}\) This requirement for ongoing disclosure was put forward for consultation by the SFC,\(^\text{114}\) with its website becoming a repository of information about unlisted investment products that have been authorized.\(^\text{115}\) The requirement of providing updates to investors is a more proactive approach to disclosure that should be applied more broadly.

\(^\text{107}\) HKMA Report, supra note 57, Recommendation 8.
\(^\text{108}\) Ibid. at para. 28.7.
\(^\text{109}\) HKMA Report, supra note 57, Recommendation 3.
\(^\text{110}\) SFC Report, supra note 56, at para. 38.4.
\(^\text{111}\) FSTB, “Consultation Paper: Proposed Establishment of an Investor Education Council and a Financial Dispute Resolution Centre” (9 February 2010).
\(^\text{112}\) Ibid. at para. 27.3.1.
\(^\text{113}\) Ibid. at para. 27.3.2.
\(^\text{114}\) SFC Consultation Paper, supra note 97, Parts II & III.
\(^\text{115}\) Ibid. at para. 27.4.
4. **Risk Assessment**

The assessment of risk was central to the Minibond incident, particularly the identification of risks associated with complex products, and the scale of risks that investors are prepared or permitted to tolerate.

The HKMA recommended that where the review results in a higher risk rating being attributed to a product, the institution should disclose this to customers to whom it recommended and sold the product.\(^{116}\) In view of the criticisms of the credit ratings agencies (discussed further below), it is surprising the HKMA would recommend continued reliance on them. The difference between credit ratings for corporate debts and structured credits was a key aspect of the Minibonds; that “AAA” rating of assets in their marketing was misleading and thus led the also disclosures to be misleading. Even if (as seems probable) credit ratings agencies are to be regulated in future, reliance should be avoided. Rather, investors should be expected to undertake their own analysis but at the same time be able to take action (or for regulators to take action on their behalf) against issuers and sellers of financial products.

Assessment is not limited to products, but extends to the risk profiling assessment of investors. The SFC recommended reviewing the appropriateness of the “professional investor” definition, the minimum asset portfolio requirement and assessment criteria under the Code of Conduct.\(^{117}\) This was put forward as part of its consultation paper.\(^{118}\)

The SFC also recommended requirements for intermediaries to adopt suitable criteria for characterizing investors to ensure suitability of advice and products for the individual investor be brought forward.\(^{119}\) This proposal has also been put forward in the consultation paper, and may prove an effective method for refining the classes of investors other than “professional” and non-professional. Its limitation may thus not be limited to unlisted derivative products alone, as was put forward in the consultation.

The HKMA’s recommendations on customer risk follow their recommendations of segregation – that assessment of customer risk profiles be separated from the sales process and be carried out by non-sales staff with mandatory audio recording requirements.

Given the reliance placed upon customer risk profiling, a spectrum of investor types, similar to the approach in the European Union under the *Markets


\(^{117}\) SFC Report, *supra* note 56 at para. 29.7.

\(^{118}\) SFC Consultation Paper, *supra* note 97, Part III.

\(^{119}\) Ibid. at para. 34.3.
in Financial Instruments Directive (MiFID) could be adopted. This would offer the advantage of uniform customer risk profiling between intermediaries and institutions, and could affect the level of independent advice required for each class of investor.

5. Dispute Resolution and Compensation

The recommendations in this area were considerably more limited than those of other areas. The SFC recommended that the SFO be amended so that orders could be sought from the Court for breaches of the Code of Conduct. It further recommended that it be empowered to impose compensation orders as a disciplinary sanction. This goes some way in addressing the disconnect between the regulatory regime and investor compensation. Further consideration should be given to the extension of rights to damages through civil suit for the contravention of the Code of Conduct. This would simplify the seeking of compensation, as it would be clear from the legislation what causes of action may exist.

Both the HKMA and the SFC put forward the idea of an ombudsman for financial services – the HKMA took into account international practice and the desirability of having a specialized organization with powers to adjudicate or settle disputes between investors and intermediaries, and recommended the establishment of a dispute resolution mechanism for the financial industry along the lines of a financial services ombudsman should be considered. The SFC recommended that the Code of Conduct be amended to require client agreements to specify a right for clients to have their grievances resolved by a dispute resolution procedure and the Government should review the need for a financial ombudsman for dispute resolution. In light of the more rapid action taken in Singapore in respect of compensation, and the limited number of voluntary settlements between investors and distributors directly and without intervention from the regulators, it is clear action is necessary for present complainants and

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121 SFC Report, supra note 56 at para. 39.4.2.
122 Ibid. at para. 40.7.
123 HKMA Report, supra note 57, Recommendation 19.
124 “Singapore ruling on minibonds brings HK hope”, South China Morning Post (17 December 2009).
125 “Talks on US legal obstacle to buy-back of minibonds”, South China Morning Post (28 November 2008); “Minibond deal raises pressure for more refunds”, South China Morning Post (24 January 2009).
dispute resolution and compensation in future. An overall mechanism for addressing consumer financial services complaints is appropriate. Reflecting these experiences and concerns, the FSTB released proposals in February 2010 for a Financial Dispute Resolution Centre to address banking and securities claims, but this is to operate in parallel to the existing insurance scheme.\textsuperscript{126}

Four options were open to complainants – litigation, arbitration, mediation, and negotiation. Litigation has in fact begun,\textsuperscript{127} but the complexity of the Lehman Brothers bankruptcy as well as overlapping civil law and regulatory regimes mean it will be some time before any court is able to come to a decision and even longer for a final result to emerge from any appellate process. The difficulties in respect of cost and timeliness of litigation in Hong Kong are further compounded by the more stringent standards applied to representative actions,\textsuperscript{128} and indeed concerns over cost and timeliness led to the implementation of the Civil Justice Reforms in the Hong Kong courts on 2 April 2009.

On 31 October 2008, the Hong Kong International Arbitration Centre (‘HKIAC’) announced its appointment as the service provider of the Lehman-Brothers-related Investment Products Dispute Mediation and Arbitration Scheme.\textsuperscript{129} Arbitration is less formal than litigation, but must still follow arbitral rules and procedure of some form, with the notion that an arbitral award rendered by a third party who may be nominated for their knowledge or expertise may be somewhat fairer than a judgment rendered by the Court. Given the complexity of the issues, there may be difficulty in finding arbitrators capable of dealing with the interacting regimes of civil law, the bank-customer relationship, the regulatory regime, and the Minibonds themselves. Moreover, the similarities of arbitration and litigation may make it difficult for a class of complainants to arbitrate simultaneously, necessitating an individual, case-by-case approach which could be time-consuming and could produce inconsistent awards. As legal or other representation is not a prerequisite of arbitration, the information gap between distributors and complainants is potentially widened. The private nature of arbitration means that decisions and awards may not be disclosed, leaving complainants and the regulatory authorities in the dark as to reasoning and the range of compensation.

Negotiation is the least formalized and probably least expensive method, involving direct negotiations between parties. Negotiating difficulties faced by

\textsuperscript{126} FSTB, \textit{supra} note 111.
\textsuperscript{127} “Illiterate minibond investor files writ”, South China Morning Post (4 December 2008); “Tribunal adjourns 12 cases relating to minibonds”, South China Morning Post (29 December 2008); “Two women sue bank over minibond losses”, South China Morning Post (11 January 2009).
\textsuperscript{128} For further in respect of representative actions, see \textit{Rules of the High Court}, Order 15, Rule 12.
\textsuperscript{129} HKIAC, Press Release (31 October 2008).
Minibond complainants are clear, as they lack bargaining power and access to information. Some assisted negotiations have led to settlements – 60 note-holders received some HK$30 million in compensation with the assistance of the Democratic Party. However these included some of the most vulnerable complainants – characterized as “elderly, less educated, [with] little investment experience and [having] invested considerable amounts of their savings,” involved “regulation violations” and were arguably the most abject cases for immediate recourse to the courts or other forms of resolution. The average amounts recovered by complainants was characterized as “high” but not disclosed.

The scale of the Lehman Brothers Minibonds problem highlights a particular weakness – the capability to cope with high numbers of complainants. As the Law Reform Commission considers the appropriateness of class action suits for Hong Kong, other mechanisms need to be introduced whereby common, widespread complaints may be dealt with.

A key issue that arises from the complexity of the Minibonds incident is whether the fact-finding process in an adversarial system or an inquisitorial process would be better for addressing the information imbalance. Despite the disparity in treatment between the settlement offered by the intermediaries as compared with that offered by the banks, the need to strengthen the links between investigations and fact-finding procedures for regulatory purposes, such as disciplinary actions and private rights, is illustrated by the reprimand made by the SFC prompting voluntary and full settlement from the two intermediaries, as well as the discontinuation of the investigation process eliciting a substantial settlement from the banks, highlighting the disconnect between the regulatory and civil law regimes. It remains to be seen whether or not this disparity will lead to reforms to the regulatory system to ensure that such disparities will not arise again; save for the need to expedite the settlement process, there seems to be little justification for customers of the intermediaries to receive a full settlement in respect of the Minibonds, whilst bank customers only receive 60 or 70 per cent of the amount invested. The discontinuation of the SFC’s investigations in particular raises the issue of whether or not the SFC is able to properly exercise its regulatory powers in respect of the banks, again raising the issue of satisfactoriness of the current regulatory regime.

In respect of dispute resolution, however, it is clear that a complaints-based approach dealt with by way of a multitude of individual cases will result in a painfully slow process that seems set to drag on for some time, but will also give rise to wildly varying rates of compensation, limit the transparency of the compensation process and introduces a high level of unpredictability.

130 “60 investors get HK$30m from banks on minibonds”, South China Morning Post (10 December 2008).
Inconsistency in the quality of justice will not only damage Hong Kong’s reputation as a centre for dispute resolution, but also harm its competitiveness as a financial centre.

For the purposes of compensation, a system for the identification and categorization of different classes of investors based upon factors relevant to the common complaint must be developed. In respect of the Minibonds incident, for example, where the common complaint is mis-selling, it would be appropriate to separate the complainants into different classes depending on factors such as age and investment experience, education level, and ability to carry out due diligence or access to independent financial advice. This would allow for common standards of compensation to be applied to various classes of investors, eliminating the inconsistency of the compensations derived thus far through the various methods.

6. Accountability Framework

A fundamental element of any regulatory system is a level of independence for regulatory organizations in discharging their responsibilities. This independence must be backed by a framework of accountability for performance. The reports of the SFC and the HKMA considered above were prepared primarily for the purpose of facilitating Government review of the existing regulatory regime in the context of the Minibonds. Both reports focus on the current structural framework. But laws and regulations must be pursued by the regulators with all appropriate due diligence if they are to be of any value. This is particularly important in the context of the central preventative objective of pre-emption or mitigation of problems prior to their occurrence.

However, neither report raises any substantial question as to the internal operations or activities, policies and practices of either regulator. In the current examination of Hong Kong’s regulatory structure, the question is whether such a review ought to be engaged in. Such a review, if undertaken, may need to be conducted independently of the regulators themselves and would seek to establish how the SFC and HKMA executed their existing powers within the regulatory regime, and in what ways their operations, activities, policies and practices could be improved for future benefit.

131 These issues are discussed extensively in the IMF’s 2003 review, supra note 47. For general discussion, see Arner, supra note 43.
132 See SFC Report, supra note 56; HKMA Report, supra note 57.
133 An analysis of such issues was not requested in the context of the SFC and HKMA reports on Lehman Brothers Minibonds.
D. Addressing Other Existing Weaknesses

Other existing weaknesses include issues respecting financial stability, implementation of international standards and addressing credit ratings and credit rating agencies.

1. Financial Stability

Hong Kong shares with Singapore an experience of the crisis that is unusual, in that there has been no general systemic instability or loss of confidence and no need for state funds for bank recapitalization. However, consumers have appeared to suffer losses in a material way, with Minibond holders facing losses similar to shareholders of large organizations such as AIG, Citigroup, Northern Rock and Royal Bank of Scotland. Hong Kong’s experience to date has been similar to those of Australia and Canada (whose financial regulatory systems are now being viewed as models) rather than the United States or the United Kingdom. Plainly, regulation of complex transactions has been deficient in Hong Kong, and supervision at the point of sale weak, in effect leading to lack of transaction transparency and increasing the risks of mis-selling. Hong Kong may be considered lucky in not having to face the failure of AIG thanks to the intervention of the US government, and it has experienced little in the way of direct exposure to the primary systemic financial problems which have emerged. In this, it largely has the HKMA to thank for not allowing the development of a significant shadow banking system – a characteristic shared with Canada and Australia.

While Hong Kong has generally dealt appropriately with financial stability issues and external reviews have generally been favourable, in light of international experience, there is a strong argument that the HKMA, like other central banks around the world, should receive an explicit legislative financial stability mandate and that the existing FSC mechanism should receive greater attention and formalization.

In considering other existing weaknesses, first are areas of specific concern raised by the crisis, namely deposit insurance, insurance consumer compensation arrangements and mechanisms for dealing with failed financial groups. In relation to deposit insurance, the crisis (through the run on BEA) has highlighted Hong Kong’s existing HK$100,000 limit is insufficient.\textsuperscript{134} The trend internationally appears to be towards more comprehensive coverage, the

\textsuperscript{134} As noted above, the Carse Report, \textit{supra} note 51 at 51, recommends the need for a review of the system.
neighbourhood of HK$500,000 probably being more appropriate. This is a level reflected in current proposals from the HKDPB.

Second, the IMF in 2003 noted Hong Kong’s lack of a similar compensation mechanism in the context of insurance. The near failure of AIG and consequent panic has highlighted the need for such a scheme, consistent with deposit protection and the investor compensation arrangements. A possible arrangement would be a merger of the existing DPS for banks and the Investor Compensation Scheme (ICS) for securities, combined with a mechanism to deal with insurance. In this way, arrangements could be both centralized and consistent, particularly in the context of the failure of a financial conglomerate.

Third, while Hong Kong has in place an effective mechanism for addressing problem banks, the failure of Lehman Brothers and the near failure of AIG has highlighted the need for a comprehensive and consistent scheme for resolution of failing financial groups based upon separately capitalized subsidiaries and a broader scheme to address corporate restructuring. Such a system would probably make the most sense as part of overall regulatory restructuring – discussed further in the final section.

Despite widespread criticism, the implementation of the dual filing regime appears to be an effective mechanism for the division of responsibilities relating to listing and listed companies between HKEx and the SFC. The effectiveness highlights the value in strengthening this system, with HKEx focusing on listing and the SFC dealing with enforcement. This system should be strengthened through implementation of the current proposals amending the SMLR to extend its scope.

2. Implementation of International Standards

Hong Kong will also need to address the range of international regulatory changes being made in response to the global credit crisis. While Hong Kong has played a significant role in the development of international financial standards (such as

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135 For discussion of deposit insurance, see R. Lastra & D. Arner, “Comparative Aspects of Depositor Protection Schemes”, in Arner & Lin, supra note 3.
137 A similar structure has been adopted in the United Kingdom under the Financial Services & Markets Act 2000. At the same time however Hong Kong’s DPS does not suffer from the same delayed payout and shared losses systems which made the UK system particularly problematic in the context of Northern Rock.
139 The Carse Report also makes this recommendation, see supra note 51 at 1 and 10.
through its membership in the FSB), it will also be important to increase this participation. After all, despite the Minibond and other problems, its financial regulatory system has performed better than most, partly because of the experience gained from past problems. In relation to implementation of standards, many jurisdictions are likely to follow a reactionary approach. If Hong Kong is able to implement international standards without stifling financial development and innovation, this may provide an important competitive advantage: the incidence of fewer problems in Hong Kong suggests that the regulatory response here can be less draconian than the approaches likely to be taken in London and New York. The emphasis of any regulatory reform should thus be on more effective regulation, not necessarily more regulation.

3. The Role of Credit Ratings and Credit Rating Agencies

As in other jurisdictions, the use of credit ratings in Hong Kong is statutorily required to assist market participants to select securities for investment purposes, to identify eligible entities or debt, to assess the value of rated securities, and to calculate capital adequacy ratio of banking institutions. Under the SFC’s current proposals, these ratings would still be used, for example, to determine the eligibility of issuers, guarantors and the collateral in collateralized structured products. Hong Kong imposes a regulatory regime on CRAs by way of recognition or approval. However, the authority to recognize or approve CRAs is scattered across different government agencies under various ordinances. The SFC and the MPFA are responsible for approving CRAs under the Securities and Futures (Financial Resources) Rules and the Mandatory Provident Fund Schemes Ordinance respectively. The Secretary for Financial Services and the Treasury is empowered to recognize CRAs under the Trustee Ordinance. The HKMA has a more important role: both the Inland Revenue Ordinance and the Inland Revenue Ordinance require the approval of CRAs before they can be recognized or approved. The SFC Consultation Paper, supra note 97, Part II.

141 See, e.g., Mandatory Provident Fund Schemes (General) Regulation, Cap. 485A, Laws of Hong Kong, s. 37(2); Securities & Futures (Insurance) Rules, Cap. 571AI, Laws of Hong Kong, ss. 4 & 5; Trustee Ordinance, Cap. 29, Laws of Hong Kong, sch. 2.
142 See, e.g., Mandatory Provident Fund Schemes (General) Regulation, ss. 68 & 71; Inland Revenue Ordinance, Cap. 112, Laws of Hong Kong, s. 14A; Securities & Futures (Financial Resources) Rules, Cap. 471N, Laws of Hong Kong, s. 58 (“Financial Resources Rules”).
143 Insurance Companies (General Business) (Valuation) Regulation, Cap. 41G, Laws of Hong Kong, s. 4.
144 See e.g., Banking (Capital) Rules, Cap. 155L, Laws of Hong Kong (“Capital Rules”).
145 SFC Consultation Paper, supra note 97, Part II.
146 Financial Resources Rules, s. 58.
147 Mandatory Provident Fund Schemes (General) Regulation, s. 2.
148 Sch. 2.
Ordinance and the Banking (Capital) Rules provide that only CRAs recognized by the HKMA may assign credit ratings in compliance with their statutory provisions. Although there are a number of statutory provisions in Hong Kong requiring credit rating, “credit rating” has not been statutorily defined. The criteria of recognition or approval is generally not set out, although the HKMA has published guidelines for recognition criteria in 2007. The inconsistencies in the current framework suggest that the regulation of CRAs in Hong Kong needs harmonizing and rationalizing.

Risk assessment and management is the responsibility of financial institutions and investors. As the regulator of banking industry, under the Basel II internal ratings-based approach, the HKMA is required to supervise the internal rating procedure adopted by banks. In respect to the use of credit ratings for prudential regulatory purposes, the HKMA should be the dominant regulatory authority. In the context of regulation of use of credit ratings for other purposes such as investment management, regulation must be with the market conduct regulator – as discussed in Section V below. Assuming that the role of ratings will be reduced and the responsibility of investors for investment decisions increased, as market information and research service providers, the regulation of rating agencies generally, including authorization and ongoing compliance, would logically come under the market conduct regulator.

V. LOOKING FORWARD: ENHANCING HONG KONG’S COMPETITIVENESS

Hong Kong is the only jurisdiction legally required to maintain its status as an international financial centre. It continues to rank highly in surveys of the perceived competitiveness of international financial centres, and according to a widely-circulated commercial survey commissioned by the City of London, Hong Kong has consistently ranked as the third or fourth most competitive international financial centre, behind London, New York and (in the most recent survey) Singapore. However, as highlighted by the preceding discussion and recently initiated by the Financial Secretary, Hong Kong needs to undertake a comprehensive analysis of the competitiveness and efficacy of its financial regulatory system, with the express objective of improving its attractiveness and

149 Inland Revenue Ordinance, s. 14A; Banking Ordinance, s. 4; Capital Rules.
151 Ibid.
152 Basic Law, Art. 109 states that the “Government […] shall provide an appropriate economic and legal environment for the maintenance of the status of Hong Kong as an international financial centre.”
effectiveness as a financial centre. In accordance with the Action Plan put forward by the FSTB to LegCo, the initial phase for taking forward the recommendations made by the SFC and HKMA focused on the implementation of measures to improve the regulation of the sale of investment products and the business code of intermediaries, as well as enhancing investor education in Hong Kong. This was to be followed by a review of the structure of the regulatory framework and other regulatory matters which would need to be implemented through primary legislation, including: whether or not two public offering regimes under the Companies Ordinance and SFO should be retained; whether a financial services ombudsman should be established by statute; whether it is necessary to adjust the regulatory framework regulating the securities business of banks; and whether a cross-border Investor Education Council should be established by statute.\textsuperscript{154} Proposals relating to the offering regime, investor education and dispute resolution have now all been released for consultation.

A. Financial Centre Competition and Competitiveness

The main factors influencing financial centre competitiveness include governance, sophistication, liberalization, participation, human capital, information technology, and hinterland. While some of these factors are more amenable to government support than others, all are areas in which governments can enhance competitiveness.

The quality and incidence of governance, including legal and regulatory issues, appear intuitively associated with international competitiveness, whether measured by volume of banking or market-based transactions, or numbers of intermediaries choosing to locate in a centre from time-to-time. No comprehensive empirical analysis exists to show the extent to which legal or regulatory incentives may attract financial activity or cause firms to relocate their operations, but anecdotal evidence suggests that legal and regulatory factors have been responsible for certain shifts from one centre to another. Foreign confidence in its regulatory setting has a positive impact on competitiveness.

Furthermore, a number of studies on specific aspects of regulation, the cost of compliance or the attractions within any single centre of certain financial market segments, have shown that law and regulation can influence cross-border capital flows, choice of listing locations, and to some extent the reasons for intermediaries to establish a local presence. Other studies have shown that the perception of quality in regulatory design and enforcement has a positive impact

\textsuperscript{154} FSTB, “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”, CB(1)678/08-09(03), (2 February 2009).
on cross-border capital flows, including foreign direct investment.\textsuperscript{155} Hong Kong would be wrong to believe an under-regulated, libertarian approach would engender financial activity, and the collapse in general confidence from 2007 to 2009 enhances the value of a regulatory regime that is seen as effective and well-enforced. High costs may deter activity but regulatory quality and intensity in enforcement seems to support market development and competitiveness.

There is also a clear relationship between the economic/financial hinterland of any given financial centre and legal and governance strategies. For instance, economic area can be increased through the formation of national, regional and international economic zones. In this respect, the development of the European Union and especially its integrated market for wholesale finance highlight the potential that may exist in other regions, with specific examples currently in ASEAN and the Gulf Cooperation Council (GCC).\textsuperscript{156}

In looking forward, one can identify the parameters of the competition between financial centres – a competition in which law and regulation play a central role. However, developing a competitive international financial centre (rather than a domestic financial centre) may conflict with other objectives, even in terms of competitiveness. For instance, it may be to a given country’s advantage to restrict certain aspects of the liberalization requisite for a successful international financial centre in the interests of the development of the country’s economy as a whole. As such, there are both benefits and costs to the competition between global financial centres.

\section*{B. Opportunities}

One area in which the crisis provides an opportunity for enhancing competitiveness lies in international responses to counterparty risk of OTC derivatives. Specifically, it may be valuable for the HKMA and HKEx to become associated with official or private sector efforts now under way in the United States and Europe to sponsor or give regulatory authorization to central organizations for the clearing and reporting of CDS contracts and their associated collateral.\textsuperscript{157} The key weaknesses which have emerged in the context of the financial crisis are counterparty risk and transparency – risks that can be directly addressed through central counterparty and reporting arrangements. Transparency has become a widespread political demand since the fall of AIG, to give both

\begin{footnotesize}
\footnote{\textsuperscript{155} See e.g., H. Jackson & M. Roe, “Public Enforcement of Securities Laws: Resource-Based Evidence,” J. Fin’l Economics (forthcoming 2009).}
\footnote{\textsuperscript{156} For discussion in the context of East Asia, see D. Arner, P. Lejot & W. Wang, “Assessing East Asian Financial Cooperation and Integration” (2010) 12 S.Y.B.I.L. 1.}
\footnote{\textsuperscript{157} For discussion, see J. Kiff \textit{et al.}, “Credit Derivatives: Systemic Risks and Policy Options”, IMF Working Paper WP/09/254 (November 2009).}
\end{footnotesize}
global markets and their regulators clear insight at any time into the general disposition of credit risk among banks and other intermediaries. At present, information on almost all completed global CDS trades, other than those wholly embedded in other transactions, is collated by the Trade Information Warehouse facility of US-based Depositary Trust and Clearing Corporation. This is however only published weekly and in aggregate form.

If the system is further developed with transnational regulatory sanction, then a single bridging facility from East Asia could be of value to users, other counterparties and regulators. The volume of CDS contracts sold by Asian counterparties is comparatively small; a new and separate local organization may seem to be of little value until the market develops. Then it may be significant to have an Asian clearing and settlement mechanism to support development of a generally useful market while supporting financial stability, particularly given the consensus recently emerging from US and EU regulators on the lack of value to an enforced migration of OTC CDS trading to a central setting involving a single exchange counterparty for all contracts. The likely result now is at least one or more counterparty arrangements in both the United States and the European Union. As such, a natural addition would be one or more arrangements in Asia.

Finally, Hong Kong’s competitive future largely depends on increasing its role as China’s global financial centre, especially in the context of yuan-denominated transactions, a locus for cross-border fund management, and a supplier of transaction resources to Mainland users. In this respect, Hong Kong has done well so far in receiving support from the central government; related initiatives therefore need to continue. In the long-run, Hong Kong’s financial sector prosperity may depend upon the extent to which it maintains its entrepôt attractions as China’s barriers to cross-border transactions are steadily removed, including the development of Shanghai as an international financial centre by 2020.

C. Reforming Regulatory Structure

One issue bears specific mention: the overarching design and structure of the financial regulatory system. In the context of the financial stability issues which arose during the crisis, given that many issues arose from regulatory gaps (particularly in the supervision of intermediaries by the SFC and HKMA) and balkanization, the first step is to consider the system in a broad and integrated way.
1. **Options**

Overall, a number of lessons have emerged. First, countries must examine the advantages and disadvantages of possible change, including the risks inherent in the change process. Second, a number of basic structures are possible including the traditional sectoral model (with separate regulators for each financial sector, namely banking, securities and insurance, often combined with strict separation or holding company structures for financial conglomerates); the functional model (with separate regulators for each regulatory function – for example, financial stability, prudential, market conduct and competition regulation – catering to financial conglomerates and product innovation); the institutional structure (with separate regulators for different types of financial institutions, most typically adopted, as in Hong Kong, in the context of banks); and the integrated structure (with one or more sectors and/or functions combined in a single agency, often combined with a universal banking model for financial services provision). It cannot be taken for granted that any model is better than any other; this depends on particular circumstances of the jurisdiction.

Under the integrated or single regulator structure, a country has a single financial regulator responsible for all aspects of the financial system and financial supervision. This model has been adopted in the United Kingdom (Financial Services Agency), Japan (Financial Supervisory Agency) and Singapore (Monetary Authority of Singapore). This model works well with universal

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158 For detailed discussion, see Arner & Lin, *supra* note 3.

159 For detailed discussion of major models and their implementation in various jurisdictions, see *ibid*. This analytical division is generally used outside the United States and by the IMF. For an alternative framework of analysis (adopted in the United States), see G-30, *The Structure of Financial Supervision: Approaches and Challenges in a Global Marketplace* (October 2008). Under the G-30/U.S. framework, there are also four models: (1) functional; (2) institutional; (3) twin peaks; and (4) integrated. Under this framework, the “functional” model is largely equivalent to the more generally used “sectoral” model. The “functional” model is largely equivalent to the more generally used “institutional” model. The “integrated” and “twin peaks” model (discussed further below) are equivalent in both the U.S./G-30 and international/IMF formulations. The G-30/U.S. framework does not have an equivalent to the international/IMF “functional” approach. To further complicate matters, in its recent review of regulatory reform options, the U.S. Treasury suggested there are four main options: (1) institutionally based functional regulation (the current U.S. model); (2) activities based functional regulation (a model based on regulators assigned specific functions within the financial system); (3) consolidated regulation (the model in the United Kingdom); and (4) objectives based regulation (the model in Australia). See U.S. Department of the Treasury, *Blueprint for a Modernized Financial Regulatory Structure* (March 2008) [U.S. Treasury Blueprint] at 138-42. As a result, terminology and understanding the definition of that terminology used is of significant importance in this context.

160 In the United Kingdom and Japan, the FSA is a separate agency from the central bank (Bank of England and Bank of Japan, respectively). In this structure, the central bank is responsible for monetary policy and financial stability, while the FSA is responsible for financial regulation.
banking but can also work with other structures of financial intermediary activities and financial conglomerates.

Under the sectoral regulation model, a country has separate regulators for each financial sector (typically, banking, securities and insurance). This model has been adopted in the majority of countries around the world, including the United States and China. This model works best with a system of strict sectoral separation of financial intermediary activities. It is also often used in countries which have adopted the financial holding company model or the parent/subsidiary model. It does not work well with universal banking models. The recent experience of the United States also highlights that it may not be ideal in the context of financial holding company models as well.

Under the functional regulation model, a country has separate regulators for separate functions, including: (1) financial stability regulation; (2) prudential regulation of financial intermediary safety and soundness; (3) financial market conduct; and (4) competition. This model has been adopted in Australia, one of the developed common law countries which did not experience serious financial sector problems in the global financial crisis. Today, financial stability regulation and prudential regulation are often combined in a single agency, with a separate agency responsible for financial market conduct (the “twin peaks” approach). This model has been adopted in the Netherlands and France and is

United Kingdom has also adopted a single statutory framework for the FSA and financial regulation, the Financial Services and Markets Act 2000. In Japan, there are separate statutes dealing with individual financial sectors (banking, securities, insurance etc) but administered by the FSA. In Singapore, the MAS combines the roles of central bank and financial regulation. The statutory framework in Singapore comprises individual laws for each major sector, administered by the MAS.

China has the clearest example: People’s Bank of China (central bank), China Banking Regulatory Commission (CBRC, responsible for banking regulation), China Securities Regulatory Commission (CSRC, responsible for securities regulation) and the China Insurance Regulatory Commission (CIRC, responsible for insurance regulation). In the Mainland, each regulator is established under and responsible for a separate statutory framework, with cross-sectoral activities generally prohibited, though increasingly being allowed especially between banks and securities activities. For fuller discussion, see J. Barth et al. eds., Financial Restructuring and Reform in Post-WTO China (The Netherlands: Kluwer Law International, 2006). The U.S. regulatory system is exceptionally complex and this complexity and resulting overlaps and gaps in jurisdiction are now regarded as significant in the subprime crisis. See U.S. Treasury Blueprint, supra note 159.

In Australia, the Reserve Bank of Australia (RBA) as the central bank is responsible for monetary policy and financial stability, the Australian Prudential Regulatory Agency (APRA) is responsible for regulating the safety and soundness of all significant financial institutions, the Australian Securities and Investments Commission is responsible for market conduct and financial product regulation, and the Australian Competition Commission is responsible for competition/antitrust.

currently being considered in the United Kingdom and was advocated by Henry Paulson, the previous U.S. Treasury Secretary. This model can work with any model of financial intermediary activities and financial conglomerate structure.

Under the institutional regulation model, all activities of a given type of financial intermediary are regulated by one regulator, regardless of the specific type of activity being undertaken. This has not been adopted generally in any system; however, it is frequently adopted for banking regulation. The most common structure resulting from the special systemic risks posed by banks and their activities, whether financial or non-financial, cross-sectoral or not, is regulation by the banking regulator (usually the central bank), with the balance of regulatory responsibility allocated on a sectoral basis. This is the traditional structure which has developed in many jurisdictions, including Hong Kong.

There is no general consensus on which model is best. The fundamental issue is tailoring a country’s financial regulatory structure to its own circumstances and especially its structure for addressing financial intermediary activities and financial conglomerates. The time for this discussion has come in Hong Kong.

Third, there is an important relationship between regulatory structure (and attendant financial and human resources), financial structure (the relative importance of banking, insurance and capital markets and the level of financial development or repression) and the structure of financial institutions (e.g., strict separation of financial sectors versus universal banking).

With this in mind, the second conclusion emerging is that regulatory structure must be designed to coincide with an economy’s financial structure. There must be full coverage of the intermediaries (especially financial conglomerates), functions and risks inherent in a given financial system and in such manner that coincides with the history, culture and legal system of that economy. An additional risk involves financial structure and regulatory design (“financial and regulatory mismatch”). The risk is that a jurisdiction’s financial regulatory structure will not equate with the structure of its financial sector. That is, financial intermediaries will be organized on a basis not appropriately addressed by the regulatory structure. In such circumstances, it is possible that significant risks may develop through financial intermediary operations which are not supervised by the existing structure. For example, in a strict separation financial system, informal financial groups may develop, which in turn are not regulated on a group basis, but only on a sectoral institutional basis, leaving the financial system exposed to the risks of the “group”. It is exactly these sorts of risk which have been highlighted in Hong Kong.

164 See U.S. Treasury Blueprint, supra note 159.
165 For a full discussion of financial structure, see Arner, supra note 43.
Against this background, reform of the existing system in Hong Kong, developed largely through trial and error and resulting in a confusing matrix of sectoral laws and agencies with many gaps and inconsistencies, should result in a more coherent system based upon specific objectives and well-defined roles. In other words, a more functional than traditional sectoral or institutional framework. Such a system could be similar to those adopted in Australia, the Netherlands and France, and presently being considered in the United States. While amalgamation of regulation into a single regulator may at first instance appear attractive in a small jurisdiction such as Hong Kong, it also would have certain disadvantages. Hong Kong has two highly regarded regulatory bodies (the HKMA and the SFC) which have generally been effective in performing their primary mandates. Any merger of these two well-established organizations would be problematic, in that one would dominate (with a consequent reduction in other functions regarded as less important than the dominant organization’s previous functions) or the integration would not succeed (with the two major pre-existing agencies working in parallel albeit under the aegis of a single umbrella).

A “twin peaks” structure, building upon existing regulatory strengths while addressing existing weaknesses would seem preferable for Hong Kong’s specific circumstances. Such an approach would bring together like responsibilities into two main regulatory bodies, one generally responsible for monetary and financial stability and prudential regulation across the financial sector and institutions and the other responsible for consumer protection, market conduct and enforcement activities. The two would in turn be supported by a separate board responsible for compensation arrangements.

Under this proposal, the HKMA could be responsible for monetary stability, financial stability, under an explicit mandate, and prudential regulation and supervision of all financial institutions, including banks, insurance companies and securities firms. Prudential regulation here specifically refers to the supervision of a firm’s capital, liquidity and leverage as part of the means of controlling systemic risk. Thus, the HKMA would, in addition to its existing monetary responsibilities, become the primary regulator of the safety and soundness of financial institutions in Hong Kong, addressing prudential concerns regarding financial conglomerates and other gaps. At the same time, the HKMA’s existing powers of intervention and management of problem financial institutions would be extended beyond banks to cover any systemically significant financial institution, with deposit, investor or insurance consumer compensation arrangements under a separate agency.

As a second element, the SFC (perhaps as a renamed Financial Services Commission) would remain responsible for securities market conduct regulation
and would continue to issue and enforce codes of business practice, although it would no longer be responsible for prudential regulation of securities firms. Furthermore, it would be responsible for regulating all financial products offered across all sectors, including banking, insurance and pensions products, by any financial institution or financial services provider. Thus, all financial products and services would be regulated in a consistent manner. At the same time, there is much to be said for having the Listing Rules managed by HKEx, with its closer connection to the financial industry, and subject to enhanced enforcement powers for the SFC. This is a system which also merits application to the rules of other SROs.

The OCI and MPFA would then be merged into the HKMA and SFC as appropriate, with prudential regulatory functions and personnel moving to the HKMA and market conduct regulatory functions and personnel shifting to the SFC/FSC. SROs would continue to be responsible for developing their various industry rules, but such SRO rules would be subject to regulatory approval and supported by regulatory enforcement authority through statutory backing, along the lines of a strengthened dual filing system or the UK proposals for statutory backing of the Banking Code.

In addition, the HKDPB and the ICC could be merged, in order to ensure equivalent treatment of consumers in the context of financial institution failure, with compensation extended on equivalent terms beyond banking and securities to insurance as well. In this structure, the system would largely run along DPS/ICS lines and thus would require a relatively simple organizational structure.

This reform would not only address financial stability concerns but also issues of regulatory competitiveness. In relation to stability concerns, the majority stem from gaps and inconsistencies resulting from the existing system; these would be addressed by a more coherent functional structure with clearly defined roles and responsibilities. In relation to competitiveness concerns, the proposal would address the major concerns, namely the complexity and expense of dealing with Hong Kong’s existing regulatory framework. Overall, such reform would therefore enhance both financial stability and competitiveness from the standpoint of compliance costs. At the same time, this would represent a major change which may not appeal to the various regulatory agencies comfortable in their roles, local business interests (which often prefer the complexity and opportunities for regulatory arbitrage and advantage it presents) or the Government, given the difficulties in managing the process. However, most consumers (whether individuals or non-local companies and financial firms) would prefer a simpler, clearer, more effective framework. Such a development in the regulatory architecture of Hong Kong would bring about meaningful benefits to consumers, issuers and intermediaries alike, as well as enhancing Hong Kong’s continued international standing as a financial centre. It remains to be seen whether such
comprehensive structural reform beyond the scope of the recent consultations will emerge. As the inquiry by the Legislative Council continues, and public interest in the Minibonds issue wanes, the political impetus for change that existed 12 months ago now seems largely lost on the road to economic recovery.