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ADR and Financial Disputes in Hong Kong: The Lehman Brothers Experience and The Way Forward

This article critically discusses the Lehman Brothers-related Investment Products Dispute Resolution Mediation and Arbitration Scheme and the proposed establishment of a permanent Financial Dispute Resolution Centre in Hong Kong in the light of regulatory gaps and other problems revealed by the Lehman Brothers saga.



DR GU WEIXIA

Introduction and background¹

In September 2008, Lehman Brothers declared itself insolvent by filing for Chapter 11 protection against its creditors under US law. This was the biggest insolvency in US corporate history. The company's share price fell from a peak of US\$85 to 10 cents, helping to trigger a global financial crisis. More than 48,000 Hong Kong investors held approximately HK\$20 billion in investments in structured products (known as 'minibonds') issued or guaranteed by Lehman Brothers. The collapse rendered their investments almost worthless.

Aggrieved investors sought to claim compensation from banks that had sold these products on the basis of alleged mis-selling practices, misrepresentation and fraud. Various existing dispute investigation and resolution mechanisms were, however, unable to deal with investor complaints effectively.

Principal regulators, such as the Hong Kong Monetary Authority (HKMA) and the Securities and Futures Commission (SFC) could investigate complaints and institute disciplinary actions against

intermediaries² but lacked power to award compensation where intermediaries were found guilty of misconduct. The costs of litigation were likely to be disproportionate, cases might take years to conclude and there were the added risks of appeals. Given the imbalance of financial and emotional resources, it was impossible for investors to deal with banks on an equal footing in litigation. Moreover, by contrast with some other jurisdictions³, there was no provision for class actions in Hong Kong. Even where claims that did not exceed HK\$50,000 had been filed in the Small Claims Tribunal, adjudicators took the view that they were beyond the Tribunal's jurisdiction because of the complex legal issues involved.⁴

“The costs of litigation were likely to be disproportionate, cases might take years to conclude and there were the added risks of appeals.”

The Consumer Council also could not assist because investors did not fall within the definition of “consumer” under the Consumer Council Ordinance.⁵

The Lehman Brothers-related Investment Products Dispute Mediation and Arbitration Scheme

Thus, in October 2008, the HKMA appointed the Hong Kong International Arbitration Centre (HKIAC) to administer the Lehman Brothers-related Investment Products Dispute Resolution Mediation and Arbitration Scheme (‘the Scheme’) to resolve minibond claims between banks and investors⁶. The Scheme came into effect on 3 November 2008.

Cases may proceed to mediation under the Scheme where (i) an investor's complaint in relation to Lehman products has been referred by the HKMA and SFC, and (ii) the bank and its customer have agreed to go to mediation under the Scheme.

Mediation under the Scheme is a confidential, voluntary, non-binding and private resolution process in which a mediator helps the parties to reach a negotiated settlement or to narrow the issues in dispute. Opinions, proposals or offers made during the mediation process shall not be disclosed in any subsequent judicial or arbitral proceedings unless the parties or an arbitrator agree otherwise.⁷ If settlement is reached, the parties shall sign a settlement agreement, thus ending the mediation process⁸.

If mediation is not successful, the parties may agree to binding arbitration administered by the HKIAC. Arbitration will then be conducted on a documents-only



basis, with an informal hearing being convened only if further clarifications of facts are considered necessary.⁹

The fixed fees of the Scheme are normally borne equally by the parties, though the HKMA will bear the fees of qualified claimants¹⁰.

As at 18 November 2009, a total of 250 requests for mediation had been made under the Scheme.¹¹ The amounts claimed ranged from some HK\$40,000 to over HK\$5 million. Among them, 85 cases proceeded to mediation, of which 75 achieved full settlement, a settlement rate of over 85%.¹²

Evaluation of the Scheme

To evaluate the success or otherwise of the Scheme, its impacts from a number of different perspectives must be comprehensively considered.

Investors

The Scheme has provided a viable alternative to costly and protracted litigation for investors in achieving their ultimate goal of compensation in the shortest time possible, even if not full compensation. It has significantly shortened the time required to resolve disputes compared with litigation. A maximum of five hours is allocated to mediation; no cases referred to arbitration shall exceed 21 calendar days from referral to final award¹³. These strict time limits considerably lower legal costs and thus make significant savings to investors. Mediation is a versatile means of dispute resolution. One of its advantages is that compensation is not limited to monetary awards; other creative remedies, such as an apology or other types of compensation 'in kind', may result from settlement agreements¹⁴.

Banks

The Scheme is an efficient platform through which banks may resolve mass disputes effectively and expeditiously. Its most direct benefit is to enable full and final settlement without having to disclose commercial sensitive information and thus to save the banks from jeopardy with respect to business reputation and shareholder

confidence. Moreover, customer relationships can be maintained, thus minimising the risk of adverse publicity from hostile demonstrations or media exposés.

The courts

The Scheme has saved court time and resources. It would otherwise take several years to adjudicate each case, with the further likelihood of appeals delaying final conclusion.

“The Scheme has provided a viable alternative to costly and protracted litigation for investors in achieving their ultimate goal of compensation in the shortest time possible, even if not full compensation.” +

Mediators and arbitrators

Dispute resolvers have benefited greatly from the Scheme, having gained considerable publicity both in the finance industry and the community as a whole. It is noted in the *Report on Lehman Brothers-related Investment Products Dispute Mediation and Arbitration Scheme* (the 'Report'¹⁵) that, immediately following the collapse of Lehman Brothers, conventional platforms (eg filing claims to the HKMA and SFC, and in litigation) were preferred by investors over mediation. Reports of deadlocks in conventional dispute resolution and of the successful conclusion of the first mediation case in December 2009 led to a substantial increase in requests for mediation. This indicates that, with adequate promotion and public education, disputant parties will be more receptive of ADR methods. There is likely, in turn, to be an

increase in work opportunities for dispute resolvers in the coming years.

General observations

At first sight, the Scheme has generated benefits all round. It has benefited both investors and banks through efficiency and certainty in concluding settlements, thus fulfilling its original purpose of providing win-win solutions, avoiding long-term confrontation and pacifying investors. Despite the Scheme's statistically high success rate, however, investors seem to remain aggrieved, as street demonstrations outside bank buildings in the Central district of Hong Kong have shown. The Scheme principally served to resolve disputes that arose from the under-regulation of sales by banks of particular high-risk financial products. Without proper government regulation, however, the root of the problem remains and a similar situation may arise in the future. It may be argued that the Scheme has in effect allowed defaulting banks to avoid legal liability by agreeing to compensate victims outside of the courts. Moreover, consumers of financial products in general remain inadequately protected without a well-defined unitary regulatory regime or a permanent external dispute resolution mechanism. This could be detrimental to Hong Kong's image as an international financial centre.

Further steps: a Financial Dispute Resolution Centre

Following widespread complaints over Lehman compensation deals that have been dragging on for over a year and the existence of a regulatory gap, pressure arose to establish an external and permanent resolution mechanism for all financial disputes. The Finance Services and Treasury Bureau of the Hong Kong SAR therefore published a *Consultation Paper on the Proposed Establishment of Investor Education and a Financial Dispute Resolution Centre* (the 'Consultation Paper') in February 2010, having considered recommendations made by the HKMA and SFC in their reports to the Bureau of 2008.



The proposed Financial Dispute Resolution Centre (the 'FDRC') is intended to provide an alternative to litigation for investors. It would administer a dispute resolution service primarily by way of mediation and, failing settlement, arbitration, thus providing a one-stop shop for consumers of financial services to resolve monetary disputes with intermediaries¹⁶. The model is close in conception to the Lehman Brothers Scheme. Financial institutions regulated or licensed by the HKMA or SFC would be compulsorily required to join the FDRC scheme as members. In addition, they would be required to enter into mediation and/or arbitration of a monetary dispute if (i) the claimant so wished, and (ii) the dispute could not be resolved directly between the parties.¹⁷ The FDRC would not have any investigative or disciplinary powers. The HKMA and SFC, as regulators, would continue to deal with regulatory breaches whereas the FDRC would deal with monetary awards. The Hong Kong Government and the regulators would provide the initial set-up costs and operating costs for the first three years of the FDRC's existence. After that, the operating costs would be borne by the financial services industry and, to a lesser extent, by claimant investors themselves.¹⁸

The need for a FDRC in Hong Kong
The proposed FDRC would no doubt be beneficial to Hong Kong's continued strategic development as a competitive and dynamic international financial services centre and conducive to the Government's plan "to promote Hong Kong to be a regional commercial dispute resolution centre"¹⁹.

With the exception of litigation, there is at present no permanent and independent mechanism in place to settle disputes between providers of financial services and consumers of those services. This inadequacy was highlighted by the HKMA as early as April 2001, when it published a comparative study report on banking consumer protection²⁰. At that time,

the Hong Kong Legislative Council took the view that it was premature to set up a UK-type Financial Ombudsman for fear of increasing the operating costs of the industry and the possibility of abuse.²¹ In fact, countries such as Australia, Singapore, the UK and the US have all set up similar bodies since the 1980s, covering banking, insurance and financial planning. Having regard to the complexity of financial activities in Hong Kong, the level of investor grievances and growing support from different sectors, such as the Law Society, HKIAC, the Consumer Council and Legislative Councillors, it is high time for Hong Kong to catch up with other global financial centres in financial dispute resolution.²² In the long run, it is in the interest of Hong Kong's reputation to set up a FDRC to attract potential investors from around the globe and assure them of the city's ability to provide world-class financial dispute resolution services.

“The Scheme principally served to resolve disputes that arose from the under-regulation of sales by banks of particular high-risk financial products. Without proper government regulation, however, the root of the problem remains and a similar situation may arise in the future.” +

FDRC: contentious issues

The arguments for establishing a FDRC in Hong Kong are compelling to many. There are, however, three

particular issues that have aroused debate.

(i) Is the cap for compensation too low?

The Consultation Paper proposes that the FDRC would handle financial disputes up to a maximum of HK\$500,000.²³ The Government has stated that the proposed maximum claimable amount would cover more than 80% of monetary disputes currently handled by the HKMA.²⁴ Critics, however, have said that the cap is too low to protect investors. For example, Phillip Khan, vice-chairman of the Alliance of Lehman Products Victims, has said –

“The limit does not make sense because even many ordinary people in Hong Kong have investments or assets worth \$1M or \$5M... the claim should be at least HK\$5M”.²⁵

This criticism is fair and reasonable. Limits of claim in the UK and Australia are, by contrast, £100,000 (HK\$1,150,000) and A\$280,000 (HK\$1,960,000) respectively, which makes Hong Kong's proposed limit of HK\$500,000 lag far behind. Even if past figures do suggest that the proposed amount would be able to cover most of the cases, it would be more appropriate for a new Hong Kong standard to follow international benchmarks. Only by doing so can Hong Kong continue to develop both as an international financial services centre and as a regional financial dispute resolution centre that is capable of dealing effectively with disputes involving far larger amounts.

(ii) Should a UK-type Financial Ombudsman be adopted?

The proposed FDRC would not have powers of investigation, by contrast with the UK Financial Ombudsman Service (FOS), which has powers both to investigate and to award compensation²⁶. It is submitted that the FOS system is not appropriate for adoption in Hong Kong because



it would lead to a complex and duplicatory regime of regulation. The Law Society of Hong Kong has expressed similar concerns about duplication of powers²⁷. Retaining the powers of the HKMA and SFC to deal with regulatory breaches while introducing a Financial Ombudsman with similar powers would very likely confuse or even jeopardize the effective division of responsibility in financial dispute resolution.

(iii) *Should insurance product claims be excluded from the FDRC scheme?* The FDRC scheme would not handle complaints against products by insurance companies because such complaints are already dealt with by the Insurance Complaints Bureau.²⁸ This exclusion of jurisdiction initially appears reasonable. In the light of common cross-selling practices in the financial services industry, however, the inclusion of insurance disputes would go with the prevailing trend. It may take some time for such a regime to become established, but once it does, the existing insurance disputes mechanism could be removed. A unitary dispute resolution mechanism (such as the FDRC) to oversee all financial disputes would be desirable.

Conclusion

The Lehman Brothers-related Investment Products Dispute Resolution Mediation and Arbitration Scheme has given much meaningful guidance on the future development of financial dispute resolution in Hong Kong. The Government has realised an urgent need to catch up with other jurisdictions in providing an independent dispute resolution mechanism for consumers of financial services and thus enhancing Hong Kong's financial competitiveness.

The consultation period on the FDRC proposals having ended, it is hoped that the Government will consider raising maximum claimable amounts by reference to international standards. Failing to do so will make the scheme uncompetitive. It would also be desirable to include insurance

disputes within the purview of the proposed scheme as part of its continuing development.

“In the long run, it is in the interest of Hong Kong’s reputation to set up a FDRC to attract potential investors from around the globe and assure them of the city’s ability to provide world-class financial dispute resolution services.”

Mediation and arbitration will undoubtedly continue to gain popularity in the resolution of disputes in the financial services sector. The establishment of the FDRC in Hong Kong, which is anticipated in the 2011 legislative year, will be a good start towards a permanent presence for ADR in the sector.

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- 1 For detailed discussion, see A Connerty, *The Credit Crunch: The Collapse of Lehman Brothers and a Hong Kong Scheme to Handle Lehman Claims* [2010] Asian DR 11.
- 2 Under the Securities and Futures Commission Ordinance (Cap 571), s 196.
- 3 For example, the United States.
- 4 ‘Minibond investors fear move spells end for claims’, *The Standard*, 24 March 2009.
- 5 Consumer Council Ordinance (Cap 216), s 2.
- 6 http://www.info.gov.hk/hkma/eng/new/lehman/lehman_dispute.htm (last visited 28 September 2010).
- 7 Rule 5 of the Scheme.
- 8 Rule 10.
- 9 Rule 11(1).
- 10 The fixed fees per case under the Scheme are as follows: (i) mediation: HK\$11,200; (ii) documents-only arbitration:

HK\$16,200 (see section C, para 1 of the Scheme). The fees are normally shared equally by the parties. As to the criteria for payment of the customer's share by the HKMA, see Section A, para 4 and Section C, para 2 of the Scheme.

- 11 Figures provided in an HKIAC press release available at http://www.hkiac.org/newspdf/HKIAC_Year_End_Report_for_2009_from_Secretariat.pdf. *Editorial note:* the *Report on Lehman Brothers-related Investment Products Dispute Mediation and Arbitration Scheme* (note 15 below) states a more precise figure of 88%.
- 12 *Ibid.*
- 13 *Supra*, note 6.
- 14 *Supra*, note 11.
- 15 *Editorial note:* the Report forms Annex 3 to the *Report of the Working Group on Mediation* (Department of Justice of the Hong Kong SAR, February 2010). Reference may be made to the Report for detailed commentary on the operation of the Scheme.
- 16 *Ibid.*
- 17 *Ibid.*
- 18 *Ibid.*
- 19 *Report of the Working Group on Mediation* (note 15 above).
- 20 *Comparative Study on Banking Consumer Protection and Competition Arrangements in the UK, Australia and Hong Kong – Role of the Financial Regulator and Regulation of Market Conduct* - <http://www.info.gov.hk/hkma/eng/speeches/speechs/joseph/20010503e1b.doc>.
- 21 Briefing by the Chief Executive of the Hong Kong Monetary Authority to the Legislative Council Panel on Financial Affairs, available at http://www.info.gov.hk/hkma/eng/speeches/speechs/joseph/20010503e_index.htm.
- 22 *Consultation Paper on FDRC – Submission of the Law Society*, issued by the Mediation Committee of the Law Society of Hong Kong, 27 April 2010.
- 23 *Supra*, note 21.
- 24 *Ibid.*
- 25 ‘Cap for dispute resolution too low’, *South China Morning Post*, 10 February 2010.
- 26 ‘Slow progress in financial sector reform’, *South China Morning Post*, 12 September 2009.
- 27 *Supra* note 22.
- 28 ‘More than apples at stake on compensation’, *South China Morning Post*, 23 February 2010.
- 29 The author wishes to thank the Ministry of Education Humanities Grant (Account Code: 09YJA820022) and the University of Hong Kong Seed Funding for Basic Research Grant (Account Code: 10400772.50213.18100.301.01) for financially supporting this research. The author also thanks Ms Carol Wong for her assistance in preparing this article.