

Dated 19 May 2010

To the Subcommittee to Study Issues Arising from
Lehman Brothers-related Minibonds and
Structured Financial Products of the Legislative Council

**RESPONSE TO THE SUBCOMMITTEE'S LETTER DATED 12 MAY 2010 FROM
MR HUNG PI-CHENG, BENJAMIN, EXECUTIVE DIRECTOR AND CHIEF EXECUTIVE OFFICER,
STANDARD CHARTERED BANK (HONG KONG) LIMITED (SCBHK)**

FOLLOW-UP TO THE HEARING ON 11 MAY 2010

1. ***As stated in paragraph 21.1 of W30(C), SCBHK decided to put on hold the sales of Lehman Brothers (LB) equity linked notes (ELNs) on 5 June 2008. Please provide relevant document(s) that recorded this decision.***
 - 1.1 On 2 June 2008 when LB's credit rating was downgraded by Standard & Poor's from A+ to A, the Bank sought further information from LB on 3 June 2008, in line with its normal business practice. LB replied on 4 June 2008, essentially stating that the impact of Standard & Poor's downgrade on Lehman Brothers' funding and liquidity was limited. As part of the Bank's ongoing review process, if an issuer's credit rating was downgraded, HKWM team would internally assess the impact and, where necessary, decide on an appropriate action plan to take. In view of market uncertainty, HKWM decided to temporarily put on hold the distribution of LB ELNs, being one of the twenty approved suppliers of structured products, pending further developments.
2. ***Regarding the liquidity of the LB ELNs in the secondary market before the collapse of LB in September 2008, please provide the following information:***
 - (a) ***the number of requests from customers of SCBHK for early redemptions of LB ELNs;***
 - 2.1 Based on the Bank's records, from August 2006 to September 2008, there was a total of 40 queries in relation to the unwinding of LB ELNs, in respect of which a secondary market pricing was quoted from the issuer and provided in response to each of these queries.
 - (b) ***the number of early redemptions of LB ELNs effected and the month/year in which such redemptions took place; and***
 - 2.2 Two requests for unwinding LB ELNs were executed in August 2008 and September 2008 respectively.
 - (c) ***the exit prices of the early redemptions in (b) above.***
 - 2.3 The exit price of the first early redemption referred to in paragraph 2.2 above was 77.75%. The exit price of the second early redemption was 77%.
 3. ***It is noted that SCBHK did not have sales targets specific to LB ELNs for sales staff (paragraph 45.20 of W30(C)). Please explain how SCBHK could work out and achieve its overall sales targets without any specific sales targets set for particular products.***
 - 3.1 The Bank had an overall revenue target for each frontline staff with no designated sales revenue targets for specific products. In other words, the sales staff could achieve the overall revenue target through the sale of any products including deposits, loans, investment products, insurance and credit cards. To encourage a balanced portfolio, the Bank provided an indicative portfolio split to guide sales staff. It is worth noting that the LB ELNs accounted for less than 1% of the total revenue for Consumer Banking, and in aggregate, net interest income accounted for more than 60% of the total revenue during the Relevant Period.
 4. ***As stated by Mr Benjamin HUNG at the hearing on 11 May 2010, apart from the simplified version of the personal financial profile (item 16 of W30(C)), there is a fuller version for the overall financial profiling of a customer. Please provide a sample copy of this fuller version.***

4.1 A sample copy of the full version of the personal financial profile is enclosed as item 1. This version would be offered to customers where they were willing to fully disclose to the Bank their overall financial positions, including details of their assets, liabilities, income and expenses, etc. It is to be noted that the SA form is the same for both versions.

5. ***Please provide the date of issue of each set of training materials at the Annexes of item 15 of W30(C).***

5.1 Below are the dates of issue for the submitted versions.

Nature	Date of issue
5Cs Sales Process	2004
Financial Market & Instruments – Debt Securities	January 2008
Structured Product Training	September 2005
Structured Notes Training	June 2008
Investment Product Sales Process	July 2008
Suitability Assessment Training Guide	June 2007
SFC Code of Conduct and Regulatory Requirements	April 2008
Suitability Training and Mis-selling	October 2007
Group Code of Conduct – Leading by Example	July 2008

6. ***It is noted that the training material in Annex 7 to item 15 of W30(C) was used in April 2008. Please provide a copy of the relevant training materials for 2006 and 2007.***

6.1 Please refer to item 2 enclosed.

Description	Date
SFC Code of Conduct	September 2006
SFC Code of Conduct	August 2007

7. ***As stated by Mr Benjamin HUNG at the hearing on 11 May 2010, three rounds of internal audits were conducted during the period between 2006 and 2008 in respect of the sales and distribution of investment products and wealth management. Please provide the key findings of these three rounds of internal audits.***

7.1 During the Relevant Period, there were three audits undertaken by Internal Audit specifically related to the sale of investment products. Key findings are set out below:

2006

In 2006, Shared Distribution of Hong Kong was audited by Internal Audit. Overall this was a pass audit and rated 'improvement required'. No significant issues were raised in respect of the sales and distribution of investment products and wealth management.

2007

In 2007, Hong Kong Investment Services was audited by Internal Audit. Overall this was a pass audit and rated 'satisfactory'. There were no high risk findings. The following key findings were reported – all were rated medium risk:

- Risk Categorization of Unit Trusts

HKWM was using the old unit trust risk rating methodology (based on a 3 year historical observed volatility) instead of the new Group initiated risk classification. This was resolved when the Group Suitability Assessment tool was launched in the same year incorporating such risk classification methodology.

- Monitoring Investment Switching Activities

There was a need to detect any potentially excessive funds switching activity and thus whether such switching was appropriate at all times. The issue was resolved through the development of a monthly report aimed at identifying irregular activities.

- Security Matrix of Unit Trust System

Investment Services Operations Centre officers were granted account maintenance functions in the Unit Trust System but this was not reflected in the security matrix. This was duly resolved when the security matrix was updated to reflect actual access granted.

2008

In 2008, a Product Suitability review was conducted by Internal Audit. Overall, this was a pass audit and rated 'improvement required'. Due to a change in audit methodology, specific findings were no longer risk rated. The report contains 2 key findings:

- 2nd Checker Control

The 2nd check for sales transactions was performed only for vulnerable customers and not for other situations such as large ticket transactions. Internal Audit recommended that there should be additional controls, and the following additional safeguards were agreed with and implemented by management:

- Use of 2nd checker control should be extended beyond transactions with "vulnerable" customers for example, to include large value transactions; and
- The 2nd checker would reiterate the need to understand the product features and their associated risks.

- Updating of Suitability Assessments (SA)

Letters had been sent out to customers requesting that they come into the branches to complete an updated suitability assessment. However, it was not clear what action had been taken by the Bank where an update instruction was not received from the customer. This was resolved by instituting a procedure whereby purchase transactions on the account would be suspended until the update instruction had been received from the customer.