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Our Ref.: B1/15C

23 October 2008

The Chief Executive  
Retail banks on the distribution list

Dear Sir/Madam,

**Selling of investment products to retail customers**

Following my earlier correspondence on investment products related to Lehman Brothers, I am writing to reiterate the general requirements for authorized institutions ("AIs") that sell securities and investment products and draw your attention, in particular, to a few key issues to which your institution should pay particular attention when selling these products to retail customers.

AIs selling securities and investment products must ensure that they have adequate effective controls and procedures for continuing compliance with the requirements of the Securities and Futures Ordinance, the rules issued pursuant to that Ordinance, and the relevant Code of Conduct issued by the Securities and Futures Commission. In addition, such AIs must comply with the requirements set out in our Supervisory Policy Manual module SB-1. Specifically on the sale of investment products, the Hong Kong Monetary Authority ("HKMA") has also issued a number of circulars to AIs (see Annex) to provide practical guidance on the expected standards and good practices. We expect that your institution will have sufficient resources to monitor and enforce compliance with these requirements.

Specifically, I would like to emphasise a few points which AIs should pay particular attention to when selling investment products to retail customers.

- (1) AIs should exercise extreme care when offering investment products to customers as an alternative to time deposits (such as when customers are proposing to renew their deposits). Apart from the implications of "cold-calling" where the customers have hitherto not opened an investment account, AIs' staff should refrain from making representations which may be taken to mean that the investment product is "equivalent or similar to a deposit". Any proposal for the sale of investment products to customers must be made by a qualified staff member and based upon proper assessment of customer suitability, having regard to the investment objective and experience, and risk profile of the customer, and

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must be accompanied by a clear explanation of the key features and risk profile of the suggested products. Further, AIs must take into account the proportion represented by the customer's investment in a particular investment product to the customer's total assets when assessing product suitability for the customer. The complexity of the investment product must be taken into account when assessing product and customer suitability. AIs must have appropriate procedures to assure themselves that customers have a reasonable understanding of the nature, structure, and risk of the products before selling those products to their customers. In exceptional cases where a customer chooses to buy an investment product with a higher risk grading than his own previously advised risk appetite, AIs must maintain enhanced records (such as tape recording) to demonstrate that the customer is fully aware of the choice he is making and the associated risks involved. Signing of a document containing risk acceptance or risk mismatch acknowledgement by the customer only is not sufficient for this purpose.

- (2) According to the standard set out in the Questions and Answers on Suitability Obligations issued by the SFC in May 2007<sup>1</sup>, AIs should perform continuous review of the risk ratings assigned to investment products offered to customers, and make revisions to the risk ratings as appropriate, taking into account latest market conditions and other relevant factors. As a matter of good practice, where a higher risk rating is assigned to an investment product as a result of such review exercise, AIs should take appropriate action to alert the affected customers to such changes in a timely manner.
- (3) AIs should ensure that customers are fully aware of the issuer risk associated with the investment products offered. Where the investment products involve or have embedded in them financial derivatives, the risks pertaining to the counterparties of such derivatives should also be adequately and clearly explained. Illustrations covering scenarios of potential maximum losses, such as arising from the failure of the issuer or any reference entities, must be clearly explained to the customer. To help ensure that frontline staff members are complying with proper selling standards, AIs should conduct regular reviews of a reasonable sample of cases and an appropriate level of "mystery shoppers" exercise.
- (4) As mentioned in our previous circular, AIs should have enhanced policies and procedures for the selling of investment products to more vulnerable customers, which include the elderly (i.e. aged 65 or above), the uneducated (or those with only elementary or relatively low level of education) and those who have limited means. AIs should exercise extra care in selling investment products to these customers. Among other things, there should be more than one frontline staff member handling the sale to such a customer, in order to ensure that the due selling process is being followed. The customer should also be accompanied by a family member, a close relative or friend, to help ensure that the customer understands the risks of taking on such a product. The selling process to

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<sup>1</sup> According to this document, institutions should ensure that product due diligence is conducted on a continuous basis at appropriate intervals having regard to the nature, features and risks of investment products.

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- vulnerable customers, covering the explanation of the nature, structure, and risk of the investment product should be tape-recorded as evidence of the explanation given at the time of the sale. AIs should also put in place independent monitoring procedures to review these transactions on a sample basis. Suitable follow-up actions should be taken immediately if any irregularity is identified.
- (5) AIs should take into account latest market conditions and critically review any sales target imposed on frontline staff for selling investment products, and the appropriateness of any incentive schemes associated with such target. In particular, incentive schemes should not be linked solely to sales volume and should take into account the relevant staff's compliance with the applicable statutory and regulatory requirements. If your institution is acting as an agent, it is required to disclose the amount of commission earned in each transaction in the relevant contract note. Alternatively, it should disclose in the contract note the fact that it is acting as principal in the transaction.

Separately, regarding the complaints received by your institution relating to Lehman related investment products, I would like to remind your institution that all customer complaints should be handled in a fair and speedy manner as required under the Code of Banking Practice and our Supervisory Policy Manual module IC-4. The requirement of the HKMA is that institutions should normally send a final response to the customer within 30 days after receiving his or her complaint. Up to 60 days is allowed for the final reply in more complicated cases, but the institution should give the complainant an interim reply within 30 days explaining why a longer period is required and indicating when it expects to be able to provide a final response. The HKMA expects that institutions should strictly adhere to this timeline and be as helpful as possible to the customers concerned, in particular, the vulnerable customers.

Your institution is required to review its internal arrangements to ensure that the above requirements are being complied with.

Yours faithfully,

Nelson Man  
Executive Director  
(Banking Supervision)

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### Annex

Circulars issued by the Hong Kong Monetary Authority on the selling of investment products by authorized institutions (AIs)

- (1) Circular of 1 March 2005 "The Securities and Futures Commission's Report (the Report) on Selling Practices of Licensed Investment Advisers": requires relevant AIs to ensure compliance with the recommendations in the Report.
- (2) Circular of 3 March 2006 "Retail Wealth Management Business": shares with all AIs the examination findings and industry good practices on retail wealth management. These include compliance with the relevant codes and guidelines, customer profiling, product suitability assessment, risk disclosure (including additional precautionary measures when selling retail wealth management products to vulnerable customers, e.g. the elderly).
- (3) Circular of 1 March 2007 "Thematic Examinations on Investment Advisory Activities": draws relevant AIs' attention to the issues and good practices identified in thematic examinations on investment advisory activities. These include customer profiling, product suitability (matching of product risk rating with client's risk tolerance level), classification of vulnerable clients, provision of product documents, management supervision, monitoring of compliance and staff competence.
- (4) Circular of 7 May 2007 "Questions and Answers on Suitability Obligations Published by the Securities and Futures Commission (SFC)": requires relevant AIs to review systems and practices in their wealth management and investment advisory activities to ensure compliance with the standards set out in the SFC's Frequently Asked Questions on suitability obligations.
- (5) Circular of 1 June 2007 "The Securities and Futures Commission's Report on Findings of Second Round of Thematic Inspection of Licensed Investment Advisers (the Report)": requires relevant AIs to ensure compliance with the regulatory standards stated in the Report.
- (6) Circular of 23 September 2008 "Investment products related to Lehman Brothers": urges relevant AIs to properly deal with customers' enquiries and complaints about investment products, and requires them to review the risk level of investment products and the selling process and to implement enhancements where necessary.