

Chapter 5 Distribution of Lehman Brothers-related Minibonds and structured financial products by retail banks to their customers

Introduction

5.1 This chapter examines the distribution of LB-related Minibonds and structured financial products by retail banks, having regard to the regulatory standards set out in the Code of Conduct¹, Internal Control Guidelines², Suitability FAQ³ and other relevant guidelines. In examining issues related to the distribution of LB structured products by banks, the Subcommittee is not tasked to look into individual complaints, nor to adjudicate on the liability of any person or institution. The Subcommittee has adopted a theme-based approach to analyze the evidence given by 55 witnesses from (i) the top/senior management of six selected banks; (ii) the frontline staff of selected branches of these six banks; and (iii) customers who had purchased LB structured products through these six banks⁴. It is not the intention of the Subcommittee to obtain evidence from the three groups of witnesses in relation to particular cases or transactions, or to verify details of individual cases and transactions with the evidence obtained. The purpose of the thematic analysis of the evidence is to understand the policies and practices implemented by retail banks in distributing LB structured products, and to find out what had transpired in the process of the sale of the products to customers. The Subcommittee has also made some observations on the thematic issues under study.

¹ Please see paragraph 3.10 of Chapter 3 and paragraphs 4.27 and 4.30 of Chapter 4 about the Code of Conduct.

² Please see paragraph 4.28 of Chapter 4 about the Internal Control Guidelines.

³ Please see paragraph 3.10 of Chapter 3 and paragraphs 4.29 to 4.30 of Chapter 4 about the Suitability FAQ issued by SFC in May 2007.

⁴ Please see paragraphs 1.16 to 1.25 of Chapter 1 about the Subcommittee's selection of the six banks and the relevant witnesses.

Overview of the distribution of LB structured products by the six banks

5.2 The Subcommittee has noted from the evidence given by the management of the six banks that they distributed LB structured products during different periods between 2002 and 2008. The period during which LB structured products were distributed by the six banks ranged from the shortest duration of about 15 months (March 2007 to June 2008) to the longest of some 67 months (July 2002 to February 2008). It is noted that LB structured products were most widely distributed by the six banks between August 2006 and June 2008.

5.3 As explained in Chapter 2⁵, among the six banks, one was the major distributor of Minibonds⁶ and another was the major distributor of LB-CLNs⁷. Minibonds and LB-CLNs were the LB structured products most widely distributed by public offer. The other four banks mainly distributed LB structured products (mostly LB-ELNs) by way of private placement, accounting for a substantial portion of the total investment in such products that remained outstanding at the collapse of LB in September 2008. Most of the LB structured products were first introduced to the banks by the Product Team of LB. Some banks⁸ were first introduced to Minibonds by the co-ordinating distributor⁹ of the product. As informed by the major distributor of LB-CLNs, the product was first introduced to it by the arranger of the product¹⁰. According to the six banks, it was usually the issuer or the arranger that decided whether the LB structured products in question were to be distributed in Hong Kong by way of public offer or private placement.

⁵ Please see Appendix 2(c) of Chapter 2 about the major distributing banks of certain outstanding LB structured products.

⁶ BOCHK, accounting for 43 % of the value of outstanding Minibonds sold by banks.

⁷ DBSHK, accounting for 59 % of the value of outstanding LB-CLNs sold by banks.

⁸ DSB and RBS.

⁹ Please see paragraph 2.6 of Chapter 2.

¹⁰ Please see paragraph 2.11 of Chapter 2.

5.4 In response to the Subcommittee, the reasons given by the six banks for deciding to distribute LB structured products included the following:

- (a) LBHI was highly rated by credit-rating agencies (e.g. it was rated A1 by Moody's until July 2008, and rated A+ by Standard & Poor's until June 2008). LBHI was one of the key suppliers in structured financial products in the region. The arranger, LBAL, was a well-known and active arranger of structured financial products.
- (b) Distributing LB structured products was in response to customers' interest and to provide greater choices to customers in terms of product types and issuers. Customers would have more options to meet their demand for higher yield products when the prevailing interest rates were low.
- (c) In deciding to act as distributors of LB structured products, the potential increase to non-interest income was only one of the factors considered by the banks. For example, some banks indicated that during the period when LB structured products were distributed, such products only accounted for about 0.9% to 3.8% of the total sales value of the investment products distributed by them.

5.5 The Subcommittee has noted from the evidence of the management of the six banks that the major distributing bank for LB-CLNs¹¹ ceased distributing the product in September 2007, some 19 months after it first distributed the product in February 2006. Four other

¹¹ DBSHK.

banks¹² ceased distributing LB structured products between March to June 2008. These banks ceased offering LB structured products mainly because of market volatilities, the downgrading of LB's credit ratings and the internal policy to avoid over-concentration on distributing the structured financial products issued by a single issuer. The remaining bank¹³, which first distributed LB structured products in June 2003, continued to distribute these products until early September 2008, and only ceased distribution after it became aware of a negative watch warning issued by a credit-rating agency against LBHI, which implied that the credit rating of LBHI might be further downgraded.

Product due diligence

Regulatory requirements

5.6 According to GP2 of the Code of Conduct, intermediaries should act with due skill, care and diligence and in the best interests of customers when conducting their business activities. As elaborated under Question 3 of the Suitability FAQ issued by SFC in May 2007, intermediaries should develop a thorough understanding of the structure of investment products, including how they work, the nature of the underlying investments, the level of risks they bear and the liquidity of the products. Other factors which intermediaries need to consider include market and industry risks, economic and political environments and any other factors which may impact on the risk-return profiles of the investments. Where necessary, intermediaries should make their own enquiries and obtain explanation from the issuers about the products instead of relying on prospectuses and marketing materials only. Intermediaries should document in which aspects the products are considered suitable for different risk categories of investors.

¹² BOCHK, CHKL, RBS and SCBHK.

¹³ DSB.

Intermediaries should also ensure that product due diligence is conducted on a continuous basis having regard to the nature, features and risks of investment products.

Relevant evidence

Approval of LB structured products for distribution

5.7 The Subcommittee notes from the evidence of the top/senior management of the six banks that internal approval was required for the distribution of new products including LB structured products. Most of the six banks¹⁴ approved the products on a series-by-series basis. According to a bank that had distributed LB-ELNs by private placement¹⁵, the distribution of investment products (including LB-structured products) required approval by the group wealth management of its banking group, and each series of the same product was reviewed and approved. The major distributor of Minibonds¹⁶ informed the Subcommittee that since October 2006, an investment product steering committee under the retail banking department of the bank has been responsible for approving each series of LB structured products. According to the major distributor of LB-CLNs¹⁷, the decision to distribute LB-CLNs as a product type was made by a resolution of its board of directors while the subsequent decision to distribute each series of the product was made by the bank management. However, the Subcommittee notes that one of the banks¹⁸ only required approval of the distribution of new product types by its senior management. Distribution of individual series of the same product did not require separate or further approval.

¹⁴ BOCHK, CHKL, DBSHK, RBS and SCBHK.

¹⁵ SCBHK.

¹⁶ BOCHK.

¹⁷ DBSHK.

¹⁸ DSB.

Conducting due diligence on LB structured products

5.8 According to the evidence of the management of the six banks, product due diligence for LB structured products was conducted as part of a bank's internal approval process to distribute these products to customers. The matters reviewed by the six banks in the process of conducting product due diligence included the following:

- (a) Product features – the product tenor, coupon payment and early redemption scenarios, percentage of capital protection and the guarantor, fees and charges on customers, secondary market, and where applicable the reference entities (and their credit ratings), underlying assets and collaterals.
- (b) Risks to customers – market risk, credit risk, interest rate risk, currency risk, liquidity risk, re-investment risk if the notes were redeemed by the issuer before maturity, issuer risk, settlement risk if the issuer or counterparty fails to settle the notes, concentration risk¹⁹, sovereign risk and foreign exchange risk.
- (c) Suitability for customers – client base (e.g. institutional, corporate or retail customers), customers' age, location, net worth, investment objectives and horizon, investment experience, risk appetite and their understanding of the product.
- (d) Risks to the bank – market risk, legal and compliance risk, operational risk, counterparty risk, reputational risk, systems risk, procedural or fraud risk arising from

¹⁹ Customers may face a concentration risk if a large portion of their funds is invested in financial products of the same issuer. They may face the risk of losing their investment should that specific issuer default.

mis-selling, documentation risk, and the concentration risk to the bank.

- (e) Financial considerations for the bank – market analysis, commission receivable, revenue and expense projections, diversification of liability base or asset portfolio of the bank, capital requirements (e.g. system enhancement), accounting and tax implications.
- (f) Legal/regulatory implications on the bank – compliance with the local laws and regulations, cross-border regulatory requirements, disclosure/reporting obligations.
- (g) Requirements on the issuer or the counterparty – its credit rating, ability to price and launch structured products in the market, and provision of suitable offer documentation. For instance, one of the six banks²⁰ required that a product issuer should have a credit rating equal to or better than single A (or equivalent) by Standard & Poor's or Moody's, whereas another bank²¹ stipulated that its counterparties must have a minimum credit rating of A- by Standard & Poor's or A3 by Moody's.

Individual banks might have taken into account all or some of the above factors when reviewing LB structured products.

5.9 The procedures in performing product due diligence varied among the six banks. For instance, for the bank which distributed LB-ELNs and LB market-linked notes (MLNs) by private placement²², new product types distributed by the bank had to undergo a product due diligence process at the global, regional and local levels. The regional

²⁰ DSB.

²¹ BOCHK.

²² CHKL.

and global product committees of the banking group would assess the commercial viability and risks of new product types and their suitability for distribution to retail customers. In addition, the local product team of the bank would prepare a product programme to address regulatory, business, risks and operational issues relating to the distribution of the product in Hong Kong. According to the management of another bank which distributed LB-CLNs²³, its local product team would work with the product experts from the banking group in undertaking product due diligence for new product types and new series of the LB-CLNs. According to the major distributor of Minibonds²⁴, its local product teams/committees comprising qualified staff with extensive relevant market experience conducted product due diligence in accordance with the bank's product due diligence guidelines. This bank also informed the Subcommittee that its teams/committees would make enquiries with the product issuer/arranger/co-ordinating dealer or obtain information from independent sources to help evaluate the product structure and features.

5.10 The Subcommittee has examined some of the papers documenting the product due diligence conducted on LB structured products. It is noted that in seeking approval to distribute Minibonds Series 27, the product team of one bank²⁵ prepared a four-page summary in Chinese giving a very short description of the features and six major risks of the product. The summary also contained a statement that the product was not suitable for investors with low or medium risk tolerance levels and elderly or inexperienced investors. It also mentioned briefly the marketing strategy and the preparation of a VCD by the training centre of the bank. The product team of another bank which distributed LB-ELNs and LB-MLNs²⁶ prepared a 41-page product programme for seeking approval on the distribution of structured notes (which included

²³ DBSHK.

²⁴ BOCHK.

²⁵ BOCHK.

²⁶ CHKL.

LB structured products). The product programme gave an analysis of eight types of risks associated with structured notes to the customers and 12 types of risks to the bank. The Subcommittee has noted that one bank²⁷ had included only "liquidity risk" under the heading of "Product Risks to the Customer" in its product approval plan when reviewing and seeking approval to distribute a non-principal-protected LB-ELN.

Risk ratings of LB structured products

5.11 According to the evidence of the six banks, each of them had their own methodology for assigning risk ratings to investment products, including LB structured products. The practices and procedures were documented. In this connection, the Subcommittee notes that one of the banks²⁸ did not introduce a formal risk rating to the LB structured products it offered until August 2004, which was some two years after it first distributed LB structured products. Another bank²⁹ had distributed LB structured products since June 2003 but there was no quantitative risk classification for these products until October 2007.

5.12 The risk ratings adopted by the six banks ranged from three to seven tiers. For instance, one of the banks³⁰ adopted a three-tier scale to categorize the risks of its products as "Conservative", "Balanced" or "Growth". Another bank³¹ classified its investment products into seven risk categories from "A" (lowest risk) to "F" (highest risk) and "P" for products with principal-protection at maturity. Some of the factors considered by the six banks in risk-rating investment products included the level and quality of principal protection of the product at maturity, the tenor of the product, and the quality of the underlying assets.

²⁷ DSB.

²⁸ BOCHK.

²⁹ DSB.

³⁰ RBS.

³¹ SCBHK.

5.13 The Subcommittee notes that five of the six banks³² had assigned a high-risk rating to non-principal-protected LB structured products such as Minibonds and LB-ELNs, taking into account their non-protection of principal, exposure to liquidity and credit risks, and where applicable, collateral asset risks, and volatility of the underlying stocks etc. It is noted that one bank³³ had assigned a "Level-2" rating (low to medium risk) to non-principal-protected LB-CLNs on its 5-level risk rating scale. The reasons as stated by the bank management were that the reference entities and collateral of the notes were all of high credit quality at the time of issue and the product risk was considered similar to the risk of a conventional corporate bond of investment grade. This bank had produced an expert opinion in support of its "Level-2" risk rating of the LB-CLNs³⁴. However, it is noted that the same product distributed by another bank³⁵ was assigned a "Grade-4" risk rating, the highest on the bank's 4-grade risk rating scale.

Continuous assessment

5.14 As stated by the management of two of the six banks³⁶, they had conducted continuous assessment of the LB structured products by reviewing their mark-to-market prices or indicative bid prices, and reviewing the credit quality of the reference entities and collaterals or the credit rating of the product issuer. One other bank³⁷ however stated that it did not consider it necessary to undertake periodic product evaluation review for LB-ELNs as they were close-ended products with fixed tenors.

5.15 The Subcommittee notes that five of the six banks³⁸ had ceased distribution of LB structured products in or before June 2008.

³² BOCHK, CHKL, DSB, RBS and SCBHK.

³³ DBSHK.

³⁴ The report of the expert opinion was dated 20 January 2010.

³⁵ BOCHK.

³⁶ CHKL and DBSHK.

³⁷ SCBHK.

³⁸ BOCHK, CHKL, DBSHK, RBS and SCBHK.

The remaining bank³⁹ had continued to distribute LB structured products until a negative watch warning was issued by Standard & Poor's against LBHI on or about 10 September 2008. When asked by the Subcommittee on the reasons for continuing to distribute LB structured products after June 2008, the top/senior management of this bank responded that this was because LBHI could still meet the bank's minimum requirement on the credit rating of an issuer.

5.16 Upon being asked by the Subcommittee whether they had alerted customers of LB structured products about LB's worsening financial situation in about mid 2008, the management of two of the six banks⁴⁰ said that information relating to the downgrading of LBHI's credit rating was already available in the public domain and reported by the media. According to most of the six banks⁴¹, they had provided updates on the mark-to-market or indicative bid prices of the LB structured products, which could reflect the market value of these products, via monthly statements to the customers or on the websites of the banks. One of these banks⁴² stated that upon receipt of information from the arranger about the change in the credit rating of collaterals for certain series of LB-CLNs, it had issued a notice to the relevant customers.

5.17 As stated by the six banks, before the collapse of LB, they had received and executed requests from their customers from time to time to dispose of the LB structured products before maturity. According to two of the banks⁴³, in response to such requests, they would quote the indicative bid price to customers for their consideration. One of the six banks⁴⁴ testified that out of the 604 requests for early redemption of Minibonds during the period from May 2003 to mid September 2008, it

³⁹ DSB.

⁴⁰ CHKL and SCBHK.

⁴¹ BOCHK, CHKL, DBSHK, RBS and SCBHK.

⁴² DBSHK.

⁴³ SCBHK and RBS.

⁴⁴ BOCHK.

had executed 595 such requests. The exit prices for different series of the Minibonds varied over time and most of them exceeded two-thirds of the original investment amount. Another bank⁴⁵ received and executed two requests for unwinding LB-ELNs in August and September 2008 at an exit price of about 77% of the principal.

Observations

5.18 The Subcommittee has found that all the six banks had put in place policies and procedures for conducting due diligence on LB structured products, and this was often done in connection with the seeking of approval to distribute the products. The practices and methodology of conducting the due diligence exercise, as well as the thoroughness of such exercise, varied among the six banks.

5.19 As it was often the case that product due diligence had been done by the six banks as part of its process of seeking approval to distribute the LB structured products, the Subcommittee has found from the relevant documentation that in reviewing the LB structured products, the banks had analyzed the risks, as well as the costs and benefits to the banks as a result of their distribution of such products. However, as described in paragraph 5.10 above, the documents examined by the Subcommittee did not clearly show in which aspects the products were considered suitable for different risk categories of investors, as required under the Suitability FAQ.

5.20 One of the banks⁴⁶ stated in the approval document for the distribution of Minibonds Series 27 that the product was not suitable for investors with low or medium risk tolerance levels and elderly or inexperienced investors. However, this statement was not found in the approval documents for some other series of the Minibonds⁴⁷ offered by

⁴⁵ SCBHK.

⁴⁶ BOCHK.

⁴⁷ Minibonds Series 9 to 12, 15 to 23 and 30 to 33.

this bank. In this connection, the Subcommittee notes that among the customers purchasing Minibonds from this bank, about 15% of them were aged 65 or above.

5.21 The Subcommittee has noted that it was up to individual banks to assign risk ratings to LB structured products after performing their own product due diligence. However, as described in paragraph 5.13 above, it is difficult to justify the different ratings of the same non-principal-protected LB-CLNs by different banks. The Subcommittee is of the view that LB-CLNs, which were non-principal-protected and linked to underlying assets, should not be rated as a product of low or medium risk. Inconsistency in risk rating by different banks of the same products would disadvantage investors in that an investor with a relatively conservative risk tolerance level might not be able to acquire the LB-CLN at one bank, but could do so at another bank which had set a lower risk rating on the same product. This undermined the effectiveness of product risk rating as an aid in determining the suitability of a product for investors, and weakened suitability assessment as a cornerstone of investor protection. Given the importance of product risk rating as an important link in investor protection, the Subcommittee is of the view that the regulators should consider introducing some form of benchmarking to achieve broad consistency.

5.22 As described in paragraph 5.6 above, intermediaries are required under the Suitability FAQ to conduct product due diligence on a continuous basis. Hence, the Subcommittee considers that distributing banks should perform product due diligence in respect of each series of a product because there could be considerable variation in product structure and risks between individual series, such as the different series of Minibonds issued after 2002 and before 15 September 2008⁴⁸. As changes in market conditions might have a significant impact on various

⁴⁸ Please see paragraphs 2.7 to 2.10 of Chapter 2 about the product structure and risks of Minibonds.

investment products, banks should perform continuous review of the risk ratings assigned to the products offered to customers, and where appropriate, take action to inform the affected customers⁴⁹.

Staff training and guidance

Regulatory requirements

5.23 As stipulated in Section III of the Internal Control Guidelines, intermediaries should establish appropriate personnel recruitment and training policies to ensure that their staff are fit and proper to perform the relevant duties and comply with the applicable regulatory requirements. The sales staff should be provided with adequate training to, amongst others, enable them to properly understand the products that may be sold to customers and to assess the suitability of the products for the customers. The management of intermediaries should also ensure that suitable training is provided both initially and on an ongoing basis.

5.24 As stipulated in the Guidelines on Competence issued by SFC in March 2003, the minimum academic and industry qualifications of an ReI are passes in English/Chinese and Mathematics in the Hong Kong Certificate of Education Examination or its equivalent, and a pass in one of the recognized industry qualifications⁵⁰. These qualifications can be compensated by a university degree or other internationally recognized

⁴⁹ According to the letter issued by HKMA to a number of RIs on 23 October 2008 after the collapse of LB, RIs should perform continuous review of the risk ratings assigned to investment products offered to customers. Where a higher risk rating is assigned to an investment product as a result of the review, the RIs should, as a matter of good practice, take appropriate action to alert the affected customers to such changes in a timely manner. This letter was brought to the attention of other RIs as an enclosure to a circular issued by HKMA on 11 December 2008. The circular is available on HKMA's website at <http://www.hkma.gov.hk>.

⁵⁰ The recognized industry qualification requirements vary with the types of regulated activities. According to Appendix C of the Guidelines on Competence issued by SFC in March 2003, for example, for Type 1 regulated activity, an ReI should pass one of the following examinations of the Hong Kong Securities Institute (HKSI): Diploma Programme Examination (DPE) Papers 1 and 3, Licensing Examination (LE) for Securities and Futures Intermediaries Papers 7 and 8, or Foundation Programme Examination (FPE) Paper 2.

professional qualifications in the specified fields (e.g. law, accounting or finance) or by the specified duration of relevant industry experience. In addition, an ReI is required to pass one of the recognized local regulatory framework papers⁵¹.

Relevant evidence

5.25 As testified by the management of the six banks, all their sales staff engaged in the sale of investment products, including LB structured products, were ReIs registered with HKMA. At the time of giving evidence, all the investment consultants (ICs) and sales staff⁵² (usually RMs) who had testified to the Subcommittee were ReIs qualified to undertake Type 1 regulated activity (dealing in securities). The majority of them were also qualified to undertake Type 4 regulated activity (advising on securities).

Product-specific training

5.26 According to the management of the six banks, it was mandatory for sales staff to attend both general and product-specific training. Information on LB structured products was provided to sales staff through product-specific training arranged by the product team or other designated teams of the banks and/or ICs whose responsibilities included the provision of training and coaching. All the six banks indicated that they would invite the issuer/arranger/co-ordinating distributor of the LB structured products to conduct initial training sessions on the new product type/structures to the ICs and/or the sales

⁵¹ The local regulatory framework paper required to be passed by an ReI varies with the types of regulated activities. According to Appendix C of the Guidelines on Competence issued by SFC in March 2003, for example, for Type 1 regulated activity, an ReI has to pass one of the following HKSI examinations: DPE Paper 2, FPE Paper 1, LE Paper 1 or Financial Market Principal Programme Examination Paper 1.

⁵² The titles of the sales staff who were directly involved in the sale of LB structured products and who had testified to the Subcommittee varied among the six banks (e.g. relationship manager, customer services manager). Their job responsibilities included the sale of banking products and services, providing customer services, building relationship with customers and answering their enquiries.

staff. One of the banks⁵³ stated that it adopted a "train-the-trainer" approach. Its product managers and representatives of the product provider would first brief the ICs on new product structures. The ICs would then conduct face-to-face training and ongoing coaching for the sales staff.

5.27 As testified by the management of one of the six banks⁵⁴, it had organized product-specific training in the form of workshops when an LB structured product and each subsequent series was launched. After attending the workshops, the sales staff had to complete and pass a quiz before they were allowed to conduct the sale of LB structured products to customers. For instance, the quiz used by this bank for Minibonds Series 35 comprised 10 multiple-choice questions covering the basic aspects of the offering of the product, such as the tenor, coupon payment, offer period, the reference entities and their credit ratings. None of the questions was related to the risks of the Minibonds series in question. According to this bank, it would also assess the sales staff's knowledge of the LB structured product by way of role-playing. Nevertheless, as the Subcommittee has noted in paragraph 5.10 above, according to what was proposed in the document seeking approval for distribution of Minibonds Series 27, the training to be arranged for the sales staff was the preparation of a VCD by the training centre of this bank.

5.28 The Subcommittee notes from the evidence of the management of most other banks⁵⁵ that they conducted product-specific training sessions mainly in respect of new product types. For subsequent series of the product, the banks provided product information on the specific series to the sales staff through briefings at the regular branch or district-level meetings and/or through emails before each series was launched. For instance, according to the bank which distributed

⁵³ SCBHK.

⁵⁴ BOCHK.

⁵⁵ CHKL, DBSHK, DSB, RBS and SCBHK.

LB-CLNs⁵⁶, the initial training covered the structure and risk factors of CLNs. There were interactive modules at the end of these sessions in which sales staff were encouraged to ask questions. After the sessions, sales staff were required to complete a quiz to assess their understanding of the product. According to the specimen provided by the bank to the Subcommittee, the quiz consisted of seven questions on a few aspects of the nature of LB-CLNs and on "credit event". Each time a new series of LB-CLNs was launched, the bank would disseminate the series-specific information to the sales staff through interactive briefings, and provided them with sales aid materials⁵⁷, prospectuses and marketing materials (where applicable).

5.29 In this connection, the Subcommittee has noted that one of the six banks⁵⁸ had launched eight series of an LB-ELN (sold by private placement) from 14 to 26 August 2008. When asked by the Subcommittee whether the sales staff had been given adequate training within such a short time to enable them to understand the products, the management of this bank responded that as the eight series of the LB-ELN in question were similar in nature and features, the training arranged before the launch of each series and the relevant product information (e.g. product termsheets) that had been provided to sales staff by "launch email" was considered adequate. It is noted that in the same period, the sales staff had to sell other financial and investment products in addition to LB structured products.

5.30 Most of the RMs who had testified to the Subcommittee confirmed that they had received product-specific training in relation to LB structured products. Some RMs informed the Subcommittee that the training provided by their banks focused on new product type/asset class (e.g. ELNs) or new product structure and was not issuer-specific.

⁵⁶ DBSHK.

⁵⁷ According to the bank, the sales aid materials included a summary fact sheet and FAQs about the key features of the product, sales scripts, and sales kits prepared by the product arranger which contained an in-depth explanation of the key features and risks of the product.

⁵⁸ DSB.

Briefings for each series of an LB structured product were usually arranged a few days or a week prior to product launch, and focused on the main differences between the new series and earlier series of the same structures. Some RMs indicated that the briefing sessions organized by their banks provided an interactive forum for them to ask questions about the products. According to two ICs, one-on-one training sessions or "sales clinics" would be organized upon request by the sales staff or for the less experienced sales staff nominated by the BMs.

5.31 In reply to the Subcommittee, the RMs were able to explain the structure and risks of Minibonds. When asked by the Subcommittee about the possible impact if a credit event occurred to one or more of the reference entities in Minibonds, one RM showed a correct understanding of the "first-to-default" nature of such products. Another RM also indicated that the extent of investment loss was not pro-rata to the number of defaulting reference entities.

Training materials for LB structured products

5.32 The management of the six banks and some ICs testified to the Subcommittee that the training materials usually comprised materials prepared by the issuer/arranger/co-ordinating distributor such as the offer documentation, powerpoint presentations, marketing and sales aid materials. According to the management of five of the six banks⁵⁹, the training materials were reviewed by their product teams or other designated teams of the banks in consultation with their legal/compliance teams. The management of the other bank⁶⁰ said that the bank did not vet the training materials received from the issuer and arranger.

⁵⁹ BOCHK, CHKL, DBSHK, DSB and SCBHK.

⁶⁰ RBS.

5.33 Two of the six banks⁶¹ had made available copies of the training materials on Minibonds. According to their management, these training materials produced by them were prepared and supplied to them by the co-ordinating distributor of the product (as so specified in the training materials). The Subcommittee has noted that in these training materials, Minibonds was described as a product "authorized by SFC" (產品"得到證監會認可") or "authorized by SFC for offer to ordinary investors" (產品"得到證監會認可，向普遍投資者銷售"). However, as explained in Chapter 4, SFC only authorized the Minibonds documentation for registration under CO, not the product itself or its suitability for offer to any investors.

5.34 The Subcommittee has asked some witnesses from the management of the three banks⁶² that had distributed Minibonds by public offer how they had understood the expression "SFC authorization" in relation to Minibonds. The Subcommittee has found that not all of them had precisely replied that SFC authorized only the product documentation but not the product. Some of them said that according to their understanding, for products such as Minibonds which were sold by public offer, SFC authorized the product for distribution to the public as well as its offer documentation. The Subcommittee also asked the sales and training staff of these banks about their understanding of the expression "SFC authorization" in relation to Minibonds. While some RMs had shown a correct understanding of SFC's role in authorizing product documentation only, the replies given by the other witnesses were:

- (a) the product was authorized by SFC for offer to the public;
- (b) the product had been reviewed by SFC;

⁶¹ BOCHK and RBS.

⁶² BOCHK, DSB and RBS.

- (c) the accuracy of the contents of the marketing materials and prospectuses of the product had been verified by SFC; and
- (d) the product issuer had fulfilled certain requirements stipulated by SFC in terms of its capital, financial reporting and the product structures.

General training

5.35 As testified by the management of the six banks, the general training provided to their sales staff focused on generic market and product knowledge, regulatory and compliance requirements (such as the Code of Conduct, KYC requirements, suitability obligations) applicable to the sale of investment products. Such training was provided in the form of induction training for new staff, E-learning training modules, compliance-related briefings, tutorials, workshops and seminars, issuance of circulars/newsletters to sales staff on compliance matters. The six banks also provided the sales staff with manuals and guidelines on conducting regulated activities. The RMs who had testified to the Subcommittee indicated that they had received training on regulatory and compliance matters. Most of the RMs also recalled that their management had drawn their attention to the Suitability FAQ issued by SFC.

5.36 Some of the ICs who had testified to the Subcommittee indicated that it was part of their responsibilities to provide market updates to sales staff. As to whether the sales staff had been briefed on the market volatilities in 2008 including the deteriorating financial position of LB, one IC stated that in early 2008, the product team of the bank had invited LB representatives to attend a meeting with the ICs to report on LB's financial status. The report from LB then was still positive and this was shared with the sales staff in the weekly briefings at

the branch. Another IC stated that most of his information about LB's deteriorating financial condition came from the media. One of the ICs indicated that he had not received any instruction requiring him to inform the sales staff about LB's worsening financial position.

Observations

5.37 The Subcommittee considers that the minimum academic qualification to be met for ReIs stated in paragraph 5.24 above is inadequate in the face of financial innovation, given that ReIs need to understand and explain the features and risks of products properly to prospective investors. The Subcommittee takes the view that the regulators should consider raising the minimum academic qualification of ReIs.

5.38 There is no doubt that continuous on-the-job training and coaching is important for ReIs to maintain their competence. The Subcommittee notes that all the six banks had made arrangement to provide general and product-specific training to their sales staff regarding the sale of investment products (including LB structured products) and the relevant regulatory requirements. The Subcommittee however is concerned about the quality of the training provided. For instance, as consecutive series of Minibonds varied considerably in design and structure, it would not suffice to conduct one-off training on the product type. Series-specific training should be provided to enable the sales staff to understand the features and risks specific to each Minibonds series. Where a post-training quiz was used as one of the tools to test the understanding of the sales staff on LB structured products, the Subcommittee considers that the questions stated in the quiz should give sufficient coverage to the structure of the products and the various risks involved.

5.39 The Subcommittee considers that the descriptions of Minibonds as a product "authorized by SFC" or "authorized by SFC for offer to ordinary investors" (as appeared in the training materials submitted to the Subcommittee by the management of some of the six banks⁶³) were misleading, as SFC did not approve Minibonds or its suitability for offer to any investors. Having considered the evidence of the witnesses from the banks which had distributed Minibonds by public offer as summarized in paragraph 5.34 above, the Subcommittee is of the view that some of the staff did not have a correct understanding of the expression "SFC authorization". In particular, the Subcommittee is concerned that as some of the sales staff could not give an accurate explanation on the nature of "SFC authorization", they could have conveyed incorrect information to their customers. Individual sales staff might think that Minibonds, having been authorized by the regulator, was a sound and safe product. They could become less concerned about the inherent risks of the product and the need to ensure suitability for individual customers. The customers in turn might have decided to acquire the Minibonds on the wrong understanding that it was a product authorized by SFC.

5.40 The Subcommittee considers it incumbent upon banks to ensure that the contents of the training materials used by their staff were accurate and presented a balanced view of the features, risks and returns of the investment product, as the information was likely relied upon by the sales staff in understanding the products. Banks should not solely rely on the training materials provided by an external party (i.e. the issuer, arranger or co-ordinating distributor). To fulfil their obligation as intermediaries, banks should conduct their own independent scrutiny or reviews of such materials to ensure that they were in order.

⁶³ BOCHK and RBS.

"Know your client" requirements

Regulatory requirements

5.41 GP4 and Paragraph 5.1 of the Code of Conduct require intermediaries to seek adequate information from their customers about their financial situation, investment experience and objectives relevant to the services to be provided. Where derivative products are involved, Paragraph 5.3 of the Code requires intermediaries to ensure, amongst others, that their customers have sufficient net worth to be able to assume the risks and bear the potential losses of trading in the products. As stipulated under Question 2 of the Suitability FAQ, the information collected from customers should be fully documented and updated by the intermediaries on a continuous basis.

Relevant evidence

Seeking information from customers

5.42 The Subcommittee notes that according to the management of each of the six banks, in addition to obtaining the customers' general information at the time of account opening, the banks also required their staff to seek from their customers information about the latter's financial situation, investment knowledge, investment horizon, risk tolerance etc. All the banks had special handling procedures for obtaining information from customers aged 65 or above in the KYC process.

5.43 According to the branch operational manual of one bank⁶⁴, if a customer approached the bank and showed interest in its wealth management services, the relevant staff must check the customer's age, net worth and risk assessment record, if any, in the bank's system. The manual also set out the workflow of risk assessment and financial

⁶⁴ DSB.

analysis, and the scoring methodology for asset allocation portfolio and product matching. There were also separate guidelines for collecting additional information (e.g. more detailed information on the customer's net worth and investment horizon) from customers aged 65 or above and other vulnerable customers. Another bank⁶⁵ required its sales staff to collect information from the customers through a personal investment analysis, as part of the account opening process. The sales staff were also required to confirm with the customers if there were subsequent changes in their personal particulars. On handling customers aged 65 or above, there were separate guidelines requiring the responsible staff to ascertain, amongst others, the customers' physical and mental conditions and their English literacy through interview before opening an investment account for them.

5.44 The Subcommittee also notes that some of the six banks⁶⁶ provided checklists for the sales staff to follow when seeking or confirming information from/with the customers. All the six banks informed the Subcommittee that they provided compliance training to their sales staff, which included KYC requirements. The management of one of the six banks⁶⁷ indicated that sales staff who had served the bank's customers for a long period of time would be familiar with the latter's financial needs and circumstances.

5.45 The Subcommittee had asked some of the RMs how they had collected information from their customers to understand their investment needs. In reply, they indicated that they had acted in accordance with the relevant policies and practices on the KYC requirements. For instance, one of the RMs said that when a customer indicated interest in certain LB structured products, she would first check the customer's risk profiling records, if any, or whether the customer had experience in investing in the same product. Another RM told the Subcommittee that

⁶⁵ RBS.

⁶⁶ BOCHK, DSB and RBS.

⁶⁷ CHKL.

he would also gather information on the customers' personal circumstances, such as their occupations and investment preferences, through his ongoing contacts with them.

Profiles of some investors of LB structured products

5.46 Most of the investors who had testified to the Subcommittee stated that they had been customers of the banks (which sold them the LB structured products) for a long time ranging from five to 50 years. Most of them indicated that they trusted the banks and the staff serving them. Some of them said that they had received very little education or were illiterate, and had no regular income. They also had no knowledge about LB or the LB structured products they had purchased. Nevertheless, they had been sold various LB structured products. For instance, one of these investors was a housewife without any formal education or investment experience in any equity or credit-linked notes. As she was over 65 years of age when she purchased Minibonds Series 35, she had expressed concern to the bank staff handling her transaction that the three-year tenor of the product was considerably longer than the term of fixed deposits she used to place. She ended up investing nearly half of her available funds in Minibonds Series 35. Another investor said that he had told his RM that he would rely on the regular interest income from the investment to support his retirement life and had expressed concern about the possibility of investment loss. He ended up using 60% of his funds to purchase a non-principal-protected LB-ELN.

Observations

5.47 The Subcommittee notes that as some investors had been long-time customers of the six banks, their RMs should have no difficulty in knowing the personal circumstances and financial needs of their customers through the information obtained from the latter at the time of account opening and subsequent ongoing contacts. However, having

regard to the profile of investors described in paragraph 5.46 above, the Subcommittee has doubt on whether the banks had properly taken into account the relevant information (e.g. age, financial needs) of these customers when introducing LB structured products to them. The Subcommittee considers that the guidelines and procedures put in place by the banks might not have ensured that their staff fulfilled their KYC obligations in all cases.

Suitability assessment

Regulatory requirements

5.48 GP2 of the Code of Conduct requires that intermediaries should act in the best interests of the customers. As required under Paragraph 5.2 of the Code of Conduct, intermediaries should ensure the suitability of the recommendation or solicitation they make for the customer is reasonable in all the circumstances. In dealing with derivative products, Paragraph 5.3 requires intermediaries to ensure, amongst others, that the clients understand the nature and risks of the products. According to the guidance given under Question 1 of the Suitability FAQ, intermediaries should provide reasonably suitable recommendations to customers by matching the risk return profile of each investment product with the personal circumstances of the customers. Intermediaries are also reminded under Question 4 of the Suitability FAQ to take extra care in handling elderly or unsophisticated customers who are likely to rely on them for investment advice.

Relevant evidence

Risk/investment profiling of customers

5.49 According to the evidence of the six banks, when a customer intended to subscribe for any LB structured product, the handling RM must first ensure that the customer had a valid risk/investment profiling⁶⁸. Risk profiling was usually conducted by way of a questionnaire which included questions on the customers' age, income, investment experience, risk appetite and investment horizon. Based on the result of the risk profiling, the customer's risk tolerance level would be established and he could subscribe for investment products whose risk ratings were commensurate with his risk tolerance level. The risk tolerance levels of customers ranged from the most conservative tier to the highest risk-taking tier. For instance, one bank⁶⁹ classified its customers into six risk tolerance levels according to the result of the risk profiling exercise: "Level 1" (Risk averse), "Level 2" (Income), "Level 3" (Conservative), "Level 4" (Balanced), "Level 5" (Growth) and "Level 6" (Enhanced growth). Another bank⁷⁰ classified customers into three tiers of risk tolerance, i.e. "Conservative", "Balanced" and "Growth". The Subcommittee notes that instead of ascribing a risk tolerance level to individual customers, one of the six banks⁷¹ asked its customers to indicate, during the investment profiling exercise, their risk tolerance level in terms of a percentage of investment loss⁷² they could bear in an investment year. Based on the results of the questionnaire, a list of investment products at the asset class level would be generated for the customers' reference.

⁶⁸ For each of the six banks, the risk/investment profiling for individual customers was valid for 12 months. If, at the time of product subscription, 12 months or more had passed since the last risk profiling, a fresh risk profiling had to be conducted on the customer.

⁶⁹ CHKL.

⁷⁰ RBS.

⁷¹ SCBHK.

⁷² The options of the percentage of investment loss provided in the investment profiling questionnaire were "about 2%", "about 5%", "about 8%", "about 10%", "about 13%" and "about 15% or worse".

5.50 Each of the six banks had their own standardized risk/investment profiling questionnaire for assessing customers' risk tolerance levels or financial profiles. The Subcommittee notes that one of the banks⁷³ additionally required customers to complete a product-specific suitability questionnaire with the RM's guidance when they intended to purchase an investment product. For example, the product-specific suitability questionnaire used by this bank for Minibonds Series 35 contained 17 questions to seek the customer's confirmation that he had understood the product structure and was willing to accept the various risks associated with the notes including the credit risks of the reference entities and other risk factors listed in the prospectus. If the customer's response to any of the questions was in the negative, the subscription process should not continue. According to an RM who had testified to the Subcommittee, one of his customers had decided not to purchase an LB structured product after responding to some questions in the product-specific questionnaire which alerted the customer of the non-principal-protected nature of the product.

Suitability of LB structured products for investors

5.51 According to the relevant prospectuses and termsheets, LB structured products such as Minibonds and LB-ELNs were not suitable for everyone and were not suitable for inexperienced investors. Investors of these products should ensure that they understood the nature of and the risks associated with these products. They should be willing to accept the risk that they might lose their investment as the notes were not principal-protected. They should also consider whether the products were suitable for themselves in the light of their investment experience, objectives, financial position and other relevant circumstances⁷⁴.

⁷³ RBS.

⁷⁴ Please see paragraph 2.17 of Chapter 2.

5.52 The Subcommittee notes that some investors of Minibonds and LB-ELNs who had given evidence were retirees or housewives with little or no formal education. They had not invested in ELNs or credit-linked notes before. What they were looking for was safe and principal-protected investments that could bring them a stable level of interest income which was more favourable than the prevailing interest rates on time deposits. These investors indicated that they could neither understand nor accept investment risks. Without earnings, these investors had used their savings to purchase the LB structured products in question. Some of them stated that they relied on the interest from their investments to pay their medical and other expenses.

5.53 The Subcommittee is aware that some persons may be regarded as capable of taking on investment risks and having sufficient net worth to bear investment losses. However, such persons may not necessarily be willing to assume such investment risks. For instance, the personal profile of one of the investors was that she was of secondary education level, about 40 years of age, in employment with stable income and of relatively high net worth. She told the Subcommittee that she was resistant to investment in equities, bonds, investment funds, not to mention any structured financial products. However, she purchased an LB-ELN as she had been assessed as suitable to invest in such product.

5.54 The Subcommittee has also noted that there were circumstances that rendered suitability assessment all the more important at the point of sale. An example was the change introduced by one of the six banks⁷⁵ in around August 2008 to adopt the so-called "50-person" exemption⁷⁶ so that each series of LB-ELN would be offered to not more than 50 investors. This was different from the practice adopted by two

⁷⁵ DSB.

⁷⁶ This was one of the "safe harbour" provisions in the Seventeenth Schedule to CO in respect of the offer of financial products by private placement. Please refer to paragraph 4.16 of Chapter 4 for further details.

other banks⁷⁷ which adopted only the "minimum subscription of HK\$500,000" exemption in offering LB-ELNs through private placement. The Subcommittee notes that as a result, the bank in question lowered the minimum subscription amount to HK\$100,000 for each transaction. As revealed in the internal document seeking approval, there were comments made by certain senior staff of the bank that lowering the minimum subscription amount could enlarge the customer base that might include inexperienced investors. It was pointed out that training and additional guidelines should be provided to the sales staff on suitability assessment so as to avoid the risk of mis-selling. According to the bank management, prior to the distribution of the LB-ELNs in question, it had organized specific training to the sales staff on the features and risks of the product and on the relevant sales procedures, including checking with the customers whether they had previous investment experience in ELNs or equity-linked deposits. Sales staff were also required to follow the bank's guidelines for conducting customer risk profiling.

Conducting risk profiling on customers

5.55 The evidence given by the top/senior management of the six banks showed that these banks had put in place guidelines on how risk/investment profiling should be conducted. These guidelines included designating the staff for conducting risk profiling on customers, the forms to be used, the steps for completing the relevant risk/investment profiling form, and/or the chart for matching the product type with the customer's risk profile, etc. The guidelines issued by some of the banks⁷⁸ explicitly required the sales staff to explain the purpose of the risk profiling exercise, go through all the questions in the questionnaire with the customer and inform the customer about the results of the risk profiling. When testifying to the Subcommittee, the RMs stated that

⁷⁷ CHKL and SCBHK.

⁷⁸ BOCHK, DSB and RBS.

they had conducted the requisite risk profiling on their customers before selling the LB structured products to them.

5.56 Most of the investors giving evidence to the Subcommittee said that they were not aware of any risk/investment profiling being conducted on them by the RMs handling their transactions. Some investors recalled that a questionnaire was completed by the bank staff without seeking their answers to the questions and telling them that the risk/investment profiling was merely a formality. One investor recalled having answered a few questions put by the bank staff, but did not have sight of the completed questionnaire which the bank staff processed on the computer. Another investor told the Subcommittee that the risk profiling questionnaire was conducted after the transaction. Almost all the investors who had testified to the Subcommittee indicated that they had not been advised by the bank staff of their risk tolerance level before the transactions were completed. Some of these investors, who had obtained a hardcopy of the risk/investment profiling questionnaire after the collapse of LB, said that certain information filled in by the bank staff (e.g. age, investment experience, acceptable level of capital loss) was factually incorrect.

Risk mismatch

5.57 The Subcommittee notes that according to the management of the six banks, each bank had its own policies and measures for dealing with risk mismatch cases, i.e. transactions in which the risk rating of an investment product exceeded the customer's risk tolerance level. Sales staff were required to advise customers if the relevant products were not suitable for them based on the results of suitability assessment. If the customers insisted on subscribing for the product of risk mismatch, additional safeguards were implemented to ensure that the customers understood the product risks. The banks usually required the customers to sign a certain declaration form to the effect that they decided to make

the investment despite being informed of the risk mismatch. Most of the six banks⁷⁹ would require the additional approval of a more senior officer for the mismatched transaction. One of the banks⁸⁰ did not permit a transaction if the mismatch between the product risk and the customer risk profile exceeded two levels. For example, customers with a risk tolerance level "1" could not purchase investment products with a risk level "4".

"Golden age customers"

5.58 According to the evidence of the management and frontline staff of the six banks, additional steps were taken in handling "golden age customers" (i.e. customers of 65 years of age or above). These included the requirements of conducting additional suitability assessment, arranging a second ReI and/or inviting the customer to bring along a family member to witness the transaction. One of the banks⁸¹ explicitly instructed its sales staff to pay due regard that products with long tenor were not suitable for "golden age customers" having regard to their liquidity needs. When taking evidence from investors, the Subcommittee tried to find out how transactions involving "golden age customers" had been handled. As stated by those investors who were over 65 years of age at the time of their purchase of the LB structured products, the bank staff who handled their transactions had not taken or arranged to take the abovementioned additional steps in the sales process.

Observations

5.59 The Subcommittee has found that the evidence given by the management and frontline staff of the six banks and the testimonies of the investors differed considerably on whether and how suitability assessment had been conducted in practice. On the one hand, the

⁷⁹ CHKL, DBSHK, RBS and SCBHK.

⁸⁰ DSB.

⁸¹ BOCHK.

Subcommittee has noted from the oral and written evidence of the six banks and their staff that policies and procedures were in place for conducting suitability assessment on customers. On the other hand, members have found that many of the investors who had appeared before the Subcommittee should not have been sold LB structured products. The Subcommittee has found it hard to justify why these investors could have been assessed as suitable for purchasing such products. It does not appear that the intermediaries had fulfilled their obligations to ascertain that the LB structured products were suitable for these customers. Given the importance of suitability assessment in investor protection, the Subcommittee considers that further safeguards should be put in place to ensure that suitability assessment will be conducted properly in all transactions.

5.60 In view of the divergence in the evidence given by the banks and by the investors as stated in paragraphs 5.55, 5.56 and 5.58 above, the Subcommittee is concerned that despite the documented guidelines and procedures of the banks, the relevant requirements might not have been properly followed by individual sales staff in all cases. This was also indicative of a lack of effective internal controls and supervision on the part of the management of some banks to ensure proper compliance by frontline staff.

5.61 As noted in paragraph 5.54 above, the senior management of the bank⁸² in question was concerned about the strong need for proper suitability assessment in anticipation of an enlarged customer base following the bank's adoption of the "50-person" exemption in offering LB-ELNs at a lower minimum subscription amount. The bank had also implemented certain measures to provide additional guidance and training to its sales staff. However, the critical question is whether the steps taken by the senior management had been effectively implemented so that their valid concerns about proper suitability assessment had been

⁸² DSB.

communicated to and followed up by frontline staff. The Subcommittee is concerned that if conflict occurred between securing additional customers for selling LB structured products on the one hand, and strict adherence to all necessary requirements in conducting the sales on the other hand, the efforts to conduct proper suitability assessment of customers might not have been maintained in all cases.

5.62 As described in paragraph 5.57 above, there were circumstances under which LB structured products could be sold to customers whose risk profiles did not match the product risk ratings. However, if the customers did not know that there had been a risk mismatch, or if the sales staff had not explained properly the risk mismatch and the purpose of the documents requiring the customer's signature, the written declaration/acknowledgement given by the customers would serve no meaningful purpose. Noting that in the case of one of the six banks⁸³, about 11% of its customers who had invested in LB structured products were involved in transactions with a risk mismatch, the Subcommittee has found it necessary for the regulators to consider certain thresholds for permitting these transactions to ensure that the purpose of conducting suitability assessment would not be defeated.

5.63 Where risk profiling tools are concerned, the Subcommittee sees merits in the use of a product-specific suitability questionnaire as described in paragraph 5.50 above which, if properly explained and administered by the RM, should have been useful in apprising prospective investors of the key risks of LB structured products. The critical issue is whether in practice, the questions had been properly explained by the RM and well understood by the investor in giving his response.

⁸³ SCBHK.

5.64 As shown in the example in paragraph 5.53 above, a person who is capable of accepting investment risks and bearing potential investment losses may not necessarily be willing to take on these risks. The age, education level, income, net worth and investment horizon of a customer can reflect the customer's ability to assume investment risk, but not necessarily his willingness to take risk. Regardless of the methodology for risk profiling, the Subcommittee considers it important that risk profiling should give sufficient weighting to the "preparedness" or "willingness", not just the ability, of a person to assume risks.

The sales process

Regulatory requirements

5.65 As stated under Question 5 of the Suitability FAQ, it is the duty of intermediaries to help customers make informed decisions by explaining the nature of and risks associated with the investment products, and give them sufficient time to consider the information provided by the intermediaries. GP5 and Paragraph 5.3 of the Code of Conduct also require intermediaries to make adequate disclosure of relevant information to the customers and ensure that they understand the products.

5.66 HKMA issued a circular to all RIs on 13 January 2003 to provide specific guidance on the restrictions on unsolicited calls⁸⁴. Pursuant to the requirements under SFO, the dealing in securities is Type 1, and advising on securities is Type 4 regulated activity. As set out in the FAQ dated 22 June 2009 on "Incidental Exemption" issued by SFC⁸⁵,

⁸⁴ The circular is available on HKMA's website at <http://www.hkma.gov.hk>.

⁸⁵ SFC has issued a number of FAQs on various licensing-related topics (e.g. competence, licensing conditions, provisional licence). One set of these FAQs is on "Incidental Exemption" (dated 22 June 2009) which gives information on the exemptions whereby corporations licensed for Type 1 regulated activity can carry on other regulated activities. The FAQ is also applicable to RIs and is available on SFC's website at <http://www.sfc.hk>.

intermediaries licensed for Type 1 regulated activity may give investment advice to clients to the extent that such activity is carried out wholly incidental, and subordinate or ancillary to the securities dealing business.

Relevant evidence

Target customers for LB structured products

5.67 Some investors giving evidence to the Subcommittee stated that they had not heard about LB or its products, but had been proactively approached and persuaded, mostly by the RMs handling their accounts, to invest available funds (e.g. matured time deposits) in Minibonds and other LB structured products. These investors alleged that at that juncture, they did not have the slightest intention to make an investment. Their RMs, however, had presented LB structured products such as Minibonds to them as safe products comparable to time deposits.

5.68 According to the evidence of the management and frontline staff of most of the six banks⁸⁶, they had not specified any target customers for LB structured products. In reply to the Subcommittee, three banks⁸⁷ stated that they did not designate any of its retail banking customers as professional investors. None of the investors who had testified to the Subcommittee said that they had been categorized by the banks as professional investors.

5.69 Some of the witnesses from the top/senior management and frontline staff of the banks stated that individual customers might become aware of LB structured products through advertisements and/or marketing materials or similar offers from other distributing banks. The RMs told the Subcommittee that they would provide information on LB structured products to the customers in response to the latter's enquiry or expression

⁸⁶ BOCHK, CHKL, DSB, RBS and SCBHK.

⁸⁷ CHKL, DSB and SCBHK.

of interest in such products during ongoing customer contacts, or upon referral by other staff (e.g. counter staff who were not ReIs) or by existing customers. When asked by the Subcommittee, the management of one bank⁸⁸ said that if a customer was referred to the RM by the counter staff, the bank would take the view that it was the customer who had indicated interest in purchasing a product and approached the bank on his own volition.

Issues related to recommendation and solicitation

5.70 According to the bank management and RMs, they only provided investment information, not investment advice or recommendation, to their customers. As testified by the investors, they had never heard about LB structured products before their RMs introduced the products to them. They had been told about the rate of coupon payment, the tenor of the product and what they would receive at the maturity of the notes. According to the investors, their RMs also highlighted the advantages of purchasing the LB structured products, and urged them to invest available funds in the products which were of low risks but could yield much higher returns. Apparently, the investors had not merely been given product information, but had been persuaded that it was in their interest to invest in LB structured products.

5.71 The Subcommittee has noticed that instead of responding to customer demands on a reactive basis, individual banks had taken measures to promote the LB structured products being offered and to encourage the customers to subscribe for the products. For example, one bank⁸⁹ displayed posters and marketing leaflets of Minibonds at its branches. This marketing strategy was clearly documented in the internal form seeking approval to distribute the Minibonds. The marketing brochures for certain series of LB-CLNs offered by another

⁸⁸ CHKL.

⁸⁹ BOCHK.

bank⁹⁰ informed the customers that "the Notes were offered for a limited period only" and that customers should "seize the investment opportunity" and "contact their designated distributors for details" ("本債券認購期有限。把握投資機會，請立即聯絡指定分銷商了解詳情。"). Some RMs informed the Subcommittee that in their regular contacts with the customers, they would inform the customers who had previously invested in LB structured products of the offer of a new series of the product, or new LB structured products.

Provision of offer documentation to customers

5.72 According to the policies and guidelines of the six banks, before completion of the transaction, a customer should be provided with the relevant offer documentation for LB structured products⁹¹ and be explained the key product features and risks, so that the customer could make an informed investment decision⁹². One of the banks⁹³ had set a minimum standard of product explanation to customers, which included explaining the product nature, name of the issuer and its credit rating, market scenarios, investment returns, transaction details and fees and commission. As stated by the RMs testifying to the Subcommittee, they did make available to their customers the relevant offer documentation specified by their banks and explained the product features and risks with reference to the prospectuses, termsheets or marketing materials (where applicable). Two RMs informed the Subcommittee that hardcopies of the prospectuses of LB structured products were received by the branch before the product was offered for sale to customers but they could not confirm how many copies were in the stock. Another RM said that the

⁹⁰ DBSHK.

⁹¹ The offer documentation would typically include the relevant prospectuses and marketing materials for LB structured products sold by public offer; and the termsheet and/or base prospectus for LB structured products distributed through private placement.

⁹² As stated under Question 5 of the Suitability FAQ, the mere provision of documentation is not enough. The sales staff are obliged to help each client make informed decisions by giving the client proper explanations of why recommended investment products are suitable for the client and the nature and extent of risks the investment products bear.

⁹³ CHKL.

sales staff could download and print the base prospectus of LB structured products from the Intranet of the bank.

Explanation on LB structured products

5.73 According to an investor of Minibonds and another investor of LB-CLNs testifying to the Subcommittee, the bank staff handling their transactions had told them that these products were safe as they were linked to a number of large and reputable corporations which would unlikely fail. Even in the unlikely event that one of the entities failed, they would only sustain a pro-rata loss on their investment. Some other investors told the Subcommittee that they were under the impression that the LB-ELNs they had purchased were issued by the distributing bank or that the high coupon payable was a special offer. An investor said that she was not aware that an LB-related entity was the product issuer, nor did she know, until after the transaction, that the LB-ELN in question was linked to the shares of listed corporations. Another investor thought that LB was the name given to the product. According to most of the LB-ELN investors who had testified to the Subcommittee, the bank staff had told them that the worst scenario was receipt of the physical shares of the worst-performing stock at the pre-determined price. One other investor thought that it was the distributing bank that guaranteed the principal protection of the LB structured product she had purchased.

5.74 According to the evidence of the management of the six banks, the banks did not specify any minimum time that sales staff must take to explain an LB structured product to a customer. The top/senior management of one of the six banks⁹⁴ indicated that it usually took some 30 to 60 minutes to complete a transaction of an investment product, depending on the investment experience of the customers and their understanding of the product in question. Another bank⁹⁵ indicated that

⁹⁴ SCBHK.

⁹⁵ CHKL.

the time spent on explaining an investment product to customers was about one hour on average. Only one of the banks⁹⁶ indicated that it had provided sales scripts to the sales staff in conducting the sale of these products. As stated by some investors, the entire transaction took some 15 to 30 minutes to complete, including a short explanation by their RMs on the product, but without informing them clearly or fully of the risks involved. One investor told the Subcommittee that she met her RM at a security counter in a shopping mall and on being urged by her RM to complete the subscription process, signed the transaction documents there hastily without understanding their contents.

Declaration/acknowledgement by customers

5.75 The Subcommittee notes that to complete a transaction, it was a common practice of the six banks to require the customer to sign a form to confirm/acknowledge that he/she had gone through the risk/investment profiling exercise, read the offer documentation, understood the product risks, and decided to invest in the LB structured products based on his/her own judgement, not as a result of any advice given by the banks. For instance, one of the six banks⁹⁷ required the investor to sign on the suitability assessment questionnaire to confirm, amongst others, that he had received, read and understood the programme prospectus of the LB structured product, and understood the nature and risks of the investment. There was also a "disclaimer" made by the bank at the end of the form (not part of the declaration signed by the customer) which stated, inter alia, that the bank did not make any representations or warranties as to the accuracy or completeness of the information in the offering documents. However, according to some of the investors who had testified to the Subcommittee, they did not have any idea of the contents or purpose of the documents they had signed as the sales staff had not explained the subject matters to them. Two investors told the Subcommittee that at the

⁹⁶ DBSHK.

⁹⁷ RBS.

request of the sales staff processing their transactions, they had signed on blank forms.

Decision to purchase LB structured products

5.76 The Subcommittee had asked the investors why they had decided to subscribe for LB structured products which were unfamiliar to them. In response, most of the investors said that they trusted the banks due to their reputation and their RMs whom they considered professional or with whom they had a long history of dealing. It also appears to the Subcommittee that during the sales process, the investors had not asked why the LB structured products they had purchased could give them a much higher return than the prevailing interests on the time deposits. For example, subject to there being no early call by the issuer or early termination event, investors of Minibonds Series 35 could receive a return on their principal at the rate of 5.6% per annum. Around the time when Minibonds Series 35 was offered to the public in February 2008, the prevailing Hong Kong dollar six-month time deposit rate was not more than 1% per annum⁹⁸. Some investors who had used about HK\$500,000 to purchase an LB-ELN⁹⁹ in February 2008 offered by private placement told the Subcommittee that they had received some HK\$20,000 to \$30,000 as coupon payment during the first five months of the tenor of the product before the collapse of LB.

Observations

5.77 The Subcommittee has noted that one of the reasons commonly given by the six banks for deciding to distribute LB structured products was to provide greater choice to customers in terms of product issuers and investment products. Hence, it was unlikely that individual

⁹⁸ Please see paragraph 3.24 of Chapter 3.

⁹⁹ Series 17 (390+1800) or Series 18 (390+1800+2800) of Lehman Brothers 1-Year HKD All Weather Coupon Daily Callable ELN.

banks would passively wait for indication of interest from customers instead of proactively approaching existing customers who might provide a ready pool of potential investors for LB structured products. The Subcommittee also considers that banks enjoyed proximity to their customers, and there were ample opportunities for sales staff to promote LB structured products in their ongoing contacts with customers, such as when the latter approached the bank for general banking services.

5.78 As described in paragraph 5.67 above, some individuals did not have any intention to make an investment when they approached the banks for general banking services. To the customers, the fact that the same RMs servicing their accounts had introduced LB structured products to them in the course of handling their deposits had blurred the demarcation between banking and investment activities. If the customers were not aware that they were making an investment, they would not be alert to the nature and potential risks of the investment products.

5.79 The Subcommittee has observed that the banks claimed that they only provided investment information, not investment advice. It is noted that intermediaries have a higher duty to fulfil in providing advice than in providing information. However, as described in paragraph 5.70 above, it might not be easy to distinguish whether certain remarks made by the sales staff were purely investment information or advice incidental to the sale of the LB structured products in question. To the customers, they might reasonably believe that they had been advised by their RMs to purchase a product which, as presented by the RMs, would bring them stable and favourable returns. The Subcommittee considers that suitable measures should be taken to minimize any possible contention over whether the customers had been given "information" or "incidental advice" in respect of their purchase of investment products.

5.80 The evidence from most of the investors testifying to the Subcommittee did not indicate that all the steps of providing offer documentation and product explanation had been taken by their RMs prior to completion of their transactions. As described in paragraph 5.73 above, the lack of understanding of the LB structured products as revealed by most of the investors testifying to the Subcommittee raised serious doubt on whether there had been adequate and proper explanation by the sales staff who handled their transactions, and whether these investors had been given reasonable time to read and understand the offer documentation, if provided, and ask questions. If only some 15 to 30 minutes had been taken to complete a transaction of LB structured products, as alleged by some of the investors, the Subcommittee does not consider that sufficient explanation could have been provided to a prospective investor who was not familiar with the nature of LB structured products to make an informed decision.

5.81 The Subcommittee has found that the banks had relied heavily on the signed written declarations as proof of the customers' understanding of the LB structured products and the suitability of the products for them. It should be noted that the signing of forms could not necessarily demonstrate that the product had been properly explained by the bank staff and understood by the customer. Each case had to be examined on its facts. However, the Subcommittee considers that in order to protect their own interest, investors should not sign on transaction documents if they did not understand the contents or purpose of such documents. Trust in the banks or their RMs was no substitute for healthy scepticism and vigilance on the part of the investors.

Sales targets and incentives

Regulatory requirements

5.82 According to GP1, GP2 and GP6 of the Code of Conduct, intermediaries should treat their clients honestly and fairly. They should act in the best interests of their clients and avoid any conflicts of interest. In the SFC's Report on Selling Practices of Licensed Investment Advisers, which was brought to the attention of all RIs by a circular issued by HKMA on 1 March 2005, SFC had raised the regulatory concern that the way the intermediaries were remunerated might give rise to potential conflicts of interest with the customers. HKMA issued a letter to a number of retail banks on 23 October 2008¹⁰⁰, reminding them that any incentive schemes for their staff 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.

Relevant evidence

Sales targets

5.83 The Subcommittee has examined whether the six banks had set any sales targets for the distribution of LB structured products. As testified by both the management and frontline staff of these banks, there were sales targets to be met by sales staff in respect of different financial and investment products¹⁰¹. However, there were no sales targets specific to LB structured products. Most of the RMs told the Subcommittee that LB structured products was only one of the many products handled by them. In response to the Subcommittee's questions on the highest number of transactions in LB structured products

¹⁰⁰ The letter was also brought to the attention of other RIs as an enclosure to a circular issued by HKMA on 11 December 2008. The circular is available on HKMA's website at <http://www.hkma.gov.hk>.

¹⁰¹ These products included insurance products, bonds, credit cards, deposits, mutual funds, structured financial products, mortgages, loans, etc.

concluded by them in a single month, the figures provided by some of the RMs ranged from two to 14. As informed by some RMs, the sale of LB structured products accounted for only some 0.67% to 4.9% of their respective total monthly sales of financial and investment products.

5.84 All the RMs stated that they did not recall having received any specific instructions from the bank management to gear up their sales efforts specifically on LB structured products. They also said that they had not been under pressure to boost the sale of LB structured products. One of the RMs recalled that during the period when the bank offered various series of Minibonds, his supervisor had advised the sales staff that each of them should preferably accomplish at least one transaction in Minibonds. However, he also said that the same advice was issued in respect of other investment products being offered. One IC recalled having received feedbacks from sales staff that they had difficulty in achieving the overall sales target as it was raised by the bank each year. Another RM indicated that he had managed to cope with the pressure arising from the need to meet the overall sales targets.

Performance appraisal of sales staff

5.85 According to the management of the six banks, the performance of their sales staff was evaluated against a number of performance indicators, which included sales achievement. One bank¹⁰² adopted three key performance indicators to appraise its staff, i.e. "sales achievement", "customer services" and "control and compliance", with a respective weighting of 50%, 20% and 30%. Another bank¹⁰³ evaluated staff performance in four aspects, namely "adherence to the bank's guidelines", "KYC or account opening", "sales/regulated activities" and "compliance/operations/service standard", each of which carried equal weighting.

¹⁰² DBSHK.

¹⁰³ RBS.

5.86 According to the top/senior management of the six banks, due regard was given to all aspects of staff performance, or as one bank¹⁰⁴ put it, a "holistic staff performance framework". The Subcommittee has examined some specimens of the performance scorecards of the six banks, and notes that sales achievement (or the revenue generated for the banks) was one of the factors in assessing staff performance. As informed by one of the banks¹⁰⁵, it lowered the weighting of "sales achievement" in staff appraisal from 60% to 50% in 2006. Another bank¹⁰⁶ stated that the entitlement of its sales staff to incentives was subject to proper compliance with the regulatory requirements. Non-compliance would lead to disciplinary action and an incentive discount of 30% to 100% depending on the severity of the misconduct.

5.87 When asked by members about the arrangements, if any, for dealing with sales staff's failure to meet requisite sales targets, most of the BMs stated that they would usually discuss with the staff concerned to find out the reasons for the under-performance. Suitable coaching and training would be provided where necessary. One BM said that she would work out an action plan for improvement with the staff. Some RMs told the Subcommittee that if their sales performance lagged substantially behind that of their peers, their supervisors (mostly BMs) would usually discuss with them with a view to assisting them to overcome difficulties and make improvements.

5.88 The BMs and most of the RMs testifying to the Subcommittee did not recall any case in which the sales staff had been dismissed or penalized solely for failure to meet sales targets or achieve the requisite level of revenue for the bank. Some RMs said that it was the practice of their management to compare the sales performance of staff. Some other RMs stated that they were provided with information from time to time on the sales performance of their peers. However, none of the RMs

¹⁰⁴ SCBHK.

¹⁰⁵ DBSHK.

¹⁰⁶ RBS.

testifying to the Subcommittee indicated that they had any hard feeling towards such practices.

Sales incentives

5.89 As testified by the top/senior management of some of the banks¹⁰⁷, the distribution fee payable by the issuer to the banks for the distribution of Minibonds or LB-CLNs was in the range of about 2% to 3% of the purchase amount. Another bank¹⁰⁸ told the Subcommittee that the commission it received for the sale of LB-ELNs was 2.64% on average, which was broadly comparable to those payable for other investment products. Both the management and frontline staff of the six banks stated that there was no incentive scheme specific to LB structured products, although there were product-level incentives for product categories such as unit trust funds, insurance, deposits and structured notes.

5.90 The Subcommittee has noted from the evidence of the top/senior management and the frontline staff of the six banks that the remuneration of sales staff (mostly RMs) was made up of a fixed basic salary and a variable pay. The latter was linked to the sales staff's overall performance, the total revenue earned by the staff for the bank from sale of different products (usually calculated on a quarterly basis), and/or the product-level incentives. Some of the banks¹⁰⁹ specifically required that compliance of the regulatory requirements was an overriding factor for the release of incentives. In reply to the Subcommittee's questions on the amount of incentives that the sales staff could earn, one RM recalled that the incentives derived from his sale of financial and investment products in a quarter could amount to five times his basic monthly salary. However, another RM said that during his one year or so of employment with the bank, he had only received the basic

¹⁰⁷ BOCHK, DBSHK, DSB and RBS.

¹⁰⁸ CHKL.

¹⁰⁹ BOCHK, CHKL, DBSHK and RBS.

monthly salary as he had not achieved the requisite quarterly sales volume to earn any incentives. Another RM told the Subcommittee that his incentives were also linked to the overall sales performance of the branch.

Observations

5.91 The Subcommittee has found that the six banks did set overall sales targets to be met by sales staff. The sale of LB structured products would contribute to the achievement of the sales targets. However, there was no evidence to suggest that sales staff had to concentrate or rely heavily on the sale of LB structured products in order to meet their sales targets, as they could conduct sales on other financial and investment products. In fact, one of the RMs told the Subcommittee that it was not easy to sell LB-ELNs to his customers. Although the Subcommittee had not received any evidence that staff who could not achieve good sales performance would be penalized, the Subcommittee has found that sales achievement was a very important aspect in the evaluation of the performance of sales staff. As described in paragraph 5.84 above, the need to meet the overall sales targets would inevitably have exerted pressure on sales staff to boost their sales effort. In this connection, the Subcommittee considers it necessary for banks to strike a proper balance between "sales performance" and "due compliance" in their remuneration/incentive structures.

5.92 The Subcommittee also notes that sales incentives were an important part of the remuneration package of frontline sales staff such as RMs. The Subcommittee considers that individual banks and their staff were aware of the importance of maintaining a proper standard of conduct while striving to maximize profits and earnings. However, in view of the large number of complaints alleging mis-selling of LB structured products, it could not be ruled out that in some cases, the sales staff might

have sought to achieve sales at the expense of observing a proper standard of conduct.

Internal controls and monitoring of the sales process

Regulatory requirements

5.93 As stipulated in the Code of Conduct and the Internal Control Guidelines, RIs are required to put in place internal control systems to ensure that their business is conducted in an orderly and efficient manner that complies with the relevant legal and regulatory requirements, and safeguard their customers from financial loss arising from professional misconduct or omissions. The RIs should also have adequate resources to supervise their staff diligently and maintain proper records of their business. The senior management of the RIs bears the primary responsibility to establish effective internal control systems, with clearly defined policies and reporting lines, for ensuring the maintenance of appropriate standards of conduct and adherence to proper procedures by the staff, and timely detection of non-compliance of the relevant requirements.

Relevant evidence

5.94 The Subcommittee notes that the six banks had put in place policies and procedures with a view to ascertaining that their staff had complied with the relevant requirements in conducting sales. It was a common practice among the six banks to conduct reviews of transaction documents to check whether they were complete and in order. According to one bank¹¹⁰, routine checking of all investment documentation was conducted by the branch service managers on a daily basis to ensure that the transactions completed at the branches were in

¹¹⁰ SCBHK.

compliance with the relevant requirements and procedures. Another bank¹¹¹ posted independent checkers at all branches to conduct inspection of all transaction documents, including the risk profiling questionnaires, subscription forms and the self-assessment checklists completed by the sales staff confirming that all necessary steps of the sales process had been taken. The transactions could only be executed when the checkers confirmed satisfaction with the documentation. With the exceptions of those transactions executed over the phone, none of the six banks had adopted the practice of audio recording the sales conducted face-to-face with the customers¹¹².

5.95 Some other measures adopted by the six banks to monitor sales included:

- (a) studying and monitoring complaint trends by the relevant business department of the bank with the BMs to consider whether any enhancement in supervision was needed;
- (b) reviewing reports on transactions with risk mismatch by the branch service managers;
- (c) conducting regular sample checking by the risk and compliance officers of the bank on the frontline staff's knowledge of compliance procedures by interviewing the staff and asking them related questions;
- (d) reviewing samples of recorded telephone conversations between sales staff and customers by a designated team of the bank to determine whether the staff in question had

¹¹¹ BOCHK.

¹¹² After the LB incident and following the review by HKMA, RIs were required to implement, amongst others, audio-recording of the risk assessment and sales process. The relevant circular issued by HKMA on 9 January 2009 is available on HKMA's website at <http://www.hkma.gov.hk>.

discussed the product features and risks with the customers during the sales process; and

- (e) conducting compliance reviews by the legal and compliance division of the bank on the sales practices and procedures adopted by the branches.

5.96 According to the BMs testifying to the Subcommittee, they usually monitored the sales process conducted by sales staff by walking around the branch and observing the discussions between the staff and the customers. Sample second-checking of transaction documentation was also performed to ascertain that the relevant internal policies and procedures had been followed during the sales process. In response to some members, the BMs said that they usually did not observe the entire sales process from beginning to end.

5.97 Five of the six banks¹¹³ informed the Subcommittee that they conducted mystery shopper exercises¹¹⁴ to evaluate whether the sales activities conducted at the branches were in compliance with the bank's internal policies and the regulatory requirements. In the light of the findings of the mystery shopper exercises, one bank¹¹⁵ enhanced its internal policies and prepared additional operation manuals and guidelines on the completion and explanation of the risk profiling questionnaire. Another bank¹¹⁶ introduced standardized techniques for analyzing the risk profiles of customers.

5.98 According to most of the six banks¹¹⁷, they conducted internal audits from time to time on different aspects of the sales process of

¹¹³ BOCHK, CHKL, DBSHK, DSB and SCBHK.

¹¹⁴ In these mystery shopper exercises, the usual practice was that staff from the bank's internal audit department or an external consultant engaged by the bank were designated to be mystery customers. They role-played customers and approached the bank staff to seek investment information or advice.

¹¹⁵ DBSHK.

¹¹⁶ DSB.

¹¹⁷ BOCHK, DBSHK, DSB, RBS and SCBHK.

investment products. One of these banks¹¹⁸ detected in one of its audit exercises that there were deficiencies in tracking the expiry date of risk profiling questionnaire and the previous transaction record of existing customers for re-profiling. The bank subsequently enhanced its computer system for checking the validity of risk profiling and reminding the sales staff to review the customers' risk profiles.

Observations

5.99 The Subcommittee appreciates that it was not practicable for the bank management to physically supervise each and every sale of investment products, including LB structured products, by their sales staff. Effective governance and supervisory measures should therefore be implemented to ensure compliance with regulatory requirements. The Subcommittee considers that initiatives such as mystery shopper exercises were useful in strengthening on-site surveillance of sales activities.

5.100 In the light of the LB incident, the Subcommittee has also noticed that banks might have relied too much on reviewing transaction documents as a means to ascertain whether all relevant steps of the sales process had been duly completed. In the view of the Subcommittee, it is highly questionable whether and how far the completeness of the documentation could fully reflect what had actually taken place in a sales process, such as how the sales staff had conducted the risk profiling with the customers or explained the investment products to them. If the transaction documents were not prepared as a true record of what had been done but only to give an appearance of it, these documents could not be relied upon for detecting non-compliance, or ascertaining whether all the necessary steps had been taken before a transaction was completed.

¹¹⁸ RBS.

Handling of complaints

Regulatory requirements

5.101 Paragraph 12.3 of the Code of Conduct and paragraph 5 under Section V of the Internal Control Guidelines require intermediaries to establish, maintain and enforce policies and procedures to ensure that complaints from customers relating to the intermediaries' business are handled in an appropriate, timely and independent manner. RIs also have to follow the guidance set out in HKMA's SPM on Complaint Handling Procedures¹¹⁹.

Relevant evidence

5.102 As stated by the top/senior management of the six distributing banks, they had received very few complaints (not exceeding five) on alleged mis-selling of LB structured products prior to the collapse of LB. Two of the banks¹²⁰ said that they had not received any such complaint.

Complaint-handling procedures

5.103 The six banks stated that in accordance with the regulatory requirements of HKMA and SFC, they had put in place policies and procedures for handling customer complaints. The Subcommittee also notes that some of the banks¹²¹ had made some adjustments to their respective complaint-handling process to deal with the large volume of complaints received after the collapse of LB. For example, two banks¹²² each set up a designated team comprising more than 100 staff from the

¹¹⁹ Module IC-4 of HKMA's SPM.

¹²⁰ DSB and RBS.

¹²¹ DBSHK, DSB and SCBHK.

¹²² DBSHK and SCBHK.

compliance, internal audit and risk management departments, which were independent of the sales teams, to investigate into the complaint cases.

5.104 Having examined the complaint-handling procedures of the six banks, the Subcommittee has found that only two of the six banks¹²³ had expressly required that complainants should be interviewed during the investigation process. According to the majority of investors of LB structured products who had testified to the Subcommittee, they had not been invited to attend meetings with the banks in connection with their complaints, and were dissatisfied that they had not been given an opportunity to be heard, nor kept informed of the progress of investigation of their complaints. Some investors said that they had encountered difficulty in obtaining from the banks copies of documents related to their purchase of LB structured products. For instance, an investor stated that she could only obtain a copy of her investment risk profiling form after repeated requests.

5.105 As stated by two of the investors, their complaints had been rejected on the grounds that they had signed relevant documents confirming their understanding of the risks of the products. Another investor who had settled her case with the bank indicated that although she was not satisfied with the terms of settlement, she had accepted it as she was worried that she might not receive anything if she rejected the offer. Based on the evidence provided by this investor, she was required, under the settlement offer, to withdraw her complaint from the bank and any other parties (including the regulators) in respect of her purchase of the LB structured product.

Banks' investigation into LB-related complaints

5.106 According to the top/senior management of the six banks, they would conduct internal investigations into their distribution of LB

¹²³ DBSHK and RBS.

structured products upon receipt of customer complaints. In this connection, the Subcommittee has noted that according to one bank¹²⁴ which had entered into the Minibonds repurchase agreement with SFC and MA, up to October 2010, its investigation of the 8 983 complaints received did not reveal any evidence of non-compliance.

5.107 The six banks stated that they generally took into account a number of factors in deciding whether or not settlement should be reached with individual customers. These factors included:

- (a) whether the transaction documents had been properly completed and were in order;
- (b) whether the bank's internal guidelines and relevant regulatory requirements had been complied with by the relevant staff; and
- (c) the customers' personal circumstances, such as investment experience, literacy, etc.

Unresolved LB-related complaints

5.108 The hearings to receive evidence from the top/senior management of the six banks took place between April to November 2010, over 20 months after the collapse of LB in September 2008. However, the Subcommittee has noted that for those banks which had not entered into any agreement with MA and SFC pursuant to section 201 of SFO, a substantial number of their customer complaints remained unresolved¹²⁵. The major distributor of LB-CLNs¹²⁶ had resolved not

¹²⁴ BOCHK.

¹²⁵ Please refer to paragraphs 6.23 and 6.31 and Appendix 6(a) of Chapter 6 about the agreements reached by SFC and MA with banks pursuant to section 201 of SFO in respect of LB structured products, and paragraphs 6.38 to 6.41 for discussion on the disputes resolution mechanism for LB-related complaints and agreements pursuant to section 201 of SFO.

¹²⁶ DBSHK.

more than 24% of the complaints when its management appeared before the Subcommittee in April 2010. When the witnesses from the top/senior management of two banks which mainly distributed LB-ELNs through private placement¹²⁷ gave evidence in May and June 2010, the Subcommittee found that each of the banks had resolved less than 13% of their complaint cases.

Agreements pursuant to section 201 of SFO

5.109 Since July 2009, MA and SFC had reached agreements with each of the six distributing banks pursuant to section 201 of SFO to, amongst others, repurchase LB structured products from their customers. In addition, a Minibonds collateral recovery agreement was announced in March 2011. The Subcommittee has found that quite a large number of complaints were resolved on a collective basis under these agreements. For example, at the time when its management gave evidence to the Subcommittee, the major distributor of Minibonds¹²⁸ had settled nearly 85% of the complaints under the Minibonds repurchase agreement announced on 22 July 2009. Another bank¹²⁹ settled about 64% of the complaints under the same agreement.

Enhanced complaint-handling procedures

5.110 Pursuant to most repurchase agreements, the distributing banks were required to implement enhanced complaint-handling procedures (ECHP) to resolve, in a fair and reasonable manner, all outstanding complaints in relation to the distribution of LB structured products that could not be resolved by the agreements pursuant to section 201 of SFO. The major requirements under the ECHP were at **Appendix 5(a)**. The Subcommittee notes that under the ECHP, it is mandatory for banks to interview the complainant in the investigation process. The investigation

¹²⁷ CHKL and SCBHK.

¹²⁸ BOCHK.

¹²⁹ DSB.

had to include an assessment of whether the conduct of the relevant staff and the bank was in compliance with the Code of Conduct and other relevant regulatory requirements. According to the top/senior management of the three banks¹³⁰ which had distributed Minibonds and reached an agreement with MA and SFC pursuant to section 201 of SFO, one bank¹³¹ had settled about 90% of its outstanding complaint cases through ECHP; while the other two banks¹³² had resolved over 20% of their outstanding cases through ECHP.

Arbitration and mediation

5.111 According to the evidence given by the top/senior management of the six banks, none of these banks had participated in arbitration. Two banks¹³³ had made use of the mediation service under the Lehman Brothers-related Products Disputes Mediation and Arbitration Scheme¹³⁴ launched by HKMA in November 2008. At the time when the investors of LB structured products gave evidence to the Subcommittee, only two of them had participated in mediation. One case had been settled while the other one was still pending.

Observations

5.112 The large number of complaints against the six banks after the collapse of LB in September 2008 stood in sharp contrast to the very few complaints received by them before the LB incident. The Subcommittee is no doubt aware of the severity of the impact of the incident and its pressure on the complaint-handling systems available at individual banks at that time. Nevertheless, the small number of settlements reached

¹³⁰ BOCHK, DSB and RBS.

¹³¹ DSB.

¹³² BOCHK and RBS.

¹³³ DSB and RBS.

¹³⁴ Please see paragraphs 6.21 and 6.39 of Chapter 6 about the Lehman Brothers-related Products Disputes Mediation and Arbitration Scheme.

between the six banks and individual customers on a case-by-case basis many months after the collapse of LB highlighted the need for individual banks to review and enhance their complaint-handling systems in order to deal with large numbers of complaints expeditiously.

5.113 The Subcommittee is concerned that in their investigation of LB-related complaints, some banks might have over-relied on the documentation signed by complainants, instead of critically reviewing how the sales process had been conducted, such as whether suitability assessment had been properly done and the LB structured products, properly explained by the sales staff. The Subcommittee considers that if the complainants were not interviewed and in the absence of any audio recording, verification of what had transpired during the sales process was very difficult. While some of the banks claimed that they had conducted "independent" investigation into the complaints received after the LB incident, the Subcommittee has noted that the teams designated by these banks to carry out the investigation consisted of staff who were independent of the sales teams of the banks, but not external parties independent of the bank.

5.114 The Subcommittee notes that individual banks are required by the Code of Conduct, the Internal Control Guidelines and HKMA's SPM to put in place policies and procedures to ensure the proper handling of complaints. With a view to enhancing the efficacy of the complaint-handling systems of individual banks, HKMA should consider requiring banks to incorporate certain requirements, such as interviewing the complainants (unless it is impracticable to do so), into the complaint-handling procedures as a mandatory requirement.