

**CITIBANK (HONG KONG) LIMITED ("CHKL" or the "Bank")**

**WRITTEN SUBMISSIONS FOR MR LO WAI-PAK, WEBER, CHIEF EXECUTIVE OFFICER AND COUNTRY BUSINESS MANAGER**

**IN RESPONSE TO ISSUES RAISED BY THE SUBCOMMITTEE TO STUDY ISSUES ARISING FROM LEHMAN BROTHERS-RELATED MINIBONDS AND STRUCTURED FINANCIAL PRODUCTS TO THE LEGISLATIVE COUNCIL**

**Role of Citibank**

**1. Please advise:**

- (a) **apart from being a seller/distributor of the Lehman Brothers (LB)-related structured financial products, did your bank act as the Arranger of any or all of such products sold by your bank? If yes, was your bank the sole Arranger or one of the joint Arrangers? Please explain the roles and responsibilities of your bank as the Arranger of such products and its relationship with the issuer(s);**
- (b) **did your bank acquired the LB-related structured financial products from the issuer(s) before further selling them to clients? If yes, please provide the details; and**
- (c) **did your bank have any involvement in the design of the LB-related structured financial products sold by your bank through private placement?**

1.1 At the material time, CHKL did not act as the Arranger of any LB-related structured financial products distributed by it.

1.2 No. CHKL (as distributor) did not purchase LB-related structured financial products from the issuer before distributing them to its customers. This means CHKL did not hold any inventory of LB-related structured financial products before distribution to its customers.

1.3 CHKL did not have any involvement in the design of the LB-related structured financial products distributed by it.

## Lehman Brothers-related structured financial products sold by CHKL

### 2. Please advise:

- (a) a list of the types of LB-related structured financial products sold by your bank from April 2003 to 15 September 2008 and the specific products under each type;
- (b) the number and value (HK\$) of LB-related structured financial products sold by your bank for each year from April 2003 to 15 September 2008;
- (c) the first and the last LB-related structured financial products sold by your bank (together with a copy of the offer documentation (such as the prospectus, programme memorandum, product booklet, term sheet, etc.) and marketing material for each of the aforesaid first and the last products); and
- (d) whether there were any major differences in design and structure between the first and the last LB-related structured financial products sold by your bank. If yes, please provide a comparison.

2.1 CHKL began to distribute LB-related market-linked notes ("MLNs") on 20 March 2007 and LB-related equity-linked notes ("ELNs") on 12 October 2007 and ceased distribution of both types of product on 13 June 2008. CHKL did not distribute any other LB-related structured financial products (e.g. LB-related Minibonds) during the relevant period. A list of the LB-related MLNs and LB-related ELNs distributed by the Bank is enclosed as **item 1**.

2.2 A total of 71 LB-related MLNs and LB-related ELNs in the total value of US\$232,037,318 were distributed by CHKL between March 2007 to June 2008.

43 LB-related MLNs and LB-related ELNs in the value of US\$143,810,652 were distributed by CHKL in 2007 and 28 LB-related MLNs and LB-related ELNs in the value of US\$88,226,666 were distributed by CHKL in 2008.

2.3 The first LB-related structured financial product distributed by CHKL was a LB-related MLN known as "*Lehman Brothers 2.5 years USD Market Leader, Monthly Auto-call Principal Protected Note*". The payment of interest and redemption payout

at maturity were linked to the performance of Nikkei 225 Stock Average Index, KOSPI 200 Index, Thailand SET 50 Index and Taiwan TAIEX Index. It had a tenor of 2.5 years. The product was designed to be principal protected by the issuer provided that it was not redeemed by the customer before the maturity date.

- 2.4 The last LB-related structured financial product distributed by CHKL was a LB-related ELN known as "*Lehman Brothers 1 Year USD Daily Accrual All Season Coupon Auto-call Note with Daily Knock-In Series 23*". The payment of interest and redemption payout at maturity were linked to the performance of China Construction Bank Corporation – H Shares (0939.HK) and China Life Insurance Company Limited – H Shares (2628.HK). It had a tenor of 1 year. The product was not designed to be principal protected by the issuer and investors could receive physical delivery of the worst performing underlying stock at the maturity date instead of the principal investment amount.
- 2.5 The Indicative Terms and Conditions, Information Sheet and draft Final Terms of the first and last LB-related structured financial products distributed by CHKL are enclosed as **item 2**. There were no marketing materials.
- 2.6 In terms of product design and structure, the major difference between the first and last LB-related structured financial products distributed by CHKL was the first LB-related structured financial product was a MLN and the last LB-related structured financial product was an ELN. Please see response in paragraphs 2.3 and 2.4 above for the other differences in terms of product features.
3. **Based on the information provided by your bank to the Subcommittee on 21 January 2009, it is noted that the following series of products recorded the highest values of sales and the highest numbers of investors and complaints:**
- (i) **Lehman Brothers 1 Year USD Daily Accrual Coupon Auto-call Note with Daily Knock-In – Series 10 linked to PetroChina (0857.HK) and China Life Insurance (2628.HK); and**
  - (ii) **Lehman Brothers 8-month HKD Daily Accrual All Season Coupon Auto-call Note with Daily Knock-In – Series 22.**

- (a) **Please complete Tables 1 and 2 and provide a copy of the offer documentation and marketing materials for each of the products; and**
- (b) **Whether there were any major differences between the following product series in terms of the product structure and design:**
- **Series 1 and Series 10 of the product in (i); and**
  - **Series 1 and Series 22 of the product in (ii).**

3.1 Please see Tables 1 and 2 on pages 37 to 39. The Indicative Terms and Conditions, Information Sheet and draft Final Terms are enclosed as **item 3**. There were no marketing materials.

3.2 In terms of product structure and design, there were no major differences between:

- (a) Series 1 and Series 10 of the product referred to in Question 3(b); and
- (b) Series 1 and Series 22 of the product referred to in Question 3(b).

There were, however, variations in the product features e.g. underlying assets, coupon payment, etc.

#### **Internal process for approval of offer**

4. **Please advise:**

- (a) **how and when the first LB-related structured financial product (mentioned in Question 2(c)) was introduced to your bank; and**
- (b) **who introduced the first LB-related structured financial product to your bank and whether all other LB-related structured financial products sold by your bank were also introduced by the same source; if no, please provide the details.**

4.1 It would be helpful for CHKL to explain its overall internal approval/product due diligence process before it addresses the specific issues raised in Questions 4(a) and (b).

### *Product Type*

- 4.2 At the material time, all new product types (such as MLNs and ELNs) which were to be distributed in Asia (including Hong Kong) had to go through a global, regional and local internal review and approval process, as required by:
- (a) Citigroup Global Consumer Group ("**GCG**") New Products and Services Policy and Standards (September 2005) (enclosed as **item 4**); and
  - (b) Citigroup Asia New Products and Services Policy and Standards (March 2006) (enclosed as **item 5**).
- 4.3 New product types such as MLNs and ELNs required the approval of Citigroup Global Structured Products Committee ("**GSPC**") and Asia Product Committee ("**APC**"). GSPC and APC would assess the commercial viability and risks of the new products and suitability for distribution to retail customers. GSPC and APC would also risk-rate the new products and may set conditions relating to, for example, the sales process.
- 4.4 Principal protected MLNs were approved (as a new product type) by GSPC and Citigroup Wealth Management Product Committee (the predecessor of APC) in 2001.
- 4.5 ELNs linked to a single stock were approved (as a new product type) by GSPC in December 2005 and by APC in January 2006. ELNs linked to the worst performing stock in two or more underlying stocks were approved (as a new product type) by GSPC in September 2006 and APC in November 2006.
- 4.6 In addition, CHKL would prepare a Product Program (enclosed as **item 6**) to address specific issues (e.g. regulatory, business, risks and operational) relating to the distribution of a new product type in Hong Kong. The Product Program had to be approved by:
- (a) CHKL's management including personnel from product, sales, risk, compliance, legal, finance, operations and technology (as may be required); and
  - (b) key personnel in the region.

At the material time, the Product Program approval was renewed annually.

### ***Product Structures and Product Series***

- 4.7 At the material time, new structures of an already approved product type were approved by:
- (a) CHKL's Product and Compliance Teams; and
  - (b) GCG Regional Product, Compliance and Legal Teams<sup>1</sup>.
- 4.8 Individual series of an already approved structure, on the other hand, were approved by:
- (a) CHKL's Product and Compliance Teams; and
  - (b) GCG Regional Product Team.

### ***Issuer***

- 4.9 Citigroup Guidelines for Retail Products (enclosed as **item 7**) required that a product issuer should have a credit rating equal to or better than single A (or equivalent) by at least one of Standard & Poor's or Moody's. LB was approved as an issuer of structured financial products in April 2005 together with Goldman Sachs, Merrill Lynch and Morgan Stanley.

### ***The first LB-related structured financial product***

- 4.10 The first LB-related structured financial product (i.e. a LB-related MLN known as "*Lehman Brothers 2.5 years USD Market Leader, Monthly Auto-call Principal Protected Note*") was introduced to CHKL by the Equity Derivatives Sales Team of Lehman Brothers Commercial Corporation Asia Limited and the product structure was approved by CHKL's Product and Compliance Teams and GCG Regional Product, Compliance and Legal Teams in March 2007.
- 4.11 All other LB-related structured financial products were introduced to CHKL by the same source i.e. the Equity Derivatives Sales Team of Lehman Brothers Commercial Corporation Asia Limited.

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<sup>1</sup> At the material time, GCG Regional Product, Compliance and Legal Teams were all based in Singapore.

5. **Before the collapse of LB, many banks in Hong Kong were the distributors of LB-related structured financial products and sold considerable quantities of such products to their retail clients. Your bank did not seem to have taken part in such retail sales. Please explain the reasons for not selling these products on a retail basis.**

5.1 As noted above, CHKL only distributed LB-related MLNs and LB-related ELNs and did not take part in the sales of other LB-related structured financial products (e.g. LB-related Minibonds). CHKL was of the view that by offering LB-related MLNs and LB-related ELNs the Bank had already addressed the investment needs of its customers.

6. **What were the considerations that prompted your bank to act as a distributor/seller of LB-related structured financial products? To what extent was the need to increase non-interest income a factor?**

6.1 LB was one of the largest international financial institutions amongst the top US broker dealers such as Goldman Sachs, Merrill Lynch and Morgan Stanley.

6.2 CHKL aimed to offer a range of different products from different issuers to its customers. CHKL decided to distribute LB-related MLNs and LB-related ELNs to offer further product and issuer diversification to its customers.

6.3 The potential to increase non-interest income was only one of the many factors that CHKL considered when offering LB-related MLNs and LB-related ELNs for distribution. In any event, the total revenue contributed by LB-related MLNs and LB-related ELNs accounted for only 0.41% of the total revenue of CHKL for the period of 2007 to 2008.

7. **Under the existing regulatory regime, banks may offer financial products to clients through "*private placement*". Please advise:**

(a) **whether your bank had offered all the LB-related structured financial products to your clients through private placement; and**

(b) **if yes, the reasons for your banks' decision for selling such products through private placement rather than by way of retail sales as other banks had been doing. For example, whether your bank would receive a**

**higher rate of commission or there was a demand for such products from bank customers.**

7.1 At all material times, LB-related MLNs and LB-related ELNs were offered to CHKL's customers by way of private placement using the "*minimum denomination of HK\$500,000*" exemption under the Companies Ordinance, Cap.32.

7.2 The fees generated from the distribution of LB-related MLNs and LB-related ELNs by private placement was at the average of 2.64%. Commission rate was not a major factor CHKL had considered. Please also see response in paragraphs 5.1 and 6.3 above.

8. **Please advise:**

- (a) **whether all of the LB-related structured financial products sold by your bank had gone through the same approval process, and whether they were approved by the same officers. If no, please provide the reasons and describe how different products/types of products were approved;**
- (b) **if yes, please describe the approval process in the form of a flow chart, together with the name(s) and position(s) of the officers(s) responsible for the approval;**
- (c) **if the approval was made by a committee or department within your bank, please provide the details of the committee or department, including its membership, scope of responsibilities and internal guidelines or code of practice that it should follow;**
- (d) **if the approval was made by the Board of Directors, please provide the date(s) of its meeting(s) at which such approval was made; and**
- (e) **please provide the record of deliberations on why the following products had been approved for sale:**
  - (i) **the first LB-related structured financial products mentioned in Question 2(c); and**
  - (ii) **the two LB-related structured financial products mentioned in Question 3.**

- 8.1 Yes, all LB-related MLNs and LB-related ELNs distributed by CHKL had gone through the same internal approval/product due diligence process and reviewed/approved by the same committees/teams. Please also see response in paragraph 4 above.
- 8.2 A flow chart describing the internal approval/product due diligence process is enclosed as **item 8**.
- 8.3 Members and details of the relevant committees/teams are enclosed as **item 9**.
- 8.4 The approval of a particular investment product is not a direct function of the Board of Directors of CHKL.
- 8.5 The records of deliberations on why the first LB-related structured financial product mentioned in Question 2(c) and the two LB-related structured financial products mentioned in Question 3 had been approved for distribution are enclosed as **item 10**.
9. **Regarding the LB-related structured financial products that were launched in the market in a number of series, was your bank's decision in approving the sale of such products made once and for all types, or individually per series? Please explain.**
- 9.1 Each series of LB-related MLNs and LB-related ELNs distributed by CHKL was separately reviewed and approved. Please see response in paragraph 4.8 above.
10. **Did your bank sell any LB-related structured financial products between June and mid-September 2008 when the financial difficulties of LB were reportedly worsening? If yes, please explain why your bank had decided to continue to sell the LB-related structured financial products amidst such reports. When and why did your bank decide to stop selling any LB-related structured financial products?**
- 10.1 As noted above, CHKL ceased distributing LB-related MLNs and LB-related ELNs on 13 June 2008. The last LB-related structured financial product (a LB-related ELN known as "*Lehman Brothers 1 Year USD Daily Accrual All Season Coupon Auto-call Note with Daily Knock-In Series 23*") was offered to customers during the period from 5 to 12 June 2008.

10.2 According to directives issued by GSPC in June 2008, to diversify issuer risk CHKL should not distribute structured financial products of an issuer such that the structured financial products of that particular issuer amounted to more than 20% of all structured financial products distributed by CHKL. LB-related MLNs and LB-related ELNs amounted to 18.8% of all structured financial products distributed by CHKL at the time. Together with market news concerning LB at the time, CHKL decided to cease distribution of LB-related MLNs and LB-related ELNs on 13 June 2008.

11. **Had your bank been approached to engage in the sale of LB Minibonds? Had there been any deliberations on whether your bank should take part in the sale of Minibonds? If yes, please provide the details (including the level at which the deliberations were made, the organ(s) and officer(s) making the decision, and the records, if any, of such deliberations).**

11.1 Please see response in paragraph 5.1 above.

#### **Product due diligence**

12. **Did your bank have any written policy/internal guidelines on how product due diligence should be conducted? If yes, please provide the relevant documentation; if no, the reasons.**

12.1 Please see response in paragraph 4 above. The relevant requirements were set out in:

- (a) Citigroup GCG New Products and Services Policy and Standards (September 2005) (enclosed as **item 4**);
- (b) Citigroup Asia New Products and Services Policy and Standards (March 2006) (enclosed as **item 5**);
- (c) CHKL Product Program (enclosed as **item 6**); and
- (d) Citigroup Guidelines for Retail Products (enclosed as **item 7**).

13. **Please name the person(s)/department(s) responsible for preparing the written policy/internal guidelines on how product due diligence should be conducted. Was reference made to the requirements of the regulators (e.g. the Hong Kong Monetary Authority (HKMA) and the Securities and Futures Commission (SFC))**

**in preparing the relevant written policy/internal guidelines? Was a copy of the written policy/internal guidelines provided to the regulators for record?**

- 13.1 Citigroup GCG New Products and Services Policy and Standards (September 2005) (enclosed as **item 4**) was prepared by Citigroup Risk Management.
- 13.2 Citigroup Asia New Products and Services Policy and Standards (March 2006) (enclosed as **item 5**) was prepared by GCG Regional Compliance Team.
- 13.3 CHKL Product Program (enclosed as **item 6**) was prepared by CHKL's Product Team and approved by CHKL's management including personnel from product, sales, risk, compliance, legal, finance, operations and technology (as may be required) and key personnel in the region.
- 13.4 Citigroup Guidelines for Retail Products (enclosed as **item 7**) was prepared by Citigroup Retail Best Practices Committee.
- 13.5 CHKL Product Program, in particular, made reference to the requirements of the HKMA and the SFC.
14. **Had any product due diligence been conducted on a LB-related structured financial product before your bank made the policy decision to sell the product to your clients? If no, please provide the reasons; if yes, please provide information on how such due diligence had been conducted and the conclusions of the exercise.**
- 14.1 Yes. In addition to the internal approval/product due diligence process described in paragraph 4 above, for each new structure of LB-related MLNs and ELNs<sup>2</sup> distributed by CHKL, CHKL's Product and Compliance Teams and GCG Regional Product, Compliance and Legal Teams would:
- (a) Review and ensure that the product type itself (e.g. MLNs or ELNs) was already approved by GSPC and APC and the product satisfied the requirements of CHKL Product Program.

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<sup>2</sup> There were 8 approved structures of LB-related MLNs and LB-related ELNs distributed by CHKL (5 approved structures of LB-related MLNs and 3 approved structures of LB-related ELNs).

- (b) Confirm that LB was a Citigroup approved issuer and LB had a rating of single A or above in accordance with Citigroup Guidelines for Retail Products.
  - (c) Review the tenor of the product to confirm that, for LB-related MLNs, the tenor was no more than 10 years, and for LB-related ELNs, the tenor was no more than 1 year.
  - (d) Review and consider the appropriateness of the underlying assets.
  - (e) Review and consider the payoff structure in order to understand the appropriateness of the manner in which the payoff was derived from the performance of the underlying assets.
  - (f) Assess the commercial viability and risks of the products and suitability for distribution to retail customers.
  - (g) Consider the relevant local legal and regulatory requirements.
  - (h) Vet/review the Indicative Terms and Conditions, Information Sheet and draft Final Terms prepared by the issuer to ensure the offering documents had adequate and accurate description of the structure, nature and risks of the product.
15. **Was product due diligence conducted in respect of each series of a LB-related structured financial product (e.g. ELNs) sold by your bank? If yes, please provide information on how your bank conducted the exercise, including the dedicated team, if any, for such work; if no, the reasons.**
- 15.1 Yes. In addition to the internal approval/product due diligence process described in paragraphs 4 and 14.1 above, CHKL's Product and Compliance Teams and GCG Regional Product Team would review and consider the product features (e.g. coupon payments, underlying asset etc.) of each series of LB-related MLNs and LB-related ELNs distributed by CHKL and review the offering documents to ensure accuracy.
16. **Did your bank make any enquiries or obtain any information from the issuer(s) and/or other independent sources about the nature, structure and risks of each LB-related structured financial product to be sold by your bank? If no, please provide the reasons; if yes, please explain using the following products as**

**examples: (i) the first and the last LB-related structured financial products mentioned in Question 2(c); and (ii) the two LB-related structured financial products mentioned in Question 3.**

16.1 CHKL did make enquiries on the nature, structure and risks of LB-related MLNs and LB-related ELNs before distribution to customers.

16.2 CHKL also took into account the views of Citigroup's investment research analyst where publicly available and considered the ability of LB (as an issuer) to price and launch structures in the market, provide suitable offering documentation and offer regular secondary market quotations, and whether the issuer was an approved counterparty of Citigroup.

16.3 Some examples include but not limited to:

(a) For the first LB-related structured financial product distributed by CHKL i.e. a LB-related MLN known as "*Lehman Brothers 2.5 years USD Market Leader, Monthly Auto-call Principal Protected Note*", CHKL made enquiries on:

- product features (interest amount and observation date);
- risks (repayment of principal under special condition like illegality and tax event); and
- the adequacy of disclaimers.

(b) For the last LB-related structured financial product distributed by CHKL i.e. a LB-related ELN known as "*Lehman Brothers 1 Year USD Daily Accrual All Season Coupon Auto-call Note with Daily Knock-In Series 23*" and the second LB-related structured financial product mentioned in Question 3 i.e. a LB-related ELN known as "*Lehman Brothers 8-month HKD Daily Accrual All Season Coupon Auto-call Note with Daily Knock-In Series 22*", CHKL made enquiries in respect of the product features (interest payment calculation method).

(c) For the first LB-related structured financial product mentioned in Question 3 i.e. a LB-related ELN known as "*Lehman Brothers 1 Year USD Daily Accrual*

*Coupon Auto-call Note with Daily Knock-In Series 10"*, CHKL made enquiries in respect of the risk factors.

17. **Did your bank have any written policy or guidelines on product risk assessment? If yes, please provide the relevant documentation; if no, the reasons.**

17.1 CHKL had established methodology to assign risk ratings to structured financial products. The methodology was set out in the Regional Policy on APAC Treasury Products re Client Risk Profiling Process & Client Risk Profile Deviation Approval and Monitoring Process (June 2003) enclosed as **item 11** and the Regional Guidelines on Asia Consumer Risk Profiling Questionnaire & Scoring Methodology (July 2007) (enclosed as **item 12**) and.

18. **Did your bank assess the risks of each product sold by your bank? If yes, please give in tabular form the risk ratings of each product assessed by your bank and explain how your bank arrived at each of the risk ratings (including all factors and criteria taken into consideration in arriving at the ratings); if no, the reasons.**

18.1 At the material time, there were 6 risk levels - Level 1 being the lowest risk and Level 6 being the highest risk. A table setting out the risk ratings assigned to each product distributed by CHKL is enclosed as **item 13**.

18.2 As stated in paragraph 4.3 above, GSPC and APC would risk-rate new product type (e.g. MLNs or ELNs). The primary factors considered were:

- (a) the level of principal protection at maturity;
- (b) the quality of the principal protection, which was determined by reference to the credit rating of the issuer; and
- (c) the tenor of the product.

19. **Please provide an explanation on the scale of risks assessment adopted by your bank in respect of the LB-related structured financial products sold by your bank.**

19.1 The risks assessment adopted by CHKL in respect of LB-related MLNs and LB-related ELNs were the same as mentioned in paragraph 18 above.

- 19.2 MLNs (including LB-related MLNs) with a tenor of not more than 7 years were originally risk-rated as 2. Since July 2007 principal protected MLNs (including LB-related MLNs) with a tenor of less than 5 years and an issuer with credit rating of single A or split ratings of single A/AA- were risk-rated as 3.
- 19.3 LB-related ELNs were assigned a risk rating of 6, the highest risk rating.
20. **Did your bank conduct any after-sale risk assessment in respect of each of the LB-related structured financial products sold by your bank? If yes, please provide the details including whether the clients were informed of the latest assessment results?**
- 20.1 CHKL reviewed the credit rating of LB on an annual basis for conformity with the requirement that a product issuer should have a single A or better rating by Standard & Poor's or Moody's. As a further safeguard, CHKL also confirmed that LB was approved as a Citigroup counterparty by Citigroup Asia Credit Department, which reviewed such approval annually.
- 20.2 CHKL also updated mark-to-market prices of LB-related MLNs and LB-related ELNs on a weekly basis. Customers were informed of the latest price of their LB-related MLNs and LB-related ELNs via internet and monthly consolidated statements. In addition, customers could enquire updated mark-to-market prices at the branches and/or contact the relevant sales staff.
21. **It is noted that between June and July 2008, credit-rating agencies (such as Standard & Poor's, Fitch Ratings and Moody's) lowered the credit ratings of LB, and the shares of LB also dropped substantially. Did your bank conduct any assessment on the possible impact of the financial difficulties of LB on the outstanding LB-related structured financial products sold by your bank? If yes, please provide the details; if no, the reasons.**
- 21.1 Researches on LB were conducted in early June 2008 and CHKL took into consideration the views of Citigroup's research analysts from Citi Investment Research and Analysis team in assessing the overall and credit quality of LB. Please also see response in paragraph 20 above.

#### **Offer documentation and marketing materials**

22. **Did your bank have any involvement in the preparation of the offer documentation and marketing materials of the LB-related structured financial products sold by your bank (such as the products mentioned in Questions 2(c) and 3)? If yes, please provide the details.**
- 22.1 The Indicative Terms and Conditions, Information Sheet and draft Final Terms of the LB-related MLNs and LB-related ELNs distributed by CHKL were prepared by the issuer. There were no marketing materials as LB-related MLNs and LB-related ELNs were distributed by CHKL by way of private placement.
23. **Since the offer documentation and marketing materials for LB-related structured financial products for sale by way of private placement did not require SFC's authorization, did your bank have any mechanism to vet/review the contents and presentation of such documentation and materials? If yes, please provide the details and whether your bank ever raised any queries/comments to the issuer(s). If no, how did your bank ensure that there was full disclosure of product information (such as risks) in such documentation?**
- 23.1 As noted in paragraphs 14.1 and 15.1 above as part of the internal approval/product due diligence process, for every new structure of LB-related MLNs and LB-related ELNs distributed by CHKL, CHKL's Product and Compliance Team and GCG Regional Product, Compliance and Legal Teams would vet/review to ensure the offering documents had adequate and accurate description of the structure, nature and risks of the product. For each series of LB-related MLNs and LB-related ELNs distributed by CHKL, CHKL's Product and Compliance Teams and GCG Regional Product Team would review the offering documents to ensure accuracy.
- 23.2 Comments and queries from both GCG Regional Product Team and CHKL's Product Team were raised with LB to ensure adequate and accurate description of key product features and risks in the offering documents. Please also see response in paragraph 16 above.
- 23.3 There were no marketing materials for LB-related MLNs and LB-related ELNs distributed by CHKL.

#### **Training and guidance to frontline sales staff**

24. **Please describe the training arrangements for staff engaged in the sale of LB-related structured financial products, including the following particulars:**

- (a) **whether the training was general or product specific or both;**
- (b) **if only general, please give the details of the training programme(s);**
- (c) **if product specific, please give details of the training programme(s) for the following products:**
  - (i) **the first and the last LB-related structured financial products mentioned in Question 2(c); and**
  - (ii) **the two LB-related structured financial products mentioned in Question 3.**
- (d) **if the training was both general and product specific, please give all details specified in (b) and (c); and**
- (e) **if there had been changes to the training arrangements, please describe.**

24.1 CHKL provided both general investment and product specific training to its sales staff.

24.2 At the material time, sales staff who engaged in the distribution of investment products must first undertake relevant training and obtain internal certification. Training included general investment training and product specific training. General investment training provided sales staff with knowledge of the characteristics and structures of different product types, and sales staff were required to pass a test in order to obtain the internal certification.

24.3 It was mandatory for all newly joined sales staff to attend investment compliance training conducted by investment compliance officers to gain an understanding of the internal and regulatory requirements governing sale of investment products. Sales staff were also trained by CHKL's Human Resources Training Team on customer risk profiling, assessment of product suitability and product recommendation before they were allowed to distribute investment products to customers. Trainers within CHKL's Human Resources Training Team held CFA and CFP qualifications. Attendance at training session was recorded and training materials and modules were reviewed periodically and updated where necessary.

- 24.4 Once sales staff had satisfactorily completed the relevant training requirements, passed the required internal examinations and met the relevant regulatory registration and competence requirements, they would be certified as being qualified to distribute investment products to customers. Sales staff engaged in the distribution of LB-related MLNs and LB-related ELNs had all completed relevant training and obtained certification status.
- 24.5 In addition to general investment training, there was on-going training provided to sales staff on specific structured products when they were first offered to customers. In terms of LB-related MLNs and LB-related ELNs, training was conducted by Lehman's Equity Derivatives Sales Team together with CHKL's Product Team for CHKL's Investment Consultants ("ICs") and Relationship Managers ("RMs"). The training materials were prepared by the issuer and vetted by CHKL's Product Team. The training materials outlined the key features, terms and risks of the products and included illustration of how the structures worked under different scenarios.
- 24.6 It is relevant to note that ICs who were stationed at different branches of CHKL were responsible for briefing RMs at the branches and to provide ongoing coaching to RMs to help them to understand the key features and risks of each series of LB-related MLNs and LB-related ELNs distributed by CHKL and to answer any queries from RMs.
25. **Did the issuer(s) or your bank or any other party conduct any product briefings and/or provide training materials to the frontline sales staff of your bank for each of the LB-related structured financial products sold by your bank? If yes, please provide the details; if no, the reasons.**
- 25.1 Before a new structure of LB-related MLN or LB-related ELN was launched, Lehman's Equity Derivatives Sales Team together with CHKL's Product Team would provide training to ICs and RMs during the weekly IC meetings or telephone conferences.
- 25.2 ICs in turn would brief and update RMs of the key features and risks of the products and answer any queries from RMs at briefings conducted at the branches.
26. **Did your bank provide any further training to your frontline sales staff for each of the LB-related structured financial products distributed by your bank prior to**

**the launch of the private placement of each of such products? If yes, please provide the details; if no, the reasons.**

- 26.1 Please see response in paragraphs 24 and 25 above.
27. **Was it mandatory for the frontline sales staff of your bank to attend the product briefing and/or training before they could sell a LB-related structured financial product to clients? If no, please provide the reasons.**
- 27.1 Yes. It was mandatory for all frontline sales staff to attend product briefing and/or training before they could distribute LB-related MLNs and LB-related ELNs to customers.
28. **Did your bank have any procedures to assess the frontline sales staffs knowledge on a LB-related structured financial product before they were allowed to sell the product to clients? If yes, please provide the details; if no, the reasons.**
- 28.1 As noted in paragraph 24.6 above, ICs were responsible for briefing RMs at the branches to help them to understand the key features and risks of each series of LB-related MLNs and LB-related ELNs distributed by CHKL and to answer any day-to-day queries from front-line sales staff. Interactive briefings were conducted at the branches in which RMs were encouraged to ask questions and ICs were in a position to gauge the understanding of the front-line sales staff and reinforce their product knowledge, as required.
29. **Did your bank receive any feedback from your sales staff on the training provided to them in relation to the sale of LB-related structured financial products? If yes, please provide the details.**
- 29.1 RMs were given opportunities at the interactive briefings to share any concerns or difficulties they might have in relation to the distribution of LB-related MLNs and LB-related ELNs.
- 29.2 CHKL has no recollection of any significant concerns or difficulties raised by sales staff in terms of the training provided to them in relation to the distribution of LB-related MLNs and LB-related ELNs.

30. **Did your bank provide any sales scripts to your frontline sales staff on the solicitation process relating to the sale of LB-related structured financial products? If yes, please provide a copy of the script.**
- 30.1 No sales scripts were provided to front-line sales staff for the distribution of LB-related MLNs and LB-related ELNs. Front-line sales staff were required to abide by CHKL's minimum standard described in paragraph 39.1 below.
31. **Please provide a copy of the operational guidelines, manual, internal memoranda, instructions or any other documents prepared by your bank to the staff engaged in the sale of LB-related structured financial products to assist them in complying with the *Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission* (the Code of Conduct). If such guidelines, manual, memoranda, instructions and documents were product specific, please supply them in respect of each of the following products:**
- (a) **the first and the last LB-related structured financial products mentioned in Question 2(c); and**
  - (b) **the two LB-related structured financial products mentioned in Question 3.**
- 31.1 Internal operational guidelines, manual, internal memoranda, etc. were prepared by CHKL to assist its sales staff to comply with the Code of Conduct including:
- (a) the Hong Kong Investment Compliance and Supervisory Manual issued by CHKL's Compliance containing references to the Code of Conduct ( enclosed as **item 14**); and
  - (b) CHKL Product Program (enclosed as **item 6**).
- 31.2 In addition, CHKL also had the following documents or practice to reinforce the guidelines:
- (a) Mandatory investment compliance training at the time of joining CHKL;
  - (b) Ad hoc investment compliance training;
  - (c) Structured products overview;
  - (d) Monitoring of Continuing Professional Training (CPT);

- (e) Monitoring of Relevant Individual registration; and
- (f) Ongoing monitoring of sales conduct.

32. **Did your bank have any policy/procedures to ensure that your sales staff would meet the Fit and Proper Guidelines, the Guidelines on Competence and the Guidelines on Continuous Professional Training issued by SFC? If yes, please provide the details of such policy/procedures; if no, the reasons.**

32.1 CHKL vetted all newly joined sales staff to ensure that they met the SFC's competence and professional requirements. Newly joined sales staff were required to make declarations about their fitness and properness and competency and CHKL would cross-check to ensure that there was no material negative record found from both internal and external sources.

32.2 As noted above, newly joined sales staff were required to attend mandatory training to ensure that they were aware of the prevailing regulatory requirements. Continuous professional training was also provided to sales staff. Further, on a quarterly basis and also when required, CHKL would issue reminders to sales staff to reinforce compliance to the relevant guidelines.

33. **Did your bank involve the legal/compliance team in vetting the relevant training materials so as to ensure that all relevant legal and regulatory requirements had been met? If yes, was any false/inaccurate/misleading information in the materials identified? If no, please provide the reasons.**

33.1 CHKL's Compliance Team was involved in vetting the relevant training materials. No false, inaccurate or misleading information was identified in the training materials.

#### **Know your clients**

34. **Did your bank have any policy/procedures to ensure that your frontline sales staff did conduct risk profiling exercise with the customers to assess their risk appetite? If yes, please provide the details; if no, the reasons.**

34.1 When a customer opens an account with CHKL, sales staff were required to collect customer information in discharge of their "*know-your-client*" duties. In addition to the "*know-your-client*" checks at the time of account opening, sales staff were

required to conduct risk profiling with the customer. CHKL has also in place additional safeguards to protect vulnerable customers. It should be noted that many sales staff may have long-standing relationships with their customers and would therefore have had knowledge, in addition to the information captured in the account opening form and risk profiling.

- 34.2 At CHKL risk profiling is conducted at each product level. If a customer wishes to invest in an investment product for the first time, an account will be opened for that particular investment product and prior to opening the investment product account, a customer risk profiling will be conducted.
- 34.3 In the risk profiling process, the customer will be asked questions. The scoring mechanism is based on the customer's choices on questions on age, expected future income, investment experience, investment objectives and risk tolerance, and the proportion of total net asset for investment in CHKL of the customer where applicable. These questions are based on the Regional Guidelines on Asia Consumer Risk Profiling Questionnaire & Scoring Methodology (enclosed as **item 12**). The customer's risk profile is then mapped against CHKL's investment portfolio suggestion to determine the types of product that are suitable for the customer.
- 34.4 At the material time, customers were classified into one of 6 risk tolerance level:
- (a) Level 1 – risk averse
  - (b) Level 2 – income
  - (c) Level 3 – conservative
  - (d) Level 4 – balanced
  - (e) Level 5 – growth
  - (d) Level 6 – enhanced growth
- 34.5 Customers were asked to sign the completed risk profiling form to acknowledge their answers provided in the risk profiling process.
35. **Did your bank require the risk profiling exercise be conducted in relation to the customers only once when they opened an investment account, or continuously at**

**regular intervals? If continuously, how did your bank ensure compliance by each staff member?**

35.1 At the material time, each risk profiling was only valid for 12 months. CHKL would ensure that a customer had a valid risk profiling at the time of the purchase of each new investment product.

36. **Did your bank have any internal mechanism to conduct periodic review of the risk profiling questionnaire and scoring system? If yes, please provide the details; if no, the reasons.**

36.1 The customer risk profiling and scoring methodology are reviewed from time to time by GCG Regional Product and Compliance Teams.

37. **Did your bank require your sales staff to assess the customers' specific needs and personal circumstances in addition to the risk profiling questionnaire? If no, please provide the reasons.**

37.1 Please see response in paragraph 34 above.

#### **Suitability of recommendation and solicitation**

38. **Were the Questions and Answers on Suitability Obligations of Investment Advisers (FAQ) published by SFC in May 2007 brought to the attention of the sales staff of your bank? Were they briefed on FAQ?**

38.1 Sales leaders and supporting units were notified of the requirements of FAQ by way of an email issued by CHKL's Compliance Team and they were required to disseminate the email message to frontline sales staff. In addition, training was conducted at the branches whereby front-line sales staff were briefed on the relevant sections of the FAQ.

39. **Did your bank have any internal controls to ensure suitability of the recommendations and solicitations for investment in LB-related structured financial products? If yes, please provide the details; if no, the reasons.**

39.1 CHKL provided guidelines to front-line sales staff setting out the minimum standard in terms of product explanation to prospective customers including:

- (a) Provide offering documents to customers.
- (b) Explain product features with the help of the offering documents.
- (c) Explain market scenarios.
- (d) Confirm with customers that they had gone through the risk factors printed on the offering documents and they fully understood the risks associated to the products.
- (e) Explain the product is a structured note and liquidity is limited.
- (f) For MLN, explain that “100% principal protection” is not applicable if the product is redeemed before maturity.
- (g) For MLN and ELN, explain that the return is derived from the performance of the underlying and return may be as low as 0% or the minimum overall return as specified in the offering documents where applicable.
- (h) For ELN, explain that the product is not principal protected. At maturity, ELN may be redeemed by physical delivery of the underlying shares. Value of the shares delivered may be substantially less than the principal invested. The value can even be zero in some cases.
- (i) Explain that hypothetical examples in the offering documents are for illustrative purpose only and are not indicative of actual and/or future performance. Past performance of underlying is not indicative of future result.
- (j) Disclose name of the issuer and its credit rating.
- (k) Confirm transaction details including but not limited to account number, currency, maturity date, denomination of the structured note, issue price, subscription amount and settlement date.
- (l) Disclose fee and commission.

39.2 Sales documentation of each transaction was reviewed by the operations supervisor of the front-line sales staff who conducted the transaction.

- 39.3 For transactions conducted by telephone, CHKL had a designated team that sample reviewed recorded telephone conversations between sales staff and customers. The main objective of the phone monitoring was to determine whether the relevant sales staff had discussed the product features of LB-related MLNs or LB-related ELNs and provided adequate risk disclosure to customers during the selling process.
- 39.4 For transactions conducted by physical meetings, CHKL conducted an annual independent mystery shopping exercise to evaluate whether the investment sales activities conducted at the branches are in compliance with CHKL's internal policies and the prevailing regulatory requirements.
40. **Did your bank have any system to require the sales staff to document the reasons for the recommendation given to the clients? If yes, please provide the details; if no, the reasons.**
- 40.1 Recommendations were made in accordance with customer documented risk profiles as reflected in the risk profiling.
41. **Did your bank have any measures to ascertain whether the clients were fully aware of the nature and risks of the LB-related structured financial products recommended by your sales staff? If yes, please provide the details; if no, the reasons.**
- 41.1 Please see response in paragraph 39 above.
42. **Did your bank have any internal controls to identify transactions in which there was a mismatch between the product risk rating and the customer's risk profile? If yes, please provide the details; if no, the reasons.**
- 42.1 CHKL has a Daily Risk Deviation Report designed to assist sales management in supervising sales activities. The Daily Risk Deviation Report captured transactions where there was a deviation from the customers' risk profile. Branch Service Managers are responsible for reviewing the daily reports.

### **Sale of products**

43. **Did all your frontline staff engaged in the sale of LB-related structured financial products sit and pass the relevant examinations for representatives to be licensed**

by SFC? If no, did your bank set any qualifications (e.g. seniority, rank, experience, education, and training courses attended) when selecting frontline staff to engage in the sale of the aforesaid products?

43.1 All staff engaged in the distribution of LB-related MLNs and LB-related ELNs at CHKL were registered with the HKMA.

44. **Was all the sale of LB-related structured financial products conducted by staff members who were Relevant Individuals registered with HKMA?**

44.1 At CHKL only Relevant Individuals registered with the HKMA were allowed to distribute LB-related MLNs and LB-related ELNs to customers.

45. **Please describe how your bank had conducted the private placement of LB-related financial products, including the following particulars:**

- (a) **how your bank had identified the target clients (using the first and the last LB-related structured financial products mentioned in Question 2(c) and the two LB-related structured financial products mentioned in Question 3 as illustration, describe the target clients (in terms of age, education level, net worth and relationship with your bank) in the sale of each of the products);**
- (b) **the criteria adopted to designate certain clients as professional investors, and whether the clients were aware that they were so classified;**
- (c) **how your bank had approached the target clients (e.g. making telephone calls, by invitation in writing or personal visits);**
- (d) **the preparatory works undertaken before private placement could take place, e.g. what promotional materials were prepared and how the staff were trained;**
- (e) **the features of the LB-related structured financial products emphasized in the relevant marketing or promotional materials used by your bank;**
- (f) **the typical process of a successful sale (from approaching a target client for the first time to the settlement of all relevant transactions);**

- (g) how such private placements were organized (e.g. by bank branches, by sales teams or by designated officers);**
- (h) how such private placements were monitored (e.g. at different levels, by a team leader or branch manager or department head or designated officer);**
- (i) the officer(s) (name(s) and position(s)) in charge of the overall strategy of staff deployment for the sale of LB-related structured financial products;**
- (j) the officer(s) (name(s) and position(s)) in charge of the overall supervision of the marketing or promotion of LB-related structured financial products;**
- (k) the officer(s) (name(s) and position(s)) responsible for ensuring the achievement of sales targets;**
- (l) how your bank ensured that the applicable law and regulations were complied with in the entire sale process;**
- (m) what records were made after each successful and unsuccessful transaction;**
- (n) the quantitative sales targets, if any, set for specific time period for each branch of your bank and for each staff member at different levels involved in such sales;**
- (o) details of the incentive scheme(s) for:**
  - (i) staff on the basis of the amount of sales of LB-related structured financial products achieved; and**
  - (ii) investors on the basis of the amount of LB-related structured financial products they purchased;**
- (p) if such incentive scheme(s) changed over time, please give details of each stage of the scheme(s) in chronological order; and**

(q) **was there a different incentive scheme if the LB-related structured financial products were sold to professional investors or where the subscription amount in a single transaction was HK\$500,000 or more.**

45.1 No customer or groups of customers were identified by CHKL as target customers for the distribution of LB-related MLNs and LB-related ELNs.

45.2 At CHKL no customer was designated as a professional investor.

45.3 As noted above, no customer or groups of customers were identified by CHKL as target customers for the distribution of LB-related MLNs and LB-related ELNs. Staff were explicitly instructed that "*cold calling*" was not allowed at CHKL. As part of CHKL's wealth management services sales staff would regularly contact customers (by email, telephone and/or physical meetings) to provide latest market information. If requested by customers, sales staff would introduce financial products such as MLNs and ELNs. Alternatively, as the Bank did not begin to distribute LB-related MLNs and LB-related ELNs until 2007, some of its customers had already heard about and/or had purchased MLNs and ELNs (issued by LB or other issuers) from other banks. These customers would ask sales staff whether CHKL offered similar financial products. The sales staff would then introduce the products to them.

45.4 CHKL did not use/have any promotional materials for the distribution of LB-related MLNs and LB-related ELNs. In terms of training for sales staff, please see response in paragraph 24 above.

45.5 As noted above, CHKL did not have any promotional materials for the distribution of LB-related MLNs and LB-related ELNs. Sales staff used the Indicative Terms and Conditions, Information Sheet and draft Final Terms to explain features of LB-related MLNs and LB-related ELNs to customers.

45.6 A typical successful selling process is as follows:

(a) If applicable, the relevant sales staff would conduct a customer risk profiling in the manner described in paragraph 34 above.

(b) A relevant investment account would be opened for the customer if the customer did not already have such account.

(c) With the help of the Indicative Terms and Conditions, Information Sheet and draft Final Terms, the relevant sales staff would take the steps described in paragraph 39.1 as required by CHKL's internal guidelines.

45.7 Distribution of LB-related MLNs and LB-related ELNs were organised by CHKL's Product Team.

45.8 Distribution of LB-related MLNs and LB-related ELNs at each branch was monitored by the relevant Branch Manager and operations supervisor.

45.9 Amy Choi, Director of Sales and Distribution of CHKL was in charge of the overall strategy of staff deployment for the distribution of LB-related MLNs and LB-related ELNs.

45.10 As noted above, CHKL did not have any marketing and promotional materials for the distribution of LB-related MLNs and LB-related ELNs.

45.11 There was no sales target or incentive scheme in particular to the distribution of LB-related MLNs and LB-related ELNs. Front-line sales staff were appraised in terms of customer services, compliance and control and their financial performance. The sales incentive scheme of CHKL in relation to the distribution of investment products was set out in the Citibanking Award Program (enclosed as **item 15**). The incentive scheme was based on the total revenue generated from the sales of a wide range of products including but not limited to investment, foreign exchange, insurance, deposit and loan products. The Citibanking Award Program did not make any distinction between revenue generated from selling any particular type of product. Revenue generated from sales of all types of product was tabulated in the same manner towards a common target. Customer satisfaction and compliance to sales conduct are prerequisites for receiving any incentives/awards.

45.12 In terms of Question 45(l), please see response in paragraphs 24, 31 and 32 above.

45.13 In terms of records made after each successful transaction, they were account opening form, customer risk profiling form and subscription form. CHKL does not have records for unsuccessful transactions.

45.14 As stated in paragraph 45.11 above, there was no quantitative sales target for any branch or any staff involved in the distribution of LB-related MLNs and LB-related

ELNs. Also, there was no incentive scheme for staff or investor on the basis of the amount of LB-related MLNs or LB-related ELNs distributed or purchased.

45.15 There was no particular incentive scheme for distribution of LB-related MLNs and LB-related ELNs to professional investors or where the subscription amount in a single transaction was HK\$500,000 or more.

46. **Using the first and the last LB-related structured financial products mentioned in Question 2(c) and the two LB-related structured financial products mentioned in Question 3 as examples, please describe your bank's sales strategies of LB-related structured financial products.**

46.1 Please see response in paragraph 45 above.

47. **Please set out in the form of a chart the organizational structure of the staff (including all sales teams or units and the number of staff) engaged in the sale of LB-related structured financial products. If the organizational structure varied over time, please provide a chart for each of the following stage:**

(a) **the sale of the first and the last LB-related structured financial products mentioned in Question 2(c); and**

(b) **the sale of the two LB-related structured financial products mentioned in Question 3.**

47.1 The relevant organization charts are enclosed as **item 16**.

48. **Besides the offer documentation and marketing material, did your bank provide any other materials, such as posters, promotional letters and leaflets, to customers for the sale of LB-related structured financial products? If yes, please provide the details and a copy of the relevant materials.**

48.1 No, CHKL did not provide any other materials to customers other than the Indicative Terms and Conditions, Information Sheet and draft Final Terms.

49. **Did your bank detect any false/inaccurate/misleading information contained in the advertising materials for a particular LB-related structured financial product which had not been consistent with the information in the offer document for the product?**

49.1 As noted above, there were no promotion/advertising materials for the distribution of LB-related MLNs and LB-related ELNs.

50. **Did your bank have any supervision or management measures to ensure that the frontline sales staff would follow the proper procedures stipulated in the Code of Conduct, as well as relevant manuals/guidelines, if any, during the selling process? If yes, please provide the details; if no, the reasons.**

50.1 Please see response in paragraphs 24, 31, 32, 39 and 45.8 above.

51. **Under the existing regulatory regime, regardless of how financial products are offered (such as through private placement or retail sale), the conduct of sale by intermediaries has to comply with the Code of Conduct. How did your bank ensure that your sales staff were aware of their obligations and complied with the requirements under the Code of Conduct, including FAQ, when selling LB-related structured financial products?**

51.1 Please see response in paragraphs 32, 38 and 39 above.

#### **Handling of complaints**

52. **Before the collapse of LB in mid-September 2008, did your bank receive any complaints in relation to alleged mis-selling of LB-related structured financial products? If yes, please provide the details, including the number of cases and particular series involved.**

52.1 CHKL received 2 complaints of alleged mis-selling of LB-related MLNs and LB-related ELNs prior to the demise of LB in mid-September 2008. The two complaints involved a LB-related MLN known as "*Lehman Brothers 4.75 Years USD One Shot, Monthly Auto-call Principal Protected Note*)" and a LB-related ELN known as "*Lehman Brothers 1 Year USD Daily Accrual Coupon Auto-call Note with Daily Knock-In – Series 12 linked to PetroChina (0857.HK) and China Communications Construction (1800.HK)*".

53. **Please provide the following information:**

- (a) **the number of customers who purchased LB-related structured financial products from your bank and were affected by the collapse of LB;**

- (b) **the number of complaints your bank received after the collapse of LB concerning the sale of LB-related structured financial products;**
- (c) **the latest number of complaints in relation to LB-related structured financial products that your bank has settled, together with information on the settlement arrangements (e.g. repurchase of the products);**
- (d) **the latest number of unresolved complaints;**
- (e) **the expected time-frame to settle the unresolved complaints;**
- (f) **whether a broad-based settlement similar to the repurchase of Minibonds by the 16 distributing banks would be reached. If yes, please provide the details; if no, the reasons; and**
- (g) **whether a broad-based settlement in relation to a particular type of LB-related structured financial products or a particular series of such a product sold by your bank has been/would be reached. If yes, please provide the details; if no, the reasons.**

53.1 A total of 1,421 customers purchased LB-related MLNs and LB-related ELNs from CHKL between March 2007 and June 2008 involving 1,681 transactions (270 transactions of LB-related MLNs and 1,411 transactions of LB-related ELNs).

53.2 As at 31 March 2010, CHKL had received 594 complaints from customers who had purchased LB-related MLNs and LB-related ELNs from the Bank. The Bank has approved settlement for 56 customer complaints (at up to 100% of the notional amount invested).

53.3 CHKL believes that it has adequate systems and controls governing the distribution of LB-related MLNs and LB-related ELNs that were in line with the then prevailing regulatory requirements. CHKL does not believe that there is a basis on which a broad-based settlement should be reached with customers who had purchased the products from the Bank.

54. **Please advise:**

- (a) **has your bank put in place any written policy/procedures on handling and investigating complaints lodged by clients who have purchased investment products from your bank?**
- (b) **if yes, please provide a copy of such policy/procedures and a flow chart on your bank's complaint handling and investigative process in relation to LB-related structured financial products sold by your bank;**
- (c) **are such policy/procedures required to be endorsed by the regulators (such as HKMA)? If no, is a copy of such policy/procedures provided to the regulator(s) for record?**
- (d) **has your bank put in place "enhanced" complaint handling procedures to resolve complaints in relation to the sale of LB-related structured financial products, similar to the 16 banks which entered into the Minibonds repurchase agreement with HKMA and SFC? If yes, please provide the details.**

54.1 CHKL has well structured customer complaints handling procedures to ensure that customer complaints are thoroughly, promptly and fairly investigated. Following the unexpected demise of LB, a designated team comprised of independent qualified staff and members from the Bank's Management Committee has been assigned to investigate complaints of purchasers of LB-related MLNs and LB-related ELNs. A copy of CHKL's customer complaints handling procedures and a flow chart explaining the investigation process in respect of LB-related MLNs and LB-related ELNs are enclosed as **item 17**.

54.2 CHKL believes that its customer complaints handling procedures are in line with the prevailing regulatory requirements. This is supported by the fact that no issues had been identified by the HKMA in respect of the Bank's customer complaints handling procedures in previous examinations conducted by the HKMA. CHKL has regularly reviewed and enhanced its policies and procedures to ensure that customer rights and interests are adequately protected.

55. **Did your bank detect any substantiated non-compliance cases in relation to the sale of LB-related structured financial products during its internal investigations**

**into the complaints filed by investors of such products? If yes, please provide the number and key particulars of such cases.**

55.1 Whilst there may have been isolated cases of lapses to meet the Bank's internal policies, CHKL has not detected a substantial number of non-compliance cases.

#### **Regulatory oversight and compliance**

56. **It is noted that since 2000, HKMA has adopted the practice of holding prudential meetings with the boards of directors of local banks once a year to the extent possible. From 2003 to September 2008, how many prudential meetings, if any, did HKMA hold with the boards of directors of your bank? At these prudential meetings, did HKMA express concerns or raise suggestions about boosting the bank's non-interest income? Please explain.**

56.1 From 2003 to September 2008, the HKMA held 5 prudential meetings with the management of CHKL. (No prudential meetings were held with the Board of Directors of CHKL.) The HKMA did not express any concern or raise any suggestion about boosting CHKL's non-interest income in any of these prudential meetings.

57. **Prior to the collapse of LB in September 2008, did HKMA, in the course of its on-site and off-site examinations, relay to your bank any concerns in the following areas in relation to the sale of structured financial products (such as LB-related products) sold by your bank:**

- (a) **product due diligence;**
- (b) **training and guidance to staff;**
- (c) **handling customers;**
- (d) **information about customers;**
- (e) **suitability of recommendation and solicitation; and**
- (f) **supervision of sales process.**

**If yes, please explain.**

57.1 The HKMA conducted 2 inspections in respect of CHKL's Wealth Management business during the period when LB-related MLNs and LB-related ELNs were distributed by the Bank.

57.2 In May 2007, the HKMA issued a report in relation to the risk-focused examination at CHKL conducted in 2006 covering relevantly areas such as compliance and control function; controls on the selling of insurance and structured products to retail customers; and implementation of best industry practices on retail wealth management business as set out in the HKMA's circular dated 3 March 2006.

It is stated in the HKMA report that "*the control environment and risk management systems of the areas examined are generally adequate*" but the HKMA noted that CHKL did not specifically require the product tenor (or lock-up period) to be compared with the customer's investment horizon. The HKMA recommended that the Bank adopt specific procedures to ensure that the lock-up period conformed with the customer's investment horizon. In response, specific procedures were established by CHKL to compare the product tenor with customer's investment horizon and should the lock-up period be longer than the customer's investment horizon, the customer would be alerted of the fact and confirmation would be sought from the customer before the subscription was processed.

57.3 In October 2007, the HKMA conducted an on-site examination of CHKL covering the following areas:

- (a) The implementation of the recommendations made in the HKMA's thematic examination of 2006 on the selling of insurance and structured products; and
- (b) The Bank's management oversight over its retail wealth management business.

It is stated in the HKMA report that "*the recommendations made by the HKMA in respect of the thematic examination on the selling of insurance and structured products of 2006 have been properly implemented and the bank's management oversight over its retail wealth management business is also generally adequate.*"

58. **It is noted that HKMA issues from time to time advice and circular letters to all Registered Institutions (for example, the circular letter dated 1 March 2005 on "The Securities and Futures Commission's Report (the Report) on Selling Practices**

***of Licensed Investment Advisers"* and the circular letter dated 3 March 2006 on "*Retail Wealth Management (RWM) Business*". Does your bank have had any arrangements in place to take heed of and/or follow up the regulatory concerns raised by HKMA? If yes, please provide the details; if no, the reasons.**

- 58.1 In general, CHKL's Compliance Team would bring the new regulatory requirements to the attention of the relevant teams (such as Product Team) and supporting units and CHKL would then identify areas of the Bank's existing practice that require review and/or enhancement. Where necessary CHKL's internal manuals, written policies and training materials would be revised/updated to ensure the regulatory concerns raised by the HKMA were addressed.

**Table 1****Statistics about major LB-related structured financial products sold by Citibank**

|  | <b>Number of investors</b>   | <b>Value of product sold (HK\$)</b>   | <b>Number of complaints received by Citibank after the collapse of LB</b>  |
|--|--|---|--|
| (i) Lehman Brothers 1 Year USD Daily Accrual Coupon Auto-call Note with Daily Knock-In – Series 10 linked to PetroChina (0857.HK) and China Life Insurance (2628.HK) | 107  | 103,038,000<br><br>(US\$13,210,000 @ exchange rate of US\$1 to HK\$7.7927)  | 48   |
| (ii) Lehman Brothers 8-month HKD Daily Accrual All Season Coupon Auto-call Note with Daily Knock-In – Series 22  | 116  | 75,850,000<br><br>(US\$9,733,468.50 @ exchange rate of US\$1 to HK\$7.7927)   | 57   |
| (i)+(ii)   | 222<br><br>(accounting for 15.62% of the total number of investors (1,421) who purchased LB-related structured financial products from Citibank) | 178,888,000<br><br>(accounting for 9.89% of the total value of LB-related structured financial products sold by Citibank)<br><br>(US\$22,943,468.50 @ exchange rate of US\$1 to HK\$7.7927) | 104<br><br>(accounting for 17.51% of the total number of complaints (594) received by Citibank in connection with the sale of LB-related structured financial products sold by Citibank) |

**Table 2**

**Particulars of major LB-related structured financial products sold by Citibank**

|                               |  |   |
|-------------------------------|--|---|
|                               | Lehman Brothers 1 Year USD Daily Accrual Coupon Auto-call Note with Daily Knock-In – Series 10 linked to PetroChina (0857.HK) and China Life Insurance (2628.HK)   | Lehman Brothers 8-month HKD Daily Accrual All Season Coupon Auto-call Note with Daily Knock-In – Series 22  |
| Arranger                      | Lehman Brothers International (Europe)   | Lehman Brothers International (Europe)  |
| Issuer                        | Lehman Brothers Treasury Co BV   | Lehman Brothers Treasury Co BV  |
| Guarantor, if any             | Lehman Brothers Holdings Inc   | Lehman Brothers Holdings Inc  |
| Offer period                  | 1 November 2007 to 8 November 2007   | 30 May 2008 to 5 June 2008  |
| Duration of note (with dates) | 1 year<br>Issue Date: 15 November 2007<br>Maturity Date: 17 November 2008  | 8 months<br>Issue Date: 12 June 2008<br>Maturity Date: 12 February 2009   |
| Minimum subscription amount   | USD70,000  | HKD500,000  |
| Coupon payment                | Bi-monthly coupon – fixed for first 2 months, variable thereafter<br><br>Fixed coupon for the first 2 months: 6.68% (equal to 40.08% p.a.)<br><br>Variable coupon: 40.08% p.a. daily accrual coupon if all underlying shares > or = 85% of initial price | Bi-monthly coupon – fixed for first 2 months, variable thereafter<br><br>Fixed coupon for the first 2 months: 2.52% (equal to 15.12% p.a.)<br><br>Upper variable coupon: 15.12% p.a. daily accrual coupon if all underlying shares > or = 89% of initial price<br><br>Lower variable coupon: 2.04% p.a. daily accrual coupon if all underlying shares < or = 89% of initial price |
| Underlying asset              | Petrochina (0857.HK)<br><br>China Life Insurance (2628.HK)   | HSBC (0005.HK)<br><br>China Mobile (0941.HK)  |
| Collateral, if any            | Nil  | Nil   |
| Liquid secondary market       | Yes, daily liquidity   | Yes, daily liquidity  |
| Maximum loss that an          | Loss of principal  | Loss of principal   |

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| investor might bear                          |  |  |
| Other risks                                  | <p>Market risk</p> <p>Liquidity risk</p> <p>Potential return risk / underperformance risk</p> <p>Early redemption or termination risk</p> <p>No claim against reference link</p> <p>Sovereign risk</p> <p>Foreign exchange risk</p> <p>Interest rate risk</p> <p>Settlement risk</p> <p>Possible conflict of interest risk</p> <p>Leverage risk</p> <p>Compounding of risks</p> <p>Adjustment / extraordinary events</p> | <p>Market risk</p> <p>Liquidity risk</p> <p>Potential return risk / underperformance risk</p> <p>Early redemption or termination risk</p> <p>No claim against reference link</p> <p>Sovereign risk</p> <p>Foreign exchange risk</p> <p>Interest rate risk</p> <p>Settlement risk</p> <p>Possible conflict of interest risk</p> <p>Leverage risk</p> <p>Compounding of risks</p> <p>Adjustment / extraordinary events</p> |
| Gift(s) for investors purchasing the product | No   | No   |
| Commission received by bank                  | <p>Distribution fee from issuer: HKD2,060,760 (2% of sales volume)</p> <p>Commission received from customers: HKD421,707 (0.41% of sales volume)</p>   | <p>Distribution fee from issuer: HKD1,517,000 (2% of sales volume)</p> <p>Commission received from customers: HKD150,000 (0.20% of sales volume)</p>   |
| Remarks                                      | N/A  | N/A  |