

Our Ref.: B1/15C

9 January 2009

The Chief Executive  
All Authorized Institutions

Dear Sir/Madam,

**Report of the HKMA on Issues Concerning the Distribution of Structured Products Connected to Lehman Group Companies**

As you will be aware, the Financial Secretary (FS) published the reports of the Hong Kong Monetary Authority (HKMA) and the Securities and Futures Commission on the sale of structured products related to Lehman Brothers on 8 January 2009 (<http://www.fstb.gov.hk/eng/sfst/fstb.html>). Given the implications these reports have on the future sale of structured investment products to retail investors, I urge your institution to study them carefully.

Registered institutions (RIs) should note in particular the 19 recommendations in the HKMA's report aimed at strengthening the existing regulatory regime and investor protection framework. As a matter of fact, the HKMA has already asked RIs to carry out a number of these recommendations in our previous communications with them. In view of the latest developments, the HKMA expects all RIs to:

1. implement those HKMA's recommendations set out in [Annex 1](#) in accordance with the timetable specified in the annex; and
2. formulate a plan on how to implement those HKMA's recommendations set out in [Annex 2](#) for discussion with the HKMA by end of March 2009.

If you have any questions on the above, please get in touch with your usual supervisory contact at the HKMA.

Yours faithfully,

YK Choi

c.c. Chairman, Hong Kong Association of Banks  
Chairman, The Deposit-taking Companies Association

Encl. [Annex 1](#) (PDF file, 130KB)  
[Annex 2](#) (PDF file, 424KB)



**Registered Institutions (“RIs”) are required to implement the following recommendations in accordance with the timetable specified**

	<b>Recommendations<sup>1</sup></b>	<b>Requirement and Implementation Timetable</b>
5	“Health-warnings” should be attached to retail structured products with embedded derivatives or to retail derivative products generally.	RIs should include a “health warning” statement, printed in reasonable font size, to all existing derivative products and structured products with embedded derivatives that are being sold to investors. RIs should draw investors’ attention to the “health warning” statement when selling such products to them.  Immediately
12	To provide further protection for investors, the assessment of a customer’s risk profile be separated from the sales process and be carried out by non-sales staff and that the customer be provided with a copy of the risk profile and asked to confirm his agreement that the risk profile is accurate. Mandatory requirements to audio record the assessment process should be introduced.	RIs should put in place appropriate structure and procedures for the separation of risk assessment and sales process. Also adequate records (including audio records) must be maintained as evidence of the risk assessment process and confirmation of agreement to the risk assessment by the investor.  As soon as possible but no later than end of March 2009.
13	The regulatory requirements at point of sale should be reviewed with a view to introducing mandatory requirements for the audio-recording of the sales process and ancillary arrangements.	RIs should ensure adequate records and audit trail (including audio records) are in place to show that due selling process is being followed for all investors.  As soon as possible but no later than end March 2009.
14	Where the continuous review by a registered institution of the risk ratings of the investment products it sells results in a higher risk rating being attributed to a product, the institution should disclose this to customers to whom it recommended and sold the product.	This is a requirement in the HKMA circular of 28 October.

<sup>1</sup> The recommendation numbers are those referred to in paragraphs 8.1 to 8.50 of the HKMA’s Report.

**Registered Institutions (“RIs”) are required to implement the following recommendations in accordance with the timetable specified**

15	In cases of sales of investment products where there is a risk mismatch between the risk rating applied to the product and the customer’s risk profile, full and complete documentation should be retained of the reasons why the customers made the investment decision, the sales process should be audio-recorded, and endorsement should be sought from supervisory staff within the institution.	<p>Adequate documentation of the investor’s reasons, understanding and agreement to the risk mismatch, and seeking of supervisor’s endorsement, are existing requirements. To enhance audit trail, RIs should take steps to have relevant discussions with the investors audio- recorded.</p> <p>Adequate Documentation and supervisor’s endorsement to be implemented immediately</p> <p>Audio recording – as soon as possible but no later than end March 2009.</p>
17	A mystery shopper programme be instituted periodically by the HKMA (as well as by registered institutions themselves) to test sales processes, and a pilot programme of customer surveys be commissioned by the HKMA to gauge whether such surveys can provide information useful for the examination of specific issues in the context of the longer-term customer relationship.	<p>RIs should put in place appropriate “mystery shopper” programme to test sales procedures.</p> <p>As soon as possible but no later than end March 2009.</p>
18	Remuneration structures for staff engaged in AIs’ securities business be subject to greater focus in the HKMA’s on-site examinations and off-site surveillance of AIs’ securities business.	<p>RIs should have adequate procedures and controls to ensure that frontline sales staff are not remunerated with bonuses calculated solely on the basis of financial performance but that other factors (including adherence to best practices guidelines and code of conduct) are in fact taken into account.</p> <p>Immediate</p>

**Registered Institutions are required to formulate a plan on how to implement the following recommendations for discussion with the HKMA by the end of March 2009**

**Recommendation 10**

AIs, which are registered institutions, continue to be permitted to undertake securities business (including selling investment products to retail customers), but steps should be taken to ensure clearer differentiation between traditional deposit-taking activities and retail securities business, including:

- physical segregation of AIs' retail securities business from their ordinary banking business
- a requirement that staff involved in selling investment products to retail customers should not be involved in ordinary banking business
- a requirement that AIs make clear, through physical signs and warnings, the distinction between deposits and investments and particularly the risks attached to the latter
- a requirement that there be complete information separation between a retail customer's deposit accounts and his investment accounts and a prohibition on an AI's making use of deposit-related information to target and channel retail customers into investment activities.

**Recommendation 11**

- the above forms of segregation should apply to AIs' insurance activities and other investment activities.