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WRITTEN SUBMISSIONS OF  
MS AMY YIP, CHIEF EXECUTIVE OFFICER OF  
DBS BANK (HONG KONG) LTD.

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

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## GLOSSARY OF TERMS USED IN THESE SUBMISSIONS

**"CB"** means the Consumer Banking Division of DBS.

**"CBBO"** means the Branch Operations of CB.

**"CLN Notes"** means the notes issued under the Programme arranged by DBSSG.

**"Code of Conduct (2001)"** means the Code of Conduct for Persons Registered with the Securities and Futures Commission issued in April 2001 by the SFC.

**"Code of Conduct (2006)"** means the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission issued in May 2006 by the SFC.

**"SFC"** means the Securities and Futures Commission.

**"Compliance Handbook"** means DBSHK's Consumer Banking Internal Control and Compliance Handbook.

**"Constellation"** means Constellation Investment Ltd., a company incorporated in the Cayman Islands with an exempted limited liability; the issuer of the CLN Notes.

**"DBSHK"** or the **"Bank"** means DBS Bank (Hong Kong) Ltd.

**"DBSSG"** means DBS Bank Ltd.

**"Fit and Proper Guidelines"** means the Fit and Proper Guidelines issued by the SFC in September 2006.

**"GFM"** means the Global Financial Markets Group of DBSSG.

**"GAA"** means the Addendum of Customer Suitability Assessment for Investment Products

**"Guidelines on Competence"** means the Guidelines on Competence issued by the SFC in March 2003.

**"Guidelines on CPT"** means the Guidelines on Continuous Professional Training issued by the SFC in March 2003.

**"HKMA"** means the Hong Kong Monetary Authority.

**"HKMA 2006 Report"** means the letter of findings and recommendations dated 7 March 2006 sent from the HKMA to DBSHK upon completion of its on-site examination of the Bank's Retail Wealth Management Business in 2005.

**"HKMA 2007A Report"** means the letter of findings and recommendations dated 2 February 2007 sent from the HKMA to DBSHK upon completion of its on-site examination of the Bank's Regulated Activities under the SFO in 2006.

**"HKMA 2007B Report"** means the letter of findings and recommendations dated 7 March 2007 sent from the HKMA to DBSHK upon completion of its on-site examination of the Bank's Retail Wealth Management Business in 2006.

**"HKMA 2008 Report"** means the letter of findings and recommendations dated 18 February 2008 sent from the HKMA to DBSHK upon completion of its on-site examination of DBSHK in 2007.

**"Internal Control Guidelines (1997)"** means the Management, Supervision and Internal Control Guidelines for Persons Registered with or Licensed by the Securities and Futures Commission issued by the SFC in May 1997.

**"IPG"** means the Investment Product Group of CB of DBSHK previously known as the Deposit and Investment Department.

**"IPQ"** means the Bank's Investment Profiling Questionnaire for CB.

**"ISM"** means Investment Services Manager of CB.

**"Internal Control Guidelines (2003)"** means the Management, Supervision and Internal Control Guidelines for Persons Registered with or Licensed by the Securities and Futures Commission issued by the SFC in April 2003.

**"LBHI"** means Lehman Brothers Holdings Inc.

**"NPSP"** means the New Product and Service Approval process adopted by DBSHK.

**"PRM"** means the Bank's Product Risk Matrix for CB.

**"Programme"** means the US\$5,000,000,000 Limited Recourse Secured Note Programme pursuant to which the CLN Notes were issued by Constellation.

**"Report on Second Thematic Inspection"** means the SFC's Report on Findings of Second Round of Thematic Inspection of Licensed Investment Advisers issued on 31 May 2007.

**"Report on Selling Practices"** means the SFC's Report on Selling Practices of Licensed Investment Advisers issued in February 2005.

**"S&D"** means the Sales and Distribution of CB.

**"SFO"** means the Securities and Futures Ordinance, Cap 571.

**"Sales Aid Material"** means the set of materials prepared in respect of each series of the CLN Notes, including launch email, sales script, sales kit, a summary fact sheet and for most of the series, FAQ.

**"Subcommittee"** means the Subcommittee to Study Issues Arising from Lehman Brothers-related Minibonds and Structured Financial Products authorised by the Legislative Council by a resolution dated 12 November 2008.

**"Suitability FAQ"** means the document issued by the SFC in May 2007 entitled "Questions and answers on suitability obligations of licensed and registered persons who are engaged in financial planning and wealth management business activities".

**"Vickers"** means DBS Vickers Hong Kong Limited, a broking house mainly responsible for providing DBS Group's house-view on the local stock market.

## RESPONSE TO THE ISSUES RAISED BY THE SUBCOMMITTEE

### Role of DBS Bank (Hong Kong) Limited

- 1** *According to the Programme Prospectuses of the Structured Retail Notes issued by Constellation Investment Limited (Constellation Notes), DBS Bank (Hong Kong) Limited and DBS Bank Limited are the Joint Arrangers and may also act singly as the sole Arranger of any Series issued under the Programme.*
- (a) *Please explain the roles and responsibilities of DBS Bank (Hong Kong) Limited as the Arranger of the Constellation Notes and its relationship with the issuer (i.e. Constellation Investment Limited).*
  - (b) *Please specify the series of the Constellation Notes of which your bank was the sole Arranger.*
  - (c) *Were the distributors required to acquire the Constellation Notes from the issuer first before further selling them to retail investors?*
- 1.1** DBSHK and DBSSG were named as the joint arrangers of the Programme. As set out in the programme agreements entered into between Constellation, DBSHK and DBSSG, the joint arrangers of the Programme were to facilitate the establishment and/or maintenance of the Programme. In fact, all the responsibilities of the arranger of the Programme were discharged solely by DBSSG. Consequently, DBSHK did not, in fact, act as the sole arranger of any series of CLN Notes.
- 1.2** DBSSG, as initial subscriber of each series of the CLN Notes, acquired all issued CLN Notes from the issuer. Pursuant to the relevant distribution agreements, on the issue date of the relevant series of the CLN Notes, DBSHK (as distributor) purchased from DBSSG an amount of CLN Notes equivalent to the amount of purchase orders received from its customers for distribution.
- 1.3** The directors of Constellation are independent from DBSHK and its subsidiaries or affiliates. Neither DBSHK nor any of its subsidiaries or affiliates has any equity interest in, or control over Constellation.

### Internal Process for approval of offer

- 2** *Please advise:*
- (a) *How and when were the Constellation Notes first introduced to DBS Bank (Hong Kong) Limited? Who introduced the Constellation Notes to your bank?*
  - (b) *What were the considerations that prompted your bank to act as the Arranger and one of the distributors of the Constellation Notes? Was the need to increase non-interest income a factor?*
- 2.1** The CLN Notes were first introduced to DBSHK by Mr William Kwok of GFM of DBSSG in 2003.
- 2.2** In 2003, various types of credit-linked notes similar to the CLN Notes were commonly offered by various banks in Hong Kong. DBSHK considered that the CLN Notes were appropriate for distribution to appropriate customers in light of the prevailing market conditions and the investment interests and profile of its customer base. The distribution of

the CLN Notes by DBSHK was intended to increase the diversity of the product selection available to its customers and to maintain its competitiveness in the market place.

- 2.3 As noted in paragraph 1 above, DBSHK did not, in fact, act as an arranger.
- 3 ***Which series was the first series of the Constellation Notes sold by your bank? When did the sale of that series begin? It is noted that Lehman Brothers Holding Inc. is one of the reference entities for some series of the Constellation Notes, please advise which was the first Lehman Brothers-related series of the Constellation Notes sold by your bank and when did the sale of that series begin?***
- 3.1 DBSHK was one of the distributors to sell Series 1 of the CLN Notes, which was launched in September 2003.
- 3.2 Series 34 was the first series of the CLN Notes distributed by DBSHK that used LBHI as a reference entity. The distribution of Series 34 began in February 2006.
- 4 ***Please describe the process through which your bank approved the sale of the Constellation Notes to retail investors, together with the names and positions of the persons responsible for giving the approval. If the decision was made by the Board of Directors, please provide the date(s) of the meeting(s) and the record of deliberation. If the said decision was made by a committee or department within your bank, please also provide the details of the committee or department, including its membership.***
- 4.1 At the material time, all new products or services which were to be distributed or provided by DBSHK had to be approved in accordance with the NPSP policy. The policy is a management process that ensures new product initiatives or services are introduced in a controlled manner and that risks inherent in the new product or service are properly addressed.
- 4.2 The issuance of the CLN Notes was approved by the heads of various business and supporting units, including the T&M Market Risk, Credit Department, Processing & Servicing or Back Office Function, Risk Management, Legal, Compliance, Finance, IT, Corporate Security/Information Security/IT, CB, Enterprise Banking, Private Banking, Audit. The final approval was granted by Mr Randolph Sullivan, the then CEO of DBSHK.
- 4.3 The decision to distribute the CLN Notes was approved by a resolution of the board of directors of DBSHK. A copy of an extract of the board resolution relevant to the approval of the CLN Notes is enclosed as item 1.
- 5 ***Was your bank's decision approving the sale of Constellation Notes to retail investors made once and for all, or per series? Please explain.***
- 5.1 Product due diligence was first conducted by the Bank prior to the first distribution of the CLN Notes in 2003. Subsequently, prior to the launch of each series of the CLN Notes, product due diligence was conducted before the management of CB decided to distribute the relevant series to its customers.
- 6 ***When your bank decided to offer the Constellation Notes for retail sale, was there any decision or discussion on who should be the target clients? If yes, please provide details of such discussion. If no, the reasons.***
- 6.1 When the CLN Notes were launched, DBSHK considered that the primary target customers for the product should be existing investment customers, mainly investors who:

- (a) possessed sufficient knowledge and experience in trading securities and securities derivative instruments;
- (b) had assets over USD25,000 / HKD200,000 available for investment;
- (c) had an investment account with DBSHK; and
- (d) were willing to take on market risks for a higher return than a time deposit normally offers.

However, it was anticipated that CLN Notes would be sold to other appropriate customers.

**7     *In addition to the Constellation Notes, did your bank distribute other Lehman Brothers-related structured financial products? Was the same process followed in authorizing the sale of such products?***

- 7.1**     Whilst CB of DBSHK has not distributed any other Lehman Brothers-related structured financial products to retail customers, another division of the Bank sold such products to a different customer base. The authorisation processes in respect of these structured products were tailored to take account of the specific product and target particular customer base.

**Product due diligence**

**8     *Did your bank have any written policy or internal guideline on how product due diligence should be conducted? If yes, please provide the relevant documentation. If no, the reasons.***

- 8.1**     Relevant requirements with respect to new product/service approval and the scope of the monthly meetings approving the distribution of new products are set out in the following documents:

- (a)     NPSP Policy (enclosed as item 2).
- (b)     Terms of Reference of CB monthly meetings with GFM (enclosed as item 3).

- 8.2**     In this regard, also see our response to Q13 below.

- 8.3**     The due diligence process conducted with respect to new or existing products in respect of the CLN Notes is also discussed in paragraphs 10 and 11 below. Relevant business and supporting units within the Bank were aware of the particular roles and responsibilities they had in conducting product due diligence.

**9     *Please name the person(s)/department(s) responsible for preparing the written policy or internal guideline. 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 internal guideline? Was a copy of the internal guideline provided to the regulators for record?***

- 9.1**     The NPSP Policy was established by Operation Risk of DBSHK.
- 9.2**     The Terms of Reference of CB monthly meetings were prepared by Richard Wong, then head of IPG.
- 9.3**     DBSHK believes that the NPSP and Terms of Reference of CB monthly meetings are consistent with the Hong Kong regulatory regimes.

9.4 According to DBSHK's records, copies of the NPSP Policy have been provided to the HKMA on several occasions. The SFC has not previously requested copies of these documents and DBSHK had not volunteered the documents to them.

10 ***Was any product due diligence done before your bank made the policy decision to sell the Constellation Notes to your clients? If yes, please provide information on how such due diligence was conducted and the conclusion of the exercise.***

10.1 Yes. When considering whether to distribute the CLN Notes, IPG engaged closely with GFM, the product expert, in the weekly product meetings as further discussed in paragraph 11.2 below. GFM made various presentations to IPG on, amongst other matters, the underlying structure, nature, features, associated risks and worst case scenario of the CLN Notes. IPG also considered the suitability of the product for the DBSHK customer base in light of the prevailing investment environment and its customers' preferences.

10.2 Prior to the business and supporting units and the approving authority granting their respective approvals, the following matters were fully considered:

- (a) the description of the CLN Notes;
- (b) an analysis of the risks arising from the CLN Notes, including risk management procedures for identifying, measuring, monitoring and controlling risks;
- (c) the impact of the CLN Notes on the overall financial condition and capital strength of the Bank and its related entities;
- (d) the accounting and tax treatment of the CLN Notes;
- (e) the legal and regulatory implications of the CLN Notes, including target client base;
- (f) consideration of resources required to support the of the CLN Notes;
- (g) a cost-benefit analysis; and
- (h) relevant local regulatory requirements.

10.3 To ensure a thorough understanding of the CLN Notes on the part of the persons responsible for approving the CLN Notes, the following items were provided:

- (a) the proposed details of the Programme and the underlying swap arrangement with DBSSG;
- (b) the documentation involved in setting up the swap and the CLN Notes;
- (c) the relationship between various parties to the transaction; and
- (d) diagrams illustrating the payment flows.

As noted above, the conclusion of the due diligence process was that CLN Notes could be distributed by DBSHK.

11 ***Was product due diligence conducted in respect of each series of the Constellation Notes 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.***

11.1 Yes. Product due diligence was conducted prior to the launch of each series of the CLN Notes to consider whether it was appropriate for DBSHK to distribute a new series of the CLN Notes to its customers.



- 11.2** The core team responsible for conducting product due diligence on the CLN Notes comprised of (i) IPG, (ii) S&D, (iii) GFM and (iv) Vickers. The team met on a weekly basis to consider the features and risks of new investment products, including any new series of CLN Notes, and form a preliminary view on whether to distribute the relevant series of CLN Notes.
- 11.3** If the core team considered that the relevant series was appropriate for distribution by DBSHK, IPG would then recommend the sale of the relevant series for approval at a monthly meeting between CB and GFM, which was attended by members of the core team, together with head of IPG, head of S&D, head of ISMs, District Managers, representatives from Vickers, representatives from Risk Management and Group Risk, head of GFM Sales, and representatives from Economic-Market Research of DBSSG.
- 11.4** At the monthly meeting, Group Research, Vickers and GFM Sales would each give their view on the prevailing market outlook, including interest rate and foreign exchange trends. After considering market commentaries, a member of IPG would present the features of the relevant series of the CLN Notes with the help of GFM where necessary. Participants would then consider the prospective series of the CLN Notes and assess whether it was appropriate that the relevant series should be distributed.
- 11.5** Each participant would have an opportunity to comment on whether the relevant series of the CLN Notes was appropriate for distribution by DBSHK. A decision to distribute the relevant series of the CLN Notes would only be made collectively by the participants after all concerns raised were fully addressed to the satisfaction of participants.
- 12** ***Did your bank make any enquiries or obtain any information from the issuer and other independent sources about the nature, structure and risks of each series of the Constellation Notes? If yes, please explain. If no, the reasons.***
- 12.1** Yes. As noted in paragraph 11.2, representatives from GFM were members of the core team responsible for assisting DBSHK in conducting product due diligence in respect of each series of the CLN Notes. IPG received: details of each series of the CLN Notes; updates on any changes in the structure or features of the product as compared with the last series distributed; and explanations of any new features and risks exhibited by the relevant series of the CLN Notes. IPG also communicated directly with GFM in respect of any queries or concerns it had regarding the relevant series of the CLN Notes.
- 12.2** As discussed in paragraph 11.3 above, GFM also attended monthly meetings with CB to assist in explaining the relevant series of the CLN Notes to the sales team and the head of CB.
- 12.3** Apart from attending the above meetings, GFM also provided further explanations of the product by way of email correspondence or over the telephone. GFM would assist the IPG team in preparing the presentation materials on the CLN Notes used in the monthly meetings with GFM and provided a sales kit in respect of each series of the CLN Notes after the management of CB decided to distribute the relevant series.
- 13** ***Did your bank have any written policy or guidelines on product risk assessment? If yes, please provide the relevant documentation. If no, the reasons.***
- 13.1** Yes. DBSHK established a methodology to ascribe risk ratings to investment products before they are distributed by the Bank. The methodology was known as the PRM.
- 13.2** At the material time, investment products were categorised into 5 different grades:

- (a) Level 1 - low;
- (a) Level 2 - low to medium;
- (b) Level 3 - medium;
- (c) Level 4 - medium to high; and
- (d) Level 5 - high.

**13.3** A copy of the indicative ranking of DBSHK Investment Product Risk Levels is enclosed as item 4.

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

**14.1** The PRM was used in the assignment of risk levels to the CLN Notes. DBSHK ascribed a risk rating to each series of the CLN Notes.

**14.2** A table with the respective risk ratings ascribed to each series of the CLN Notes distributed by DBSHK is set out in Appendix 2. For the avoidance of doubt, Series 38 and 75-77 of the CLN Notes were not distributed by DBSHK and Series 54 of the CLN Notes were equity-linked notes which were withdrawn due to under-subscription. The risk ratings of these series are therefore not included in the table.

**14.3** CLN Notes with reference entities of investment grade were categorised as Level 2 products. In ascribing such risk ratings to the CLN Notes, DBSHK considered factors including (but not limited to):

- (a) credit rating of the underlying reference entities, reference obligations and collateral;
- (b) geographical spread;
- (c) investment period;
- (d) quality of underlying asset/instrument; and
- (e) asset allocation.

**14.4** In each annual review of the PRM until DBSHK ceased to distribute the CLN Notes in September 2007, the Bank maintained the view that the CLN Notes with reference entities of investment grade should be categorised as a Level 2 product.

**14.5** In assessing the risk of a credit-linked product like the CLN Notes, the Bank considered that a Level 2 risk rating was appropriate for the reasons set out below.

- (a) Credit quality

The probability of default of the CLN Notes was best reflected by the credit quality of the reference entities and the collateral.

Given that the reference entities of the CLN Notes were all of high quality investment grade (i.e. most of them were A-rated or above) at the time of issue, DBSHK considered that the product risk of the CLN Notes would be similar to the risk of a conventional corporate bond of investment grade.

Similarly, at the time of issue, the collateral of the CLN Notes had to have the highest credit rating ascribed by the rating agencies and could not be the subject of negative credit watch. Based on the available statistics at the material time, DBSHK reasonably considered that the risk of default of the collateral was very low.

(b) Relativity of product risks

It was considered that the CLN Notes were riskier than principal protected products rated at Level 1. It was also considered that the CLN Notes were not, at the material time, as risky as equity-linked notes which were rated at Level 3 and above. Consequently, it was considered appropriate for the CLN Notes to be rated as a Level 2 product at the material time with a risk level similar to conventional bonds of investment grades.

- 14.6** Series 5, 12, 13, 51 and 52 of the CLN Notes are equity-linked notes. These CLN Notes were respectively rated as Level 3 or 4 products to reflect the higher risk presented by being equity-linked in accordance with the PRM principle.
- 14.7** Series 53 was rated as a Level 1 product because it was principal-protected.
- 14.8** With respect to Series 30 and 31, these CLN Notes were rated as Level 3 products at the time of issue. The reason for this was that one out of the 15 reference entities of these series of the CLN Notes was not of investment grade (i.e. BOC Hong Kong was not rated). Applying the PRM principle, a higher risk of Level 3 was ascribed to Series 30 and 31 to reflect the fact that investors would be assuming a greater credit risk given the reference entities.
- 14.9** Series 32 and 33 of the CLN Notes were categorised as Level 4 products at the time of issue. As a number of the 33 reference entities of these series were not rated by the rating agencies, the Bank raised the risk level of Series 32 and 33 to Level 4 to reflect the higher risk assumed by investors of such CLN Notes.
- 14.10** In light of the HKMA's request made in February 2008, and in consideration of the economic situation at the relevant time, the Bank revised the risk ratings for all the CLN Notes to Level 5 in March 2008. As further explained in paragraph 16.4 below, DBSHK ceased to distribute the CLN Notes in September 2007 and did not distribute any CLN Notes with a risk rating of Level 5.
- 15** *Please provide an explanation on the scale of risks assessment adopted by your bank in respect of the Constellation Notes.*
- 15.1** See paragraph 14 above.
- 16** *Did your bank conduct any after-sale risk assessment in respect of each series of the Constellation Notes sold by your bank? If yes, please provide the details including whether the customers were informed of the latest assessment?*
- 16.1** Yes. After the sale of each series of the CLN Notes, the indicative bid prices of each series of the CLN Notes were made available on the intranet of the Bank (updated on a bi-weekly basis). As the credit market became more volatile, the Bank enhanced the monitoring of the product. Indicative bid prices were reviewed weekly by IPG. Where significant changes in the prices were observed, IPG would consult GFM and, where appropriate, alert CB management to consider follow-up actions. See paragraph 16.3 below.

- 16.2** DBSHK also established a semi-annual discussion forum between GFM and the management of CB to proactively review the performance of the CLN Notes. In particular, the forum reviewed the credit quality of the underlying reference entities and collateral for all CLN Notes. In addition, from time to time, GFM would provide updates on the credit ratings of the reference entities and collateral for review and discussion by the CB management. For example, when there was a change in the credit ratings of collateral of the CLN Notes (as a result of Fitch adopting a different rating methodology), GFM notified DBSHK of the change for discussion by CB management.
- 16.3** DBSHK has regularly provided updates on the performance of the CLN Notes. For example, the indicative bid prices of the relevant series are set out in monthly statements issued to customers. Notices or information about the product received from DBSSG, as arranger, were communicated to the customers. For example, DBSSG issued a notice dated 25 June 2008 notifying all distributors of the change of credit rating of collateral for Series 71-74, 78-81 and 82-85 as a result of Fitch adopting a revised rating methodology. Consequently, the Bank sent a notice to all relevant customers on 3 July 2008. In addition, IPG prepared documentation including guidelines, scripts, internal FAQ, economic market update to enhance understanding of this development and to assist sales staff in handling related customer queries.
- 16.4** In or about September 2007 (i.e. a few months before the HKMA asked banks to raise the risk rating of the CLN Notes), in consideration of the US sub-prime crisis, DBSHK made a decision to stop distributing the CLN Notes to the public after conducting the regular product due diligence process.

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

- 17** *Please describe the training arrangements for staff engaged in the sale of the Constellation Notes including the following particulars:*
- (a) *whether the training is general or product specific;*
  - (b) *if only general, please give details of the training programme;*
  - (c) *if product specific, please give details of the training programme for:*
    - (i) *the first series of the Constellation Notes sold by your bank;*
    - (ii) *the first Lehman Brothers-related series of the Constellation Notes sold by your bank;*
    - (iii) *the last series of the Constellation Notes sold by your bank;*
  - (d) *if the training is both general and product specific, please give all details specified in (b) and (c); and*
  - (e) *if there had been changes in the training arrangements, please describe.*
- 17.1** The Bank provided both product-specific training and general diligence-related training to its sales staff.
- 17.2** When the CLN Notes were first distributed in September 2003, all members of the sales staff were required to attend one of the training sessions on the CLN Notes conducted by the product expert, GFM. Such training covered the structure of the CLN Notes including the credit default swap underlying the CLN Notes as well as the risk factors relevant to the CLN Notes. There were interactive modules at the end of these sessions in which sales

staff were encouraged to ask any questions they had. After these sessions, sales staff had to demonstrate their understanding of the product by completing a quiz.

- 17.3** Each time a new series of the CLN Notes was launched, comprehensive Sales Aid Material was provided to sales staff to ensure their understanding of the relevant series of the CLN Notes. The Sales Aid Material was up-loaded on to the Bank's intranet so that sales staff could access it quickly and conveniently.
- 17.4** The Sales Aid Material comprised a comprehensive exposition of the features of the CLN Notes:
- (a) Sales kits, which were prepared by GFM, contained an in-depth explanation of the key features and risks of the product.
  - (b) Sales scripts contained a recommended script for sales staff to use when speaking to potential customers about the CLN Notes. It highlighted the key product features of the CLN Notes that should be discussed with customers.
  - (c) To further enhance the understanding of sales staff, FAQs were provided which set out a detailed analysis of the key features and risks of the CLN Notes in a question and answer format .
  - (d) Launch emails would include key information in respect of the CLN Notes (including the currency, tenor, interest payment), target customers of the product and important reminders (such as to remind customers to read the prospectuses).
  - (e) A summary fact sheet, which provided easy access to key features of the CLN Notes for internal reference only.
- 17.5** In addition to the Sales Aid Material, order forms, a set of prospectuses relevant to that series of the CLN Notes and marketing materials, which included leaflets, print advertisements and posters were made available to the sales staff before the relevant series was sold.
- 17.6** Sales staff also received information about the CLN Notes through interactive briefings conducted regularly by the ISMs. Briefings proximate to the launch of a series of CLN Notes would be used by ISMs as an opportunity to reiterate information relating to the series of the CLN Notes being launched. Sales staff had the opportunity to raise any queries about the product in such briefings.
- 17.7** Newly arrived sales staff were required to attend induction training. A presentation of the products being sold by the Bank (including the CLN Notes) was given to them.
- 17.8** In order to equip the ISMs to conduct briefings and handle more difficult questions raised by customers, apart from receiving the above training, the ISMs would have additional opportunities to learn about the product:
- (a) prior to the launch of each series of the CLN Notes, the senior ISMs were members of the core team involved in the product due diligence process in which GFM made presentations in relation to the product and participants discussed the benefits, risks and features of the product;
  - (b) the head of ISM, together with the product manager and GFM (where appropriate), conducted weekly meetings with the ISMs to ensure that the ISMs were well equipped with sufficient knowledge about the CLN Notes to be launched and to answer any queries raised by the ISMs; and

- (c) the head of ISM provided individual coaching to ISMs as and when needed, including in circumstances where ISMs had queries about the CLN Notes.
- 17.9** Apart from the abovementioned product-specific training and materials pertaining to the CLN Notes that were provided to the sales staff, DBSHK required all sales staff to attend diligence-related training. This training was designed to ensure that sales staff acted with due skill, care and diligence, acted in the best interests of customers, and made adequate disclosure of material information to clients when conducting sales in compliance with the relevant regulatory requirements.
- 17.10** The following messages were reiterated regularly in the ethical selling component of the diligence-related training, and also in the product-specific training and briefings:
- (a) sales staff must ensure the risk profiles of customers are updated and may only introduce products that match the customers' risk profile;
  - (b) if a customer expresses an interest in a certain investment product, the sales staff should provide product information (including product features, risks and benefits) to enable the customer to make his/her own investment decision;
  - (c) if a customer expresses an interest in purchasing a product of a rating higher than his or her rating, the handling staff is required to introduce a product of lower risk to the customer;
  - (d) in respect of the CLN Notes, the relevant prospectuses are provided to interested customers prior to subscription by such customers, and such customers are reminded to read the prospectuses carefully (in particular, the risk disclosure statement) and seek independent legal advice if necessary; and
  - (e) sales staff must not provide personal investment advice as DBSHK does not act as an investment adviser to retail customers.
- 17.11** In addition, all CB staff members were required to attend a quarterly CB People Forum town hall event conducted by the head of CB which sought to reinforce key compliance messages. One example of these messages is to "offer suitable products that match customer needs and risk tolerance level."
- 17.12** A quarterly newsletter was issued to all CB sales staff to remind them of important control and compliance messages. Similarly, sales staff were reminded to consider customer needs in assessing the suitability of a product.
- 17.13** DBSHK has also set out key policies and guidelines and raised general control and compliance awareness in the Compliance Handbook for the reference of the sales staff. In particular, guidance on the prevention of mis-selling and risk disclosure requirements are highlighted in the Compliance Handbook.
- 17.14** The procedures outlined above were followed in respect of all series of CLN Notes, i.e. including, the first series; the first Lehman Brothers-related series; and the last series. However, the Compliance Handbook was first produced in March 2005. The convening of People Forum and the issuance of the newsletter were commenced in late 2005 and early 2006 respectively after the establishment of CB Control and Assurance Group. Accordingly, these measure were put in place after the launch of the first series.
- 18** *Did the issuer or any of the Joint Arrangers or any other party conduct any product briefings and provide training materials to the frontline sales staff of your bank for*

***each of the series sold by your bank? If yes, please provide the details. If no, the reasons.***

**18.1** Yes. GFM worked closely with IPG to arrange product-specific training sessions for the sales staff of DBSHK. As noted in paragraph 17, GFM helped to conduct a series of training sessions on the CLN Notes when the product was first distributed by DBSHK in September 2003. GFM regularly participated in weekly meetings conducted by product managers to equip ISMs with sufficient knowledge about the CLN Notes and answer any queries about the product that might be raised by the ISMs.

**18.2** In addition, as discussed in paragraph 12.3 above, GFM provided a sales kit in relation to each series of the CLN Notes, which contained an in-depth explanation of key features and risks of the relevant series of the CLN Notes.

**19** ***Did your bank provide any further training to your frontline sales staff for each of the series distributed by your bank prior to the launch of each of such series? If yes, please provide the details. If no, the reasons.***

**19.1** Yes. See paragraph 17 above.

**20** ***Was it mandatory for the frontline sales staff of your bank to attend the product briefing and/or training before they could sell the Constellation Notes to clients? If no, the reasons.***

**20.1** Yes. As noted in paragraph 17.2 above, it was compulsory for all members of the sales staff to attend the training sessions on the CLN Notes conducted by the product expert, GFM before they could sell the CLN Notes to their customers. The sales staff were also required to attend the briefings conducted regularly by the ISMs.

**21** ***Did your bank have any procedures to assess the frontline sales staff's knowledge on the product before they were allowed to sell the Constellation Notes to clients? If yes, please provide the details. If no, the reasons.***

**21.1** As noted in paragraph 17.2 above, after attending the training sessions on the CLN Notes, sales staff had to show their understanding of the product by completing a quiz.

**21.2** As further explained in paragraph 42 below, the Bank conducted regular inspections to ascertain, amongst other matters, whether adequate and material information about the product was discussed by sales staff with customers.

**21.3** Also, as noted in paragraph 17.2 above, there were interactive modules at the end of the training sessions conducted by GFM in which sales staff were encouraged to ask questions. GFM and management were, thereby, in a position to gauge the understanding of the sales force.

**22** ***Did your bank receive any feedback from your sales staff on the training provided to them in relation to the sale of the Constellation Notes? If yes, please provide the details.***

**22.1** As noted in paragraph 17.6 above, the product-specific briefings given to sales staff were interactive. In addition, sales staff attended daily briefings conducted by Branch Managers. Sales staff were afforded every opportunity at these briefings to share any concerns or difficulties they might have in relation to the sale of the CLN Notes. The ISMs or Branch Managers would then relay the relevant messages to the management of CB.

- 22.2 The sales staff also had the opportunity to communicate with the management of CB at the quarterly sales conference conducted by the head of S&D and the quarterly CB People Forum town hall event conducted by the head of CB. Of course, if the sales staff wish, they may communicate directly with management of CB.
- 22.3 The Bank has no recollection of any significant issues or concerns being raised by sales staff in relation to the training provided to them in relation to the sale of the CLN Notes.
- 23 ***Did your bank provide any sales scripts to your frontline sales staff on the solicitation process? If yes, please provide a copy of the script.***
- 23.1 As noted in paragraph 17 above, sales scripts were provided in respect of each series of the CLN Notes distributed by DBSHK. A copy of the sales script in respect of Series 78-81 of the CLN Notes is enclosed as item 5.
- 24 ***Please provide a copy of the operational guidelines, manual, internal memoranda, instructions or any other documents prepared by your bank to your staff engaged in the sale of the Constellation Notes to assist them to comply 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 series of the Constellation Notes sold by your bank;***
  - (b) ***the first Lehman Brothers-related series of the Constellation Notes sold by your bank; and***
  - (c) ***the last series of the Constellation Notes sold by your bank.***
- 24.1 The following documents comprise materials published by the Bank to raise awareness amongst its sales staff and its business and supporting units of the regulatory requirements set out in the Code of Conduct (2001) and (2006) and to ensure compliance with the same. In particular, items n to u below are guidelines applicable to the sale of the CLN Notes.
- (a) Broadcast email to all CB staff: New Procedure - Proper training before selling
  - (b) S&D announcement email: Reinforcement on investment products selling – Investment Advice Dos and Don'ts
  - (c) Control & Compliance Newsletters, which include Investment Advice Dos & Don'ts and Unsolicited call requirements
  - (d) Extracts of materials on CB People Forum
  - (e) Professional Skills Training Curriculum
  - (f) CPT Monitoring Procedures (an extract from Training Operations Manual)
  - (g) CB Branches - CPT Monitoring Report
  - (h) Training on CB Investment Products
  - (i) Overview of DBSHK IF Business
  - (j) Compliance Training on Investment Products: Ethical Selling
  - (k) Training Materials on Mis-selling and Related Issues, Duties and Obligations of Financial Advisor



- (l) Compliance Self-assessment on Regulated Activities of the Securities and Futures Ordinance, which is a control self assessment checklist developed by Compliance Department, relevant business and supporting units are required to complete annually
- (m) Relevant HKMA circulars disseminated to business and supporting units by Compliance Department, the purpose is to enhance the awareness of relevant business and supporting units on latest regulatory requirements e.g. the Report on Second Thematic Inspection and the Suitability FAQ
- (n) Retail Bonds DBS4J
- (o) Notes DBS4P
- (p) Securities Trading DBS4K
- (q) Completion Guideline of Unsolicited Call Questionnaire
- (r) Process of Customer Suitability Assessment Guideline
- (s) Suitability Assessment for Golden Age Customer
- (t) Customer Suitability Assessment on Investment and Insurance Products DBS4O
- (u) Sales Aid Material in respect of Series 1, 34 and 85 of the CLN Notes.

Copies of the above documents are enclosed as items 6 to 28.

**25** *Did your bank have any policy and 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 and procedures.*

**25.1** The following list comprises materials published by the Bank to raise awareness amongst its sales staff and its business and supporting units of the regulatory requirements set out in the Fit and Proper Guidelines, Guidelines on Competence and Guidelines on CPT and to ensure compliance of the same.

- (a) CB People Forum Training Materials; Fit & Proper Training and Managing Mis-selling risk
- (b) Escalation & Investigation procedure and Disciplinary Action Policy
- (c) Operating Manual on Handling of Complaints
- (d) Samples of the Compliance Handbook
- (e) Code of Conduct for staff of DBS Group, which sets out the principle and standards of behaviour that DBSHK staff should follow e.g. section 2.4 stipulated the requirement for fair dealings with customers
- (f) Relevant Individual Registration Manual, which sets out the regulatory requirements for the registration of Relevant Individual
- (g) Executive Officer Registration Manual, which sets out the regulatory requirements for the registration of Executive Officer

- (h) Quick Reference Guide for Compliance with Securities and Futures Ordinance, which serves as a reference guide for the staff on SFO and its subsidiary legislations
- (i) Compliance Training on Investment Products: Ethical Selling
- (j) Sales Aid Material in respect of CLN Notes

**26** *Did your bank involve the legal/compliance team in vetting the 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, the reasons.*

**26.1** Training materials involving regulatory requirements and compliance issues were reviewed by the Compliance Department.

**26.2** No false, inaccurate or misleading information was identified in the training materials.

#### **Know your clients**

**27** *Did your bank have any policy and 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.*

**27.1** Upon the opening of an investment account with DBSHK, CB customers must complete the IPQ in order that their risk profile may be assessed. It is an internal mandatory requirement (DBSHK's operation manual on "Customer Suitability Assessment on Investment and Insurance Products", see item 25) that no investment product will be sold to a customer without a fully completed and valid IPQ.

**27.2** The IPQ contains a set of questions covering age, investment experience, net worth, liquidity, preferred investment horizon, risk appetite and investment expectations. The purpose of the questions is to provide a general risk profile for customers when the answers are considered cumulatively. A score is allocated to each response and the total aggregate score is taken to reflect the risk profile of the customer at that point of time. The customer's risk profile is then mapped against the PRM to determine the kinds of products that are suitable for the customer. This methodology of matching customers' risk tolerance level against the risk rating of the product was endorsed by the HKMA as an example of good practice adopted by certain banks.<sup>1</sup>

**27.3** At the material time, according to their IPQ score, customers were classified into one of 5 suitability levels:

- (a) Level 1 - conservative
- (b) Level 2 - moderate
- (c) Level 3 - balanced
- (d) Level 4 - growth
- (e) Level 5 – aggressive

<sup>1</sup> See the Circular dated 1 March 2007 issued by the HKMA regarding Thematic Examinations on Investment Advisory Activities

- 27.4 Customers were asked to sign the completed IPQ to acknowledge their understanding of their risk profiling and acceptance of the investor type assigned, together with the acknowledgment that investment products might be introduced in accordance with the assigned investor type.
- 28 ***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?***
- 28.1 Each IPQ is valid for 12 months and, once expired, customers must update it before placing an order for any product.
- 28.2 As discussed in paragraph 42 below, DBSHK had internal measures in place to ensure that the sales staff complied with the requirements to complete and update the IPQ of customers.
- 29 ***Did your bank have an internal mechanism to conduct periodic review of the risk profiling questionnaire and scoring system? If yes, please provide the details. If no, the reasons.***
- 29.1 Since the establishment of the IPQ, the IPQ form has been reviewed and revised at least once a year. Revised IPQ forms were endorsed by an independent external advisor, Professor Chan Kalok, Ph.D, head of the Finance Department of the Hong Kong University of Science and Technology.
- 30 ***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, the reasons.***
- 30.1 Sales staff were reminded regularly of the requirement to obtain from customers information about their financial situation, investment experience and investment objectives (and meet the "know-your-client" standards before entering into any transactions) in various training forums, including the quarterly People Forum, quarterly Control & Compliance Newsletter, and relevant compliance training.
- 30.2 The account-opening documents helped staff members comply with their "know-your-client" obligations. For example, customers were asked to describe their education level, occupation and monthly personal income when applying to open a securities account with DBSHK.
- 30.3 Moreover, as noted in paragraph 27, customers were required to provide details in the client information statement of their financial status, investment objectives, investment experience and risk tolerance in the IPQ. Customers were asked to review the IPQ to ensure their investment decisions were in line with their respective attitudes towards risks.
- 30.4 In assessing the suitability of investment products for customers, the Bank has in place additional safeguards to protect vulnerable customers. Customers who are 65 – 74 years old or are otherwise considered vulnerable are required to sign an additional document (i.e. the GAA) witnessed by an independent sales staff if the relevant investment product has (i) a tenor of 5 years or above, or (ii) a risk level of 4 or above, or (iii) a transaction amount of HK\$1 million or more. For customers aged 75 years or older, they have to sign the GAA for every purchase regardless of the amount, tenor and risk level and in the presence of an independent sales staff. The GAA, together with the additional procedures,

are designed to draw the attention of vulnerable investors to the risks relating to the relevant investment product and ensure complete understanding of the product by these investors before investing.

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

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

**31.1** After the Suitability FAQ was issued on 8 May 2007, the Compliance Department circulated an email to all business and supporting units to raise their awareness of the latest regulatory requirements set out in the Suitability FAQ. Also, the Suitability FAQ were discussed with sales staff at the People Forum in June 2007.

**32** *Did your bank have any internal controls to ensure suitability of the recommendations and solicitations for investment in the Constellation Notes? If yes, please provide the details. If no, the reasons.*

**32.1** As discussed in paragraph 27 above, at the material time, the Bank used the IPQ and required sales staff to conduct suitability assessments when selling the CLN Notes. The requirements were clearly conveyed to staff members in operation manuals and were highlighted to staff members in various seminars and in-house publications. The assessment procedure included a risk matching system that has been endorsed by the HKMA.

**32.2** The risk matching system was only one part of DBSHK's suitability assessment measures. As noted in paragraph 30 above, DBSHK also required sales staff to properly discharge their obligations to "know-your-customer" and consider customer needs in addition to the customer risk tolerance levels in determining what products were suitable for customers.

**32.3** Moreover, DBSHK provided product-specific training to sales staff, provided further Sales Aid Material to assist sales staff in conducting sales properly, required sales staff to make sufficient disclosure in respect of the characteristics of the product to customers and closely monitored sales staff to ensure compliance with the above measures.

**32.4** CB Control and Assurance group conducts independent inspections of the sales process of investment products to ascertain whether relevant policies and procedures are being followed. In addition, an external consultant has been engaged to perform mystery shopper exercises to test if sales staff comply with the policies and procedures governing various aspects of the sales process, including the customer suitability assessment, as further explained in paragraph 42 below.

**32.5** Apart from the above measures, customers were required to read the relevant prospectuses and understand the CLN Notes before investing and to confirm they had done the same by means of a declaration in the relevant order form.

**33** *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.*

**33.1** DBSHK did not undertake any advisory role in the distribution of the CLN Notes. It is clearly stipulated in account-opening documents completed by the customers of CB that the Bank does not act as a financial adviser, and does not provide investment advice.

**33.2** We note that the Report on Selling Practices refers to the keeping of records of recommendations on client files. It is said to apply specifically to licensed investment advisers. In any event, the references in that report to financial plans and use of client files indicates that this requirement is applicable to professional investment advisers rather than branch offices of retail banks such as DBSHK.

**33.3** Similarly, the Internal Control Guidelines (1997 and 2003) require those who provide advisory services for remuneration to document their advice. Paragraph 6 of the Suitability FAQ also requires investment advisers to document and provide a copy of the rationale underlying investment recommendations made to clients. These record-keeping requirements applied only to investment advisers and therefore did not apply to DBSHK in the context of its distribution of the CLN Notes.

**34** ***Did your bank have any measures to ascertain whether the clients were fully aware of the nature and risks of the products recommended by your sales staff? If yes, please provide the details. If no, the reasons.***

**34.1** Yes. DBSHK secured customers' acknowledgements of the fact that they understood the CLN Notes.

- (a) Order Forms – The order forms for the CLN Notes contain a risk disclosure statement which the customer has to sign and thereby acknowledges (in English and Chinese) that the customer has received, read and understood and agrees to the terms and conditions and the risk factors stated in the prospectuses. In addition, the statement also reminds customers to read the prospectuses in their entirety and to consult their own professional advisers before deciding to invest in the CLN Notes.
- (b) Terms and Conditions of the application – The (English and Chinese) terms and conditions printed on the order forms of the CLN Notes provide that: the applicant shall only rely on the information and representations contained in the prospectuses in deciding to invest; the applicant has read and understood the prospectuses and terms and conditions of the CLN Notes as set out in the prospectuses before signing the order form and agrees to be bound by them; and that any decision to invest is made solely by the applicant on the basis of the contents of the prospectuses. Again, holders of the CLN Notes were expected to read these clauses and were reminded of the need to read the prospectuses.

**34.2** As noted in paragraph 17 above, DBSHK provided training and materials to the sales staff to ensure their understanding of the product.

**34.3** DBSHK issued internal policies to require sales staff to provide adequate explanations of the CLN Notes to customers and to comply with all regulatory guidelines, including:

- (a) Operation Manual for Notes – This requires sales staff to explain product features, terms and risks of the product to customers, and to provide prospectuses to customers.
- (b) Operation Manual for Securities Trading – When customers are engaged in securities trading, the sales staff are required to explain the product features to customers. In addition, if customers' investment experience makes them unsuitable for securities trading, sales staff are required to highlight clearly the risk of trading securities to the customer.

**34.4** DBSHK provided sufficient guidance to sales staff on conducting sales:

- (a) Branch office briefings – These have been mentioned in previous parts of these submissions. This is an opportunity for ISMs not only to highlight product features and risks to the frontline sales staff, but also to remind them to comply with in-house policies and regulatory guidelines. This also goes to diligent supervision of the conduct of the sales force.
- (b) Launch emails issued to sales staff prior to the launch of each series of the CLN Notes – These reminded sales staff that: (i) only qualified relevant individuals can sell the product and all inquiries must be handled by relevant individuals; (ii) they need to ensure the customers' risk suitability levels match the product risk; (iii) they need to check risk level and age of customers via ISMS (the Bank's customer information system) before taking customer orders; and (iv) they should remind the customers to read the prospectuses, especially the section on "risk factors" before submitting the application.
- (c) Quarterly people forum and newsletter and other ethical training – Sales staff were constantly reminded of their obligations to ensure adequate disclosure of relevant material information to customers and to comply with regulatory requirements, internal policies procedures and operational controls.

**34.5** DBSHK had measures in place to monitor the selling process:

- (a) CB Control and Assurance Group conducts independent inspections of the sales process of investment products to ascertain whether relevant policies and procedures are being followed.
- (b) Since 2004, an external consultant has been engaged to perform mystery shopper exercises to test if sales staff comply with the policies and procedures governing various aspects of the sales process, including adequacy of risk disclosure.

**35** *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.*

**35.1** Yes. The Bank had such internal controls. Where a customer's risk rating is lower than the risk level of the CLN Notes, the Bank's sales staff were required to comply with the following procedures:-

- (a) sales staff were required to advise customers that the CLN Notes are not suitable, and introduce a product of lower risk to the customer;
- (b) if the customer insisted on subscribing for the CLN Notes, the staff were required to explain the underlying risks of the CLN Notes to the customer, perform know-your-client procedures to understand thoroughly the customer's investment objectives and experience; and
- (c) the customer was required to complete and sign an additional declaration, which reminded customers to reconsider the product features and risks as they may be inconsistent with his investment preferences. The declaration has to be signed by a more senior staff member and the handling sales staff member.

**35.2** If a customer wishes to purchase a product two or three risks levels above his/her risk rating, additional approvals by senior staff are required.

- 35.3** The above procedures are set out in the Customer Suitability Assessment On Investment and Insurance Products.

### **Sale of products**

- 36** *Did all your frontline staff engaged in the sale of the Constellation Notes sit and pass the relevant examinations for representatives to be licensed by SFC? If not 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 Constellation Notes? Was all the sale of the Constellation Notes conducted by staff members who were Relevant Individuals registered with HKMA?*

- 36.1** All staff members engaged in the sale of CLN Notes were appropriately licensed by the HKMA.

- 36.2** It is the Bank's policy that only Relevant Individuals registered with the HKMA can sell investment products. This is set out in the Master workflow to manage sales staff's RI/TR eligibility.

- 36.3** As set out in the launch email in respect of each series of the CLN Notes, only Relevant Individuals can sell the CLN Notes and all enquiries about the product must be handled by a Relevant Individual.

- 37** *Please describe your bank's sales strategies of the Constellation Notes, which should include the following particulars:*

- (a) *the target group of customers in terms of age, education level, net worth and relationship with your bank;*
- (b) *the sources of information used for locating individual customers of the target group;*
- (c) *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;*
- (d) *the features of the Constellation Notes emphasized in your bank's marketing or promotional materials;*
- (e) *details of the incentive scheme(s) for:*
  - (i) *staff on the basis of the amount of sales of the Constellation Notes achieved;*
  - (ii) *investors on the basis of the amount of the Constellation Notes they purchased; and*
- (f) *if such incentive scheme(s) have changed over time, please give details of each stage of the scheme(s) in chronological order;*
- (g) *the officer(s) in charge of the overall strategy of staff deployment for the sale of the Constellation Notes;*
- (h) *the officer(s) in charge of the overall supervision of the marketing or promotion of the Constellation Notes; and*
- (i) *the officer(s) responsible for ensuring the achievement of sales targets.*

- 37.1** Paragraph 6 above describes the primary target customers of the CLN Notes. The characteristics of target customers for each series of the CLN Notes might vary depending on the features of the relevant series of the CLN Notes. For example, for Series 78-81, as the relevant tenor is 5 years or longer, DBSHK decided that the relevant series should not be recommended to customers who are aged 65 or above.
- 37.2** From existing records describing its customer base, DBSHK identified potential investors who fulfilled the relevant criteria of the target customers to assist the sales staff in distributing the CLN Notes.
- 37.3** In addition, sales staff could distribute the CLN Notes to their existing clients where they considered such sales appropriate. Sales staff also received referrals of new customers who were interested in the CLN Notes. There were also new customers who expressed an interest in the product after seeing the relevant advertisements at the Bank's branch offices or in newspapers and the like.
- 37.4** DBSHK did not set any product-specific sales target with respect to the CLN Notes for sales staff or branches to meet.
- 37.5** As identified in launch emails and sales scripts, the key selling points of the CLN Notes include:
- (a) relatively high interest payments were payable on a quarterly basis throughout the term of the product;
  - (b) the Reference Entities had strong credit ratings at the time of issue;
  - (c) the collateral was ascribed the highest credit rating by the rating agencies at the time of issue;
  - (d) there was a choice of tenor for each series of the CLN Notes;
  - (e) there was the possibility for early termination of the product after a prescribed period where full principal repayment would be made.
- 37.6** The launch emails and sales script also emphasised to the sales staff and customers that the CLN Notes were not principal protected and the performance of the product was subject to the default of the Reference Entities on a "first-to-default" basis.
- 37.7** In respect of customers who purchased certain series of the CLN Notes, including the Lehman-related CLN Notes, DBSHK offered a special one-month fixed deposit rate for any new funds deposited with DBSHK. Apart from this, DBSHK did not provide any other incentive or specific reward to investors who invested in the CLN Notes. For the avoidance of doubt, customer incentives provided in respect of certain series of the CLN Notes, such as supermarket coupons, were offered by the issuer, Constellation.
- 37.8** The head of S&D was in charge of the overall strategy of staff deployment for the sale of the Bank's investment products, including the CLN Notes. This person was also in charge of the overall supervision of the marketing and promotion of the CLN Notes. At the material time, Lilian Kwan and Sion Huang were consecutively the head of S&D.
- 37.9** The head of CB, head of S&D and head of IPG were jointly responsible for ensuring the achievement of general sales targets in respect of all investment products sold by the Bank. As noted above, there were no product-specific sales targets with respect to the CLN Notes.



**38** 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 the Constellation Notes. If the organizational structure has varied over time, please provide a chart for each of the following stage:

- (a) the sale of the first series of the Constellation Notes sold by your bank;
- (b) the sale of the first Lehman Brothers-related series of the Constellation Notes sold by your bank; and
- (c) the sale of the last series of the Constellation Notes sold by your bank.

**38.1** The organisational structures of the sales staff engaged in the sale of the CLN Notes in (i) September 2003; (ii) February 2006; and (iii) August 2007 are set out in Appendix 3.

**39** Please provide a copy of prospectuses and advertising materials in respect of each of the following products:

- (a) the first series of the Constellation Notes sold by your bank;
- (b) the first Lehman Brothers-related series of the Constellation Notes sold by your bank; and
- (c) the last series of the Constellation Notes sold by your bank.

**39.1** A set of prospectuses and advertising materials in respect of each of Series 1, 34 and 85 of the CLN Notes is enclosed as items 29 to 31 respectively.

**40** Besides the prospectuses and advertising materials authorized by SFC, did your bank provide other marketing materials, such as posters, promotional letters and leaflets, to customers for the sale of Constellation Notes? If yes, please provide the details and a copy of the relevant materials.

**40.1** Apart from the prospectuses and advertising materials authorised by the SFC, DBSHK did not issue any marketing materials to customers for the sale of any series of the CLN Notes.

**41** Did your bank detect any false/inaccurate/misleading information contained in the authorized advertising materials for a particular series of the Constellation Notes which was not consistent with the information in the prospectus?

**41.1** DBSHK did not detect any false/inaccurate/misleading information contained in the authorised advertising materials for any particular series of the CLN Notes.

**42** Did your bank have any supervision or management measure 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.

**42.1** The Bank's relevant operation manuals applicable to the sale of the CLN Notes are described in paragraph 24 above.

**42.2** The Bank had in place a set of policies which ensured that appropriate levels of supervision over the selling process were maintained, including:

- (a) Operation Manual covering handling of credit-linked notes transactions, which requires daily documentation checks to be performed at branch level; and

- (b) Inspection Methodology, which defines the frequency and scope of regular health checks on branches and reviews compliance with the relevant sales process, including documentation quality.

**42.3** In particular, the following measures were in place at the material time to supervise the sale process of the CLN Notes:

- (a) Before processing any order placed by a customer, a branch officer was required to check:
  - (i) customer's risk profile against the product risk level;
  - (ii) customer's declaration of risk acceptance is in place if the product risk level exceeds the customer risk profile; and
  - (iii) with respect to vulnerable customers, the GAA is completed.
- (b) The IPG reviewed transactions within certain periods and prepared monthly reports identifying transactions with any risk level disparity between the customer's risk profile and the product risk level. This report was circulated to the District Head for review and ISMs reviewed any disparities to check whether all required documents had been completed. The monthly trend of these reports and the ISM investigation results were reviewed by management at the Regulated Product Compliance Committee's monthly meeting.
- (c) CB Control and Assurance Group conducted independent inspections of the sales process of investment products to ascertain whether relevant policies and procedures were being followed.
- (d) Since 2004, an external consultant has been engaged to perform annual mystery shopper exercises. Different customer risk profiles and investment scenarios were presented to sales staff to test if they complied with the policies and procedures governing various aspects of the sales process, including the customer suitability assessment process and the adequacy of risk disclosure.

The Mystery Shopping Study in 2006 revealed that over 90% of the sales staff explained the purposes and implications of completing the IPQ and correctly identified the risk profiles of the customers and also indicated that there was no disparity in matching the customers' risk profiles against the products introduced.
- (e) Since 2005, the Audit Department of the Bank has carried out annual audits of the sales process.
- (f) The Compliance Department of the Bank carried out ad hoc reviews of the sales process as and when a need was identified. For example, in response to the HKMA's request following the downgrading of the ratings of the collateral of a number of the series of the Notes in July 2008, a review was conducted to consider whether the product risk assessment and customer suitability assessments were being properly conducted. No major irregularities in the sales process were identified. In particular, it was noted that IPQ was adequately completed and all customers of the Bank who purchased the CLN Notes were identified as having a suitability level of 2 or above.
- (g) As to the sales staff's knowledge of the investment products, based on the internal reviews conducted, the sales staff demonstrated that they had an appropriate level

of knowledge about the products they were selling and were aware of the standards to be observed in the sales process.

### Handling of complaints

**43** *Before the collapse of Lehman Brothers in mid-September 2008, did your bank receive any complaints in relation to alleged mis-selling of the Constellation Notes? If yes, please provide the details, including the number of cases and particular series involved.*

**43.1** DBSHK did not receive any complaints of mis-selling of the CLN Notes prior to the bankruptcy of the LBHI in mid-September 2008.

**44** *Please provide the following information:*

- (a) *the number of customers who purchased the Constellation Notes from your bank and were affected by the collapse of Lehman Brothers;*
- (b) *the number of complaints your bank received after the collapse of Lehman Brothers concerning the selling of Lehman Brothers-related series of the Constellation Notes;*
- (c) *the latest number of complaints in relation to the Constellation Notes that your bank has settled, together with information on the settlement arrangements (e.g. repurchase of the Notes);*
- (d) *the latest number of unresolved complaints;*
- (e) *the expected time-frame to settle the unresolved complaints; and*
- (f) *whether a broad-based settlement similar to the repurchase of Minibonds by 16 distributing banks would be reached.*

**44.1** 3,396 customer accounts purchased the CLN Notes that are linked to LBHI as a reference entity.

**44.2** As at 11 March 2010, the Bank had received complaints from 2,775 customer accounts in respect of CLN Notes that are linked to LBHI as a reference entity. The Bank has settled 636 customer complaints (at up to 100% of the notional amount invested). The Bank has established a rigorous complaint-handling process.

**44.3** DBSHK has been working with an independent reviewer, PwC, at the request of the HKMA to review its complaints handling procedures. PwC concluded that: *"nothing has come to our attention that causes us to believe that the Bank's complaint handling processes for the period from 1 October to 31 December 2008 in respect of customer complaints pertinent to the Bank's selling practices or staff conduct in relation to Lehman Brothers-related investment products were not established and maintained in accordance with the requirements set out in the [IC4 – Complaint Handling Procedures as set out in the HKMA's Supervisory Policy Manual], guidelines, codes and circulars issued by the HKMA and the SFC."*

**44.4** As noted above, DBSHK believes that it has dealt with and continues to deal with customer complaints in a rigorous and fair manner. Of course, there have been instances when customers have not agreed with DBSHK's assessment of the merits of their complaints. In such cases, it is impossible to predict if a mutually acceptable resolution will be reached as

between the relevant customer and DBSHK and, if so, when such a resolution will be achieved.

- 44.5** At the present time, viewed from its perspective, DBSHK does not believe that there is a basis on which a broad-based settlement should be achieved with all purchasers of Lehman-related CLN Notes. DBSHK has assessed customer complaints on a case-by-case basis as it believes that such an approach is plainly more rigorous and equitable. DBSHK does not believe that it suffered a systemic failure in relation to the sale of CLN Notes which might form the basis for a broad-based settlement. DBSHK is not aware of the current intentions with regard to settlement of the other distributors of Lehman-related CLN Notes.

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

- 45** *It is noted that since 2000, the Hong Kong Monetary Authority (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, has HKMA held with DBSHK? At these prudential meetings, did HKMA express concerns or raise suggestions on boosting the bank's non-interest income? Please explain.*

- 45.1** Between 2003 and September 2008, the HKMA had three meetings with the Bank's board of directors: on 28 January 2005, 24 November 2006 and 17 October 2007. The HKMA did not express any concerns or make any suggestions in relation to the Bank's non-interest income at any of these meetings.

- 46** *Prior to the collapse of Lehman Brothers 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 the Constellation Notes and other structured financial 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.*

- 46.1** Between 2003 and 2007, the HKMA conducted a number of inspections at DBSHK and made certain recommendations for systemic enhancements. Relevantly:-

- (a) In the HKMA 2006 Report and the 2007A Report, the HKMA made certain recommendations as to how the IPQ could be improved. CB in DBSHK revised the IPQ to take account of the HKMA's comments. In the subsequent inspection in 2007, the HKMA did not make any further recommendations with respect to the content or scoring system of the IPQ.

The HKMA also noted in the HKMA 2006 Report that copies of the IPQ and GAA were not provided to customers and that the IPQ form was not reissued regularly.

In response to the HKMA's comments, the Bank has provided a full set of the IPQ and GAA to customers since November 2005 and engaged an external consultant in June 2005 to conduct an annual review of the IPQ form.

- (b) In the HKMA 2007B Report, the HKMA noted that the Bank did not specifically require that the product tenor (or lock-up period) should 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, or otherwise, to ensure that the customer was aware of and consented to the product's tenor or lock-up period.

In response, DBSHK revised the order form to include the product tenor. In the order form for each series of the CLN Notes, customers were required to acknowledge their understanding and acceptance of the tenor of the CLN Notes.

- (c) In the HKMA 2007A Report and HKMA 2007B Report, the HKMA also noted that the Bank:
- (i) should do more to ensure that its sales staff were not providing investment advice to customers.
  - (ii) should do more to monitor investment orders placed over the telephone; and

The HKMA also identified certain anomalies in certain account-opening documents, investment product order forms and GAA.

Each of the above issues was addressed by DBSHK.

**46.2** In the HKMA 2007B Report, the HKMA stated that: *"the Bank's risk management controls on the selling of insurance and structured products to retail customers are generally adequate"*.

**46.3** In the HKMA 2008 Report, the HKMA stated 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 [B]ank's management oversight over its retail wealth management business is also generally adequate"*.

**47** *It is noted that HKMA issues from time to time advice and circular letters to all Registered Institutions (RIs) (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", the circular letter dated 3 March 2006 on "Retail Wealth Management (RWM) Business"). Does your bank have any arrangements in place to take heed of and/or follow up the regulatory concerns raised by HKMA? If yes, please provide details. If no, the reasons.*

**47.1** As demonstrated in paragraph 31, and as a matter of practice, upon the publication of any new regulatory requirements, CB Control and Assurance Group and Compliance Department communicate the new requirements with all business and supporting units. Participants in the Regulated Products Compliance Meeting (which includes representatives from Compliance, CB Control and Assurance Group, IPG and CBBO ) would then identify areas of the Bank's existing practice that require enhancement or review.

- 47.2** CBBO would conduct regular review of the Bank's internal policies and practices to ensure compliance with all regulatory requirements.