

Response to item (e)

Follow-up issues arising from the hearing on 14 April 2009

(e) *The findings of each HKMA's on-site examinations and off-site reviews from April 2003 to 14 September 2008 about RIs' sale practices in relation to investment products.*

1.1 The work of the HKMA in regulating the regulated activities of registered institutions (RIs) includes both on-site examinations and off-site reviews.

On-site examinations

1.2 During the period from April 2003 to 31 December 2008¹, the HKMA conducted 170 on-site examinations of RIs that covered, in whole or in part, the conduct of the securities business by RIs.

1.3 Three types of examinations were conducted: Tier-1 examination, Tier-2 examination and the more specialised thematic examinations. A breakdown of the number of RIs covered by the securities-related on-site examinations by type and by year is set out in Table 1 below.

¹ Statistics of on-site examinations in the HKMA's records do not cover the snapshot as of 14 September 2008. Therefore, the information on on-site examinations up to 31 December 2008, instead of up to 14 September 2008, is provided in this response.

Table 1

Type of Securities-related Examinations	Number of RIs Covered in Different Rounds of Examinations						
	2003 (Apr to Dec)	2004	2005	2006	2007	2008	Total
(a) Tier-1 examinations	-	8	5	5	10	9	37
(b) Tier-2 examinations	11	6	5	7	7	1	37
(c) Thematic examinations							
Thematic examinations which reviewed RIs' sale practices related to investment products -							85
(i) Retail Wealth Management Business	-	-	13	22	18	-	53
(ii) Investment Advisory Activities	-	-	-	10	-	-	10
(iii) Controls to Ensure Fitness and Propriety of Relevant Individuals	-	-	-	-	11	-	11
(iv) Investment Advisory and Dealing Activities in Credit-linked Investment Products	-	-	-	-	-	4	4
(v) Compliance Function in relation to Regulated Activities under the Securities and Futures Ordinance	-	-	-	-	-	2	2
(vi) Investment Advisory and Dealing Activities in Stock Accumulators	-	-	-	-	-	5	5
Thematic examinations which did not review RIs' sale practices related to investment products -							
System Capacity and Contingency Planning for On-line Securities Trading Services	-	-	-	-	-	11	11
<i>Total number of thematic examinations per year</i>			<i>13</i>	<i>32</i>	<i>29</i>	<i>22</i>	<i>96</i>
Total number of securities-related on-site examinations	11	14	23	44	46	32	170

1.4 During the period from April 2003 to 31 December 2008, securities-related on-site examinations comprised: (a) Tier-1 examinations covering the high level controls of RIs over their regulated activities; (b) Tier-2 detailed examinations on the internal controls and status of compliance with regulatory requirements; and (c) thematic examinations reviewing a particular activity or function across

a selection of RIs. One of the objectives of the thematic examinations was to identify good practices and common issues through peer reviews for sharing with the industry. As set out in Table 1 above, during the said period, the HKMA conducted 85 thematic examinations to review the sale practices of individual RIs under the six themes of (i) to (vi) in Table 1. The thematic examinations on system capacity and contingency planning for on-line securities trading services were not related to selling practices because they only involved a review of internal controls related to on-line securities trading system.

1.5 Section 120 of the Banking Ordinance (Cap.155) (BO) imposes restrictions on the Monetary Authority's (MA) ability to disclose supervisory information of the type requested that was obtained in the course of the exercise of the MA's functions under the BO. Nevertheless, section 120(5)(a) of the BO provides one of the gateways through which the MA may disclose such information provided that it is disclosed in the form of a summary so as to prevent particulars relating to the business of any particular authorized institution being ascertained from it. To assist the Subcommittee in its inquiry, we have therefore summarized the findings of the thematic examinations of RIs' sale of investment products which were conducted during the period from April 2003 to end of 2008.

1.6 Summaries of the three rounds of thematic examinations (first one done in 2005 with two follow-ups in 2006 and 2007) on the retail wealth management business of RIs are at Annexes 1(A) to (C). A summary of the round of thematic examinations on investment advisory activities (conducted in 2006) is at Annex 1(D), and that on controls to ensure fitness and propriety of relevant individuals (conducted in 2007) is at Annex 1(E).

- 1.7 With respect to the three rounds of thematic examinations in 2008 on: (a) investment advisory and dealing activities in credit-linked investment products; (b) investment advisory and dealing activities in stock accumulators; and (c) compliance function in relation to regulated activities under the Securities and Futures Ordinance (SFO), the summaries are at Annexes 1(F) to (H). Due to the collapse of Lehman Brothers (LB) and the redeployment of supervisory resources to handle the LB-related complaints, the HKMA was not able to complete the three rounds of thematic examinations.
- 1.8 Nevertheless, the three rounds of thematic examinations conducted before 14 September 2008 identified a number of suspected mis-selling cases. Up to 27 April 2009, suspected mis-selling cases involving a total of 123 customers identified during the thematic examinations have already been referred to the HKMA's securities enforcement team for appropriate action. Among these cases, as mentioned in my response to item (d)(iii) of SC Ref. No. M15, cases involving 84 customers were related to RIs which sold LB-related Minibonds and structured financial products and were the subject of LB-related complaints²: of which cases involving 37 customers were referred to the HKMA's securities enforcement team between 1 January 2008 and 14 September 2008 while the remaining cases involving 47 customers were referred to the team after the latter date.

Off-site Reviews

- 1.9 Each RI is assigned to a case officer at the HKMA (or a team of officers for larger institutions) who is responsible for the overall supervision of such a RI which includes conducting on-going off-site

² According to the list of RIs in the "Table Showing Information Required In Respect of Outstanding Lehman Brothers-related Products (Up to 8 Dec 2008)" submitted to the Legislative Council Subcommittee (SC Ref. No. M1(C)).

reviews of the relevant institution to supplement the work through on-site examinations. These reviews cover a wide range of issues, including the financial conditions of the RI, the policies and systems in managing risks, statistical returns, etc. Through these reviews, the case officer is also required to ensure that issues identified through on-site examinations, including those related to the conduct of securities business, are properly addressed and recommendations made are duly implemented.

- 1.10 In addition, since 2005, an increasing number (50 in 2008) of large and complex, or particularly active RIs (including all active retail banks) are required to commission an annual assessment by an independent unit (for example, a unit independent from the conduct of regulated activities, such as the compliance department or the internal audit department) to review the RIs' compliance with the regulatory requirements. The review report has to be signed off by the chief executive of the RIs before submitting to the HKMA. These self-assessment reports are jointly examined by the case officers of the respective RIs and the securities supervision team of the HKMA. The summary results of the assessment reports are shared with all participating RIs of the compliance self-assessment process. Copies of these summary results for 2005 to 2007 are at [Annex 2](#).

Annex 1(A): Summary of Findings of the Thematic Examinations on Retail Wealth Management Conducted in April to November 2005

Introduction

1. The Banking Supervision Department (BSD) of the HKMA conducted a round of thematic examinations of the retail wealth management (RWM) business of RIs. During the period from April to November 2005, the BSD examination teams conducted examinations of a total of 13 RIs on this theme.

The Scope

2. The scope of the examinations covered the following aspects in relation to the sale of wealth management products to retail customers:
 - (i) the customer suitability management of the RIs;
 - (ii) their know-your-customer (KYC) documentation;
 - (iii) their new product development process; and
 - (iv) their complaint handling procedures.
3. The examinations aimed to identify areas where improvements to operations within the above scope could be made, including the adoption of good practices observed in their peer institutions.

The Approach

4. Each examination team spent around 2 weeks on each institution to carry out on-site assessment of the adequacy of the institution's operations in the above areas. During the examination, the team reviewed the relevant policies and procedures, held discussions with the RI's management and staff at different levels, and performed sample reviews

of different types of documents and records.

The Assessment

5. In general, the BSD examination teams considered that the operation of the RIs in areas (ii) – (iv) in paragraph 2 above, i.e. KYC documentation, new product development process and complaint handling procedures was adequate and satisfactory. There was some room for improvement in area (i) above, i.e. customer suitability management.

6. Specific observations on the four areas of review were as follows:

(i) Customer suitability management

7. On customer profiling, all RIs were found to have established procedures to collect information on the customer's investment objective, horizon, experience, risk tolerance level and financial condition at the time of account opening. Some RIs would then ascertain the customer's risk profile and appetite using suitability assessment questionnaires, and some deployed more advanced tools such as system-based profiling models. In respect of 4 of the RIs examined, the teams also identified and recommended possible improvements in certain aspects of their customer suitability assessment process, including extending the coverage of risk profiling to all customers instead of vulnerable customers only and enhancing the risk profiling mechanism to give more weight to objective and pre-determined benchmark (e.g. investment experience, education level) rather than the relationship manager's subjective assessment of customer's replies to profiling questions. In respect of 6 of the RIs examined, the teams identified individual cases through the sampling review where the customer's risk profile could be updated on a more timely basis or omissions of certain information were found in some of the sampled customer profiles.

8. On product suitability assessment, the teams observed that front-line sales staff generally had customised their marketing of RWM products with respect to the assessed risk appetite of the customers.
9. On risk disclosure, the teams examined the precautionary measures adopted by RIs in handling the transactions with vulnerable customers and transactions involving a risk mismatch. The teams noted that a number of RIs performed additional suitability assessment on such cases and would request additional risk acknowledgement from customers to confirm their understanding of the risks involved. Certain good practices above and beyond this arrangement were also observed, including the involvement of an additional member of staff in the selling process; requiring a supervisor to approve such transactions; or inviting vulnerable customers to be accompanied by their family members, relatives or close friends in the selling process. Through the sampling review, the teams also identified possible areas of improvement for individual RIs, for example, in one RI, the team found that there were cases where the necessary risk acknowledgement from the customer was not obtained.
10. On management oversight of the suitability assessment, the teams observed a number of good practices, including the practice by 5 of the examined RIs in requiring their independent departments such as compliance or quality assurance departments, to perform regular compliance review of the selling practices adopted by front-line sales staff, and the practice of 3 RIs in generating regular reports to capture and monitor those customer transactions which deviated from their risk profile and appetite. A recommendation was made to the other RIs which did not adopt these good practices to implement similar measures.

(ii) KYC Documentation

11. The teams found that the management and control of the RIs in this area were generally adequate and satisfactory as far as retail wealth management was concerned, although some cases involving possible issues with anti-money laundering controls were identified in 7 of the RIs examined. The RIs concerned were asked to take remedial actions to strengthen their controls in this regard.

(iii) New Product Development Process

12. The teams found that the new product development process of the RIs was generally adequate and satisfactory.

(iv) Complaint Handling Procedures

13. The teams found that the complaint handling procedures of the RIs were satisfactory, except that a couple of minor exceptions were found in 2 of the examined RIs during the sampling review. These included, for example, late replies/acknowledgements given to some complainants.

Follow-up Actions

14. The findings of each examination were communicated in writing to the individual RIs, and they generally agreed with the HKMA's assessment and recommendations for improvements. Following the receipt of the HKMA's examination report, the RIs provided written responses setting out the specific actions to be taken to rectify the identified issues with specified implementation timeframe. Once the planned actions were agreed with the HKMA, the relevant case officers monitored the implementation of the recommended measures. In addition, the BSD reviewed in their next round of examination to ensure that appropriate

follow-up action had been effectively taken by the RIs concerned to implement the improvements required.

15. To share with the industry the good practices adopted by some RIs in the management of customer suitability as set out above, the HKMA issued a circular to all authorized institutions on 3 March 2006 setting out these practices. The RIs were expected to implement these good practices, and this was subject to review in the next round of thematic examinations.

Annex 1(B): Summary of Findings of the Thematic Examinations on Retail Wealth Management Conducted in March to September 2006

Introduction

1. Further to the thematic examinations of RWM business of RIs completed in 2005, the BSD of the HKMA conducted another round of thematic examinations in 2006 on a wider circle of RIs, focusing on their selling of insurance and structured products to retail customers. During the period from March to September 2006, the BSD examination teams conducted examinations of a total of 22 RIs on this theme.

The Scope

2. The scope of the examinations covered the following aspects in relation to the sale of wealth management products to retail customers:
 - (i) Follow-up of the RIs examined in 2005, and assessment of the situation of other RIs, on the implementation of the best industry practices recommended in the HKMA's Circular of 3 March 2006;
 - (ii) Compliance with relevant standards and guidelines including the Code of Practice for the Administration of Insurance Agents; and
 - (iii) Controls and practices regarding new product development, training and staff compensation scheme.

The Approach

3. Each examination team spent around 3 weeks on each institution to carry out on-site assessment of the adequacy of the institution's operations in

the above areas. During the examination, the team reviewed the relevant policies and procedures, discussed with the RI's management and staff at different levels, and carried out sample reviews of different types of documents and records.

The Assessment

4. The BSD examination teams considered that the RIs had generally established adequate customer risk profiling process and complied with the regulatory requirements relating to their insurance business. The control systems for new product development, training and staff compensation scheme were also considered satisfactory. There were some areas for improvement identified and recommendations made to RIs, especially in relation to their implementation of the best industry practices. A summary of the related issues and recommendations made is set out below.
5. For a number of the RIs examined, the coverage of their customer profiling process over the range of RWM products was considered to be reasonably comprehensive. RIs also had generally established an adequate customer suitability management process for these products. The examination, however, identified some room for improvement in the case of several RIs, including ambiguous wordings used in some questions of their customer profiling questionnaires, unclear or lack of formal policy for mapping the risk tolerance level to the product risk rating, and the need to ensure more frequent updating of customer risk profiles.
6. The RIs generally implemented additional precautionary measures when selling RWM products to vulnerable customers (such as elderly, illiterate or visually impaired) or when there was a risk mismatch. For example,

an additional staff of the RI or a family member of the customer would be involved in the interview with the customer. Recommendations were made to several RIs to extend the precautionary measures to cover illiterate or visually impaired customers and to strengthen such measures for risk mismatch transactions.

7. Good practice was observed where some RIs engaged an independent party to regularly review their risk profiling and suitability assessment tools (i.e. the profiling questionnaire and product mapping framework).
8. Many of the RIs established internal management reports to assist the management in reviewing transactions involving vulnerable customers and risk mismatch.
9. The RIs generally established policies in relation to due diligence to be conducted on products originated from external vendors. Room for improvement was observed in a number of cases concerning the documentation of this process or in relation to the due diligence process to be conducted for products developed internally.
10. Recommendation was also made for refinement to be made to the staff compensation scheme of a couple of RIs to take account of qualitative factors such as compliance review results, audit results and complaint records, instead of using only sales performance to determine the incentive rewards for staff.

Follow-up Actions

11. The findings of each examination were communicated in writing to individual RIs, and they generally agreed with our assessment and recommendations for improvements. Following the receipt of the

HKMA's examination report, the RIs provided written responses setting out the specific actions to be taken to rectify the identified issues with specified implementation timeframe. Once the planned actions were agreed with the HKMA, the relevant case officers monitored the implementation of the recommended measures. In addition, the BSD reviewed in their next round of examination to ensure that appropriate follow-up actions had been taken by the RIs concerned to implement the improvements required.

12. As this round of thematic examinations focused primarily on reviewing RIs' implementation of best industry practices suggested in the previous circular of 3 March 2006 and major additional best industry practices were not identified, the issuance of another industry circular on the subject was not considered necessary.

Annex 1(C): Summary of Findings of the Thematic Examinations on Retail Wealth Management Conducted in 2007

Introduction

1. The BSD of the HKMA conducted the third round of thematic examinations of the RWM business of RIs in 2007. These thematic examinations were conducted as part of the regular on-site examinations which also covered other banking businesses of 18 RIs.

The Scope

2. The examination objective was to ascertain the implementation progress of the HKMA's recommendations made pursuant to the last round of thematic examinations on this topic.

The Approach

3. During the examinations, the BSD examination teams reviewed the relevant policies and procedures, discussed with the RI's management and staff at different levels, and obtained and reviewed different types of documents and records.

The Assessment

4. The BSD examination teams observed that the RIs had generally taken actions to address the findings identified in the previous round of examinations and to implement the improvements recommended.
5. For individual RIs, the BSD teams made further suggestions to improve and strengthen their practices in the following areas:

(i) Customer suitability management

6. Most RIs were found to have made improvements in response to the HKMA's recommendations made to them in the previous round of examinations, such as establishing a system for risk mismatch monitoring and enhancing the controls over risk mismatch transactions and transactions with vulnerable customers. Further improvements were suggested by the teams to strengthen the system for customer suitability assessment, in terms of its coverage (for example, one RI was found not to cover all investment products, though it was noted that system enhancements were being made at the time of examination to rectify this issue), and the need to establish clear guidelines on the system and to have regular management review of its implementation and procedural documentation. Suggestions were also made to 3 RIs to adopt measures to ensure that their customers' information and profiling records would be updated on a regular basis.

(ii) Measures to strengthen the internal process and procedures

7. Recommendations were made to individual RIs to further strengthen their internal control systems with respect to the following areas:
- to update the customers' risk profiling information into the computer system;
 - to reflect the new and improved control procedures in the relevant internal procedural manuals, and in written guidelines issued to staff;
 - to maintain proper documentation of the product suitability assessment process, and to conduct product due diligence for all investment products on a continuous basis; and

- to enhance the approach adopted for the independent review performed on the customer profiling mechanism, and to maintain adequate records for such independent review.

Follow-up actions

8. The progress of RIs' implementation of our recommendations was kept under review and followed up by the respective case teams. Following the receipt of the HKMA's examination report, the RIs provided written responses setting out the specific actions to be taken to rectify the identified issues with specified implementation timeframe. Once the planned actions were agreed with the HKMA, the relevant case officers monitored the implementation of the recommended measures. In addition, the BSD would review the progress in their next round of examination to ensure that appropriate follow-up actions have been taken by the RIs concerned to implement the improvements required.

Annex 1(D): Summary of the Findings of the Thematic Examinations on Investment Advisory Activities Conducted in September to November 2006

Introduction

1. The BSD conducted a round of thematic examinations of the investment advisory activities of RIs. During the period from September to November 2006, the BSD conducted a total of 10 examinations (covering 5 retail banks and 5 private banks) on this theme concurrently with the Securities and Futures Commission's (SFC) inspections on their licensed investment advisers.
2. Prior to the concurrent inspections, the SFC had shared with the BSD its inspection process and major review areas in relation to inspections on investment advisers. There was reciprocal secondment of inspection staff between the two regulators for some of the examinations in this exercise.

The Scope

3. On the basis of the inputs from the SFC, the scope of the examinations covered the following aspects in relation to the investment advisory activities:
 - (i) Product due diligence
 - (ii) Information about client
 - (iii) Selling practice and product suitability
 - (iv) Management supervision
 - (v) Complaint handling

4. The examinations aimed to ascertain the level of compliance with the relevant regulatory standards and to identify good practices for sharing with the industry.

The Approach

5. Each examination team spent around 3 weeks on each institution to perform the on-site review. During the examination, the team reviewed the applicable policies, procedures, and management information reports, internal audit and compliance review reports, discussed existing control processes with relevant staff at different levels, ascertained the investment advisory process of the RIs, and conducted compliance tests and reviews of relevant controls.
6. The team consulted the SFC in its analysis of the major examination findings before it finalized the findings and recommendations.

The Assessment

7. All the RIs had implemented controls to comply with the SFC's regulatory standards, with some controls above the requirements¹. Certain areas for improvement were identified in respect of areas mentioned in paragraph 3(ii) to 3(iv) above.
8. Specific observations on the areas reviewed are set out below:

¹ At the time of this round of thematic examinations, the standards were mainly set out in the SFC's Code of Conduct for Persons Licensed by or Registered with the SFC (SFC Code of Conduct) and the SFC's Report on Selling Practices of Licensed Investment Advisers issued on 23 February 2005.

(i) Product due diligence

9. The management and controls of the RIs in this area were generally acceptable.

(ii) Information about client

10. All the RIs had taken reasonable steps to comply with the SFC's requirement to establish the clients' financial situation, investment experience and investment objectives. 4 RIs collected information on general investment experience of clients through risk profiling exercises, but did not document information on clients' investment experience by types of products.

(iii) Selling practice and product suitability

11. All the RIs had established policies and procedures on selling practices and product suitability. The private banks generally had less sophisticated controls. Nevertheless, since their clients were more sophisticated and generally had investment experience in the products offered, their controls were considered generally acceptable.
12. 6 RIs adopted special handling procedures for transactions where product risk ratings exceeded clients' risk tolerance levels (e.g. supervisor's approval, client's signed acceptance of mismatch). A total of 6 RIs established specific criteria for classifying clients into "vulnerable clients" (e.g. the elderly, illiterate, visually impaired) and had introduced special handling procedures regarding transactions with vulnerable clients (e.g. further explanation by another staff, supervisor's approval, third party witnessing of the transaction).

13. All the RIs documented information on the investment horizons of clients, and established policies to ensure suitability for clients. However, 3 RIs did not have procedures requiring frontline staff to properly compare the investment horizons of clients and the product tenors.
14. For 8 RIs, the selling practices for investment products the offer documents of which did not need the SFC's authorisation were acceptable. 2 private banks did not have formal policies for carrying out the SFC's required procedures to document the assessment process before classifying a client as a "professional investor" for the purpose of selling investment products under the private placement regime. In addition, these 2 RIs did not maintain a central log to keep track of the offer to clients of investment products the offer documents of which did not need the SFC's authorisation. Nevertheless, these RIs provided supporting documents (e.g. the clients' account balances maintained with the RIs) to the team for examination, indicating that all relevant clients of these 2 RIs were able to meet the definition of "professional investor" under the SFO. The examination team did not find any breach of the statutory requirements under the private placement regime.
15. 7 RIs established procedures and practices of providing product documents to clients and explaining product features and risks by frontline staff before transaction. 3 private banks provided verbal explanation of product nature and risks as well as product term sheets to clients, but they had not provided the prospectuses and annual reports of mutual funds to the clients unless the clients requested such documents. These RIs were asked to provide these documents to the clients unless the clients expressly refused to receive the documents.
16. 2 RIs adopted the good practice of using formal checklists to remind frontline staff to provide all required documents to clients.

17. For one RI, the elderly customers sampled by the team were assigned medium or high risk tolerance rating. The RI was recommended to review the appropriateness of the risk tolerance rating assigned to vulnerable customers.

(iv) Management supervision

18. 7 RIs had conducted regular compliance reviews of their investment advisory activities. 2 RIs did not carry out regular compliance reviews on their private banking investment advisory activities due to limited compliance resources.
19. For good practices, 3 RIs performed “mystery shopper” inspections and 2 RIs conducted “post transaction surveys” with clients to assess the selling processes of frontline staff.
20. 6 RIs produced internal management reports on investment advisory activities (e.g. mis-match of client tolerance levels against product risk ratings, unusual patterns on switching of mutual funds) to facilitate management supervision. Recommendations were made to 4 RIs on possible improvement in the coverage of their internal reports in line with industry practice.
21. As a good practice, 2 RIs required their frontline staff to pass an internal competence test (covering selling practices of investment products) annually.

(v) Complaint handling

22. The management and control of the RIs in this area were generally acceptable except for one RI where room for improvement was noted in the documentation of the complaint handling process.

Follow-up Actions

23. The findings of each examination were communicated in writing to the individual RIs, and they generally agreed with the HKMA's assessment and recommendations for improvements. Following the receipt of the HKMA's examination report, the RIs provided written responses setting out the specific actions to be taken to rectify the identified issues with specified implementation timeframe. Once the planned actions were agreed with the HKMA, the relevant case officers monitored the implementation of the recommended measures. In addition, the BSD reviewed in their next round of examination to ensure that appropriate follow-up actions had been taken by the RIs concerned to implement the improvements required.

24. The HKMA issued a circular to all RIs on 1 March 2007 to share the general observations, major common issues and good practices identified in the thematic examinations.

Annex 1(E): Summary of Findings of the Thematic Examinations on Controls to Ensure the Fitness and Propriety of Relevant Individuals Conducted in May to November 2007

Introduction

1. The BSD conducted a round of thematic examinations of the controls related to the fitness and propriety assessment and registration of relevant individuals (ReIs). During the period from May to November 2007, the BSD conducted examinations of a total of 11 RIs on this theme.

The Scope

2. The scope of the examinations covered the following areas of controls in relation to the fitness and propriety assessment and the registration of ReIs:
 - (i) Policies and procedures
 - (ii) Background checks and self-declarations
 - (iii) Competence assessment
 - (iv) Observing Continuous Professional Training (CPT) requirement
 - (v) Submission of information for HKMA register
3. The examinations aimed to ascertain the level of compliance with the relevant regulatory standards and to identify good practices for sharing with the industry.

The Approach

4. Each examination team spent around 3 weeks on each institution to perform the on-site review. During the examination, the team reviewed the applicable policies and procedures, management information reports, and internal audit and compliance review reports. The team also

discussed existing control processes with relevant staff at different levels, and conducted compliance tests and reviews of relevant controls.

The Assessment

5. In general, most RIs had adequate controls for ensuring compliance with the regulatory standards¹, although possible improvements were identified for some RIs in certain areas of their control processes.

6. Specific observations on the areas reviewed are set out below:

(i) Policies and procedures

7. All the examined RIs had established policies and procedures to ensure compliance with the relevant regulatory requirements on staff fitness and propriety and registration of ReIs. 3 RIs' policies and procedures were not sufficiently clear and detailed which could in turn affect the effectiveness of the process to ensure that the fitness and propriety assessments of proposed ReIs were conducted properly and with sufficient documentation maintained. For instance, these policies and procedures did not describe the division of duties and responsibilities among different units of the RIs involved in the assessment process, as well as the requirement for establishing and maintaining audit trails and supporting documentation on the assessment process (including the follow-up actions on apparent irregularities found in such process). As a result, in some of the cases reviewed, certain assessment steps had not been performed due to misunderstanding of the involved units about their respective duties and responsibilities.

¹ The requirements are mainly set out in the SFC Fit and Proper Guidelines; the SFC Guidelines on Competence; the SFC Guidelines on Continuous Professional Training; the HKMA Supervisory Policy Manual module SB-1; and various circulars issued by the HKMA.

(ii) Background checks and self-declarations

8. The team observed certain good practices for sharing with the industry:
- 2 RIs clearly documented the performance and the results of background checks of proposed ReIs in a standardised assessment checklist, and maintained a good record keeping system for such information.
 - The background checks of proposed ReIs performed by 2 RIs included areas such as civil litigations and criminal records, which covered a wider scope than the existing regulatory requirements.
9. The major issues identified in respect of certain RIs included incomplete coverage of background checks of proposed ReIs under certain circumstances (e.g. transferees from group entity), no documentary evidence to support the performance of the background checks and / or follow up actions of adverse results in some cases, and registration of ReIs before completion of the assessments in the cases of some ReIs. Control deficiencies in respect of obtaining self-declarations from ReIs include insufficient scope of the self-declaration form to ensure compliance with subsection 5.4 of the HKMA Supervisory Policy Manual module SB-1, registration before obtaining or without evidence of having obtained self-declarations, and no documentary evidence of follow-up actions on any apparent irregularities.

(iii) Competence assessment

10. 2 RIs had adopted a good practice of using a standardised and comprehensive assessment checklist to evidence the performance of competence checking and assessment. The completed checklist was supported by relevant documents and approved by an independent reviewer. The documentation of another 3 RIs was insufficient to

demonstrate how a proposed ReI met the competence requirements. For instance, the basis for the competence assessment of every proposed ReI was not documented, including:

- whether he / she had been grandfathered (and if so, how he / she became eligible for grandfathering) when the SFO came into operation on 1 April 2003;
- whether he / she fulfilled all elements of the initial competence requirements before registration; and
- whether the registration was subject to the “six-month grace period” arrangement under the current regime, or exemption from examination subject to condition(s) (and if so, how he / she became eligible for such exemption and the specific condition(s) applicable).

Nevertheless, these RIs provided other supporting documents (e.g. certificates of education) to the examination team for review.

(iv) Registration control

11. Most RIs adopted adequate controls for registration of staff. The team found the following good practices:
 - 2 RIs established clear guidelines on the mapping of job duties and internal ranks with the types of regulated activities and the capacity to be registered for different categories of staff members across various business units; and
 - 2 RIs performed regular checks between the internal records of ReIs and the HKMA register to ensure accuracy of registration details.
12. 3 RIs’ registration of certain ReIs was considered to be inappropriate given that their duties (e.g. mortgage business, anti-money laundering monitoring) were not related to any regulated activities.

(v) *Ongoing monitoring mechanism*

13. The team found the following good practices from the policies and procedures of certain RIs for the on-going monitoring of ReIs' fitness and propriety:

- 5 RIs performed regular bankruptcy checks against their internal credit database on all existing ReIs to ensure their continuous fitness and propriety in financial status.
- 3 RIs required all ReIs to make an annual self-declaration on matters set out in subsection 5.4 of the HKMA Supervisory Policy Manual module SB-1 to ensure their continuous fitness and propriety.
- All the examined RIs had a common practice of referring potential breaches of regulatory requirements by ReIs (e.g. arising from customer complaints) to the compliance unit for review and appropriate action.

(vi) *Other areas*

Observing the Continuous Professional Training (CPT) requirement

14. The majority of the examined RIs had adequate controls to ensure compliance with the CPT requirements. 2 RIs had on a small number of occasions erroneously included as CPT eligible hours the attendance by staff in meetings or certain training courses which were not relevant to enhancing the technical skills, professional expertise, ethical standards or regulatory knowledge of ReIs.

Problems in obtaining information from previous employers

15. Some deficiencies were observed in certain incidents such as previous employment check not performed or not supported by evidence, registration of staff before receipt of results of such checking on previous employment, and no documentary evidence of follow-up actions on any

apparent irregularities. In some cases, the deficiencies in the previous employment checks and the fitness and propriety assessments were attributable to the difficulties in obtaining timely and satisfactory employment reference and confirmation on grandfathering and registration details from other RIs (as previous employers).

16. To address the issue, in its circular of 12 March 2008, the HKMA reminded RIs of the requirement to provide information of the relevant industry experience of their former employees to the new / potential employer in a reasonable manner.

Follow-up Actions

17. The findings of each examination were communicated in writing to the individual RIs, and they generally agreed with our assessment and recommendations for improvements. Following the receipt of the HKMA's examination report, the RIs provided written responses setting out the specific actions to be taken to rectify the identified issues with specified implementation timeframe. Once the planned actions were agreed with the HKMA, the relevant case officers monitored the implementation of the recommended measures. In addition, the BSD would review progress in their next round of examination to ensure that appropriate follow-up actions have been taken by the RIs concerned to implement the improvements required.
18. The HKMA issued a circular to all RIs on 12 March 2008 to share the general observations, major common issues and good practices identified in the thematic examinations.

Annex 1(F): Summary of Findings of the Thematic Examinations on Investment Advisory and Dealing Activities in Credit-linked Investment Products in February to August 2008

Introduction

1. The BSD conducted a round of thematic examinations of the investment advisory and dealing activities in retail credit-linked notes (CLNs) of RIs. This round of thematic examinations was intended to cover 11 RIs but only 4 examinations were completed before the collapse of LB in September 2008. During April to August 2008, some regulatory resources were redeployed to conduct an urgent and unscheduled round of thematic examinations on stock accumulators. After September 2008, substantial resources were deployed to deal with work in relation to the collapse of LB, and the remaining examinations regarding retail CLNs could not proceed as planned.

The Scope

2. The scope of the examinations covered the following aspects in relation to the investment advisory and dealing activities in retail CLNs:
 - (i) Product due diligence
 - (ii) Information about client
 - (iii) Selling practice and product suitability
 - (iv) Management supervision
 - (v) Complaint handling
3. As the examinations proceeded, the examination team deployed most resources on ascertaining the level of compliance with the relevant regulatory standards, and on identifying and handling possible cases of non-compliance. As a result, the work done in previous rounds of

thematic examinations in identifying general good practices for industry sharing was not done in this round of examinations.

The Approach

4. Each examination team spent around 3 to 5 weeks on each institution to perform the on-site review. During the examination, the team reviewed the applicable policies, procedures, and management information reports, internal audit and compliance review reports, discussed existing control processes with relevant staff at different levels, ascertained the investment advisory and dealing activities of the RIs in relation to retail CLNs, and conducted compliance tests and reviews of relevant controls.

The Assessment

5. The team identified some possible mis-selling cases during the examinations. The nature and severity of the internal control issues relating to the possible mis-selling cases varied among different RIs.
6. Up to 27 April 2009, suspected mis-selling cases involving 52 customers were identified and referred to the HKMA's securities enforcement team for appropriate action. The key findings of the examination team regarding possible internal control issues giving rise to these referred cases include:
 - issues on the disclosure of key risks and features of the products during the selling process;
 - errors in the documentation related to the selling process;
 - issues on the documentation of product due diligence process;
 - need for improvement in individual staff's understanding of certain key features of the product selected by the examination team; and
 - need for improvement in the management supervision of the activities.

7. As the suspected mis-selling cases identified through these examinations are currently being processed by the HKMA's securities enforcement team and the fact that only a small number of RIs were involved in the examinations, it would not be appropriate for the HKMA to discuss the examination findings in greater detail at this stage. Premature disclosure of details about the examination findings could prejudice the on-going enforcement process.

Follow-up Actions

8. The findings of each examination were communicated in writing to the individual RIs, and they generally agreed with our assessment and recommendations. Following the receipt of the HKMA's examination report, the RIs provided written responses setting out the specific actions to be taken to rectify the identified issues with specified implementation timeframe. Once the planned actions were agreed with the HKMA, the relevant case officers monitored the implementation of the recommended measures. In addition, the BSD would review progress in their next round of examination to ensure that appropriate follow-up actions have been taken by the RIs concerned to implement the improvements required.

Annex 1(G): Summary of Findings of the Thematic Examinations on Investment Advisory and Dealing Activities in Stock Accumulators in March to August 2008

Introduction

1. The BSD conducted a round of thematic examinations of the investment advisory and dealing activities in stock accumulators of RIs. During the period from March to August 2008, the BSD conducted examinations of a total of 5 RIs on this theme. The HKMA intended to extend this round of thematic examinations to cover a few more RIs after identifying some possible mis-selling cases during the examinations. However, after September 2008, as substantial resources were deployed to deal with work in relation to the collapse of LB, no further examinations of other RIs were conducted in this aspect in 2008.

The Scope

2. The scope of the examinations covered the following aspects in relation to the investment advisory and dealing activities in stock accumulators:
 - (i) Product due diligence
 - (ii) Information about client
 - (iii) Selling practice and product suitability
 - (iv) Management supervision
 - (v) Complaint handling
 - (vi) Controls over credit risks
3. As the examinations proceeded, the examination team deployed most resources on ascertaining the level of compliance with the relevant regulatory standards, and on identifying and handling possible cases of non-compliance. As a result, the work done in previous rounds of

thematic examinations in identifying general good practices for industry sharing was not done in this round of examinations.

The Approach

4. Each examination team spent around 3 to 5 weeks on each institution to perform the on-site review. During the examination, the team reviewed the applicable policies, procedures, and management information reports, internal audit and compliance review reports, discussed existing control processes with relevant staff at different levels, ascertained the investment advisory and dealing activities of the RIs in relation to stock accumulators, and conducted compliance tests and reviews of relevant controls.

The Assessment

5. The team identified some possible mis-selling cases during the examinations. The nature and severity of the internal control issues relating to the possible mis-selling cases varied among different RIs.
6. Up to 27 April 2009, suspected mis-selling cases involving 71 customers were identified and referred to the HKMA's securities enforcement team for appropriate action. The key findings of the examination team regarding possible internal control issues giving rise to these referred cases include:
 - issues on the disclosure of key risks and features of the products during the selling process;
 - errors in the documentation related to the selling process;
 - issues on the documentation of product due diligence process; and
 - need for improvement in the management supervision of the activities.

7. Although not related to the selling practices, the examinations also revealed some areas for improvement on credit risk controls for the RIs concerned in relation to the exposure arising from clients' outstanding contracts in stock accumulators.
8. As the suspected mis-selling cases identified through these examinations are currently being processed by the HKMA's securities enforcement team and the fact that only a small number of RIs were involved in the examinations, it would not be appropriate for the HKMA to discuss the examination findings in greater detail at this stage. Premature disclosure of details about the examination findings could prejudice the on-going enforcement process.

Follow-up Actions

9. The findings of each examination were communicated in writing to the individual RIs, and they generally agreed with our assessment and recommendations. Following the receipt of the HKMA's examination report, the RIs provided written responses setting out the specific actions to be taken to rectify the identified issues with specified implementation timeframe. Once the planned actions were agreed with the HKMA, the relevant case officers monitored the implementation of the recommended measures. In addition, the BSD would review progress in their next round of examination to ensure that appropriate follow-up actions have been taken by the RIs concerned to implement the improvements required.

Annex 1(H): Summary of Findings of the Thematic Examinations on the compliance function in relation to regulated activities under the SFO in March to August 2008

Introduction

1. The BSD conducted a round of thematic examinations of the compliance function of RIs in relation to regulated activities under the SFO. This round of thematic examinations was intended to cover 8 RIs but only 2 examinations were completed before the collapse of LB in September 2008. During April to August 2008, some regulatory resources were redeployed to conduct an urgent and unscheduled round of thematic examinations on stock accumulators. After September 2008, substantial resources were deployed to deal with work in relation to the collapse of LB, and the remaining examinations regarding compliance function could not proceed as planned.

The Scope

2. The scope of the examinations covered the effectiveness of the compliance function to ensure compliance with all applicable legal and regulatory requirements as well as internal policies and procedures.
3. As the examinations proceeded, the examination team deployed most resources on ascertaining the level of compliance with the relevant regulatory standards, and on identifying and handling possible cases of non-compliance. As a result, the work done in previous rounds of thematic examinations in identifying general good practices for industry sharing was not done in this round of examinations.

The Approach

4. Each examination team spent around 3 weeks on each institution to perform the on-site review. During the examination, the team reviewed the resources, policies, procedures and reports related to the compliance monitoring function, and discussed with the management and staff performing such functions.

The Assessment

5. The team identified possible internal control issues on:
 - the resources and expertise of the compliance function; and
 - the frequency and coverage of the compliance monitoring reviews.
6. The RIs covered in this round of examinations were also covered in the thematic examination on retail CLNs or stock accumulators in 2008, in respect of which suspected mis-selling cases have been referred to the HKMA's securities enforcement team. The findings in this round of thematic examinations were also relevant to these cases.
7. As the suspected mis-selling cases related to the RIs examined are currently being processed by the HKMA's securities enforcement team and the fact that only a small number of RIs were involved in the examinations, it would not be appropriate for the HKMA to disclose the examination findings in greater detail at this stage. Premature disclosure of information about these cases could prejudice the on-going enforcement process.

Follow-up Actions

8. The findings of each examination were communicated in writing to the individual RIs, and they generally agreed with our assessment and

recommendations. Following the receipt of the HKMA's examination report, the RIs provided written responses setting out the specific actions to be taken to rectify the identified issues with specified implementation timeframe. Once the planned actions were agreed with the HKMA, the relevant case officers monitored the implementation of the recommended measures. The BSD would review progress in their next round of examination to ensure that appropriate follow-up actions have been taken by the RIs concerned to implement the improvements required.

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Our Ref.: B9/70C

22 March 2006

The Chief Executive
Registered Institutions participating in
the Compliance Self-Assessment process

Dear Sir/Madam,

**Summary Results of Self-Assessment on
Compliance with the HKMA Supervisory Policy Manual SB-1
and Other Requirements over Regulated Activities**

I write to thank you for your participation in the compliance self-assessment process on regulated activities. This letter is to share with you a summary of the results, and invite feedback from your institution on the self-assessment process.

Summary of the assessment results

30 registered institutions (RIs) participated in the compliance self-assessment process in 2005. The exercise covered 44 review areas that were developed based on the HKMA Supervisory Policy Manual module SB-1 and relevant circulars. The overall results are summarised below (see Annex 1 for industry benchmarking results)¹:

- 76% of the review areas were reported with a Green rating;
- 11% of the review areas were rated either Yellow or Red; and
- the remaining 13% were rated Blue.

To help the participating RIs better prioritise their resources in ensuring compliance with legal and regulatory requirements on regulated activities, further details of the assessment results and a list of major common issues are set out in Annex 2 and Annex 3 respectively for your reference.

¹ The definitions of the Green, Yellow, Red and Blue ratings are as follows:

GREEN rating -- The RI has fully complied with the requirement.

YELLOW rating/issue -- The RI has partly complied with the requirement. It has either (i) complied with a significant part of the requirement or (ii) taken alternative measures.

RED rating/issue -- The RI has neither (i) complied with any portion of the requirement nor (ii) implemented any alternative measures.

BLUE rating -- The requirement is not applicable.

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According to individual RIs' self-assessment, corrective actions for 99% of the Red and Yellow issues will be completed before 30 June 2006 while no further action will be undertaken for the remaining 1% because the identified risk can be mitigated by existing effective compensating controls. A projection on the progress of corrective actions on a quarterly basis is at Annex 4.

I would like to remind your institution to ensure the rectification of all the outstanding Red or Yellow issues in accordance with the reported corrective action plans.

Actions to be taken by the HKMA

The HKMA will follow up with RIs on those issues giving rise to more significant supervisory concerns (e.g. insufficient procedures regarding marketing of investment products, inadequate monitoring of staff dealing activities) in on-site examinations. Other yellow or red issues identified will be followed up in the on-going supervisory process.

The HKMA plans to implement this compliance self-assessment on an annual basis, and may increase the number of participating RIs in 2006.

Feedback from participating RIs

In order to facilitate our review of the self-assessment process, we would welcome feedback from your institution. Please have the attached survey form (Annex 5) completed and returned to us **by 21 April 2006**.

Should you have any questions about this letter, please feel free to contact Ms Alice Lee at 2878 1603.

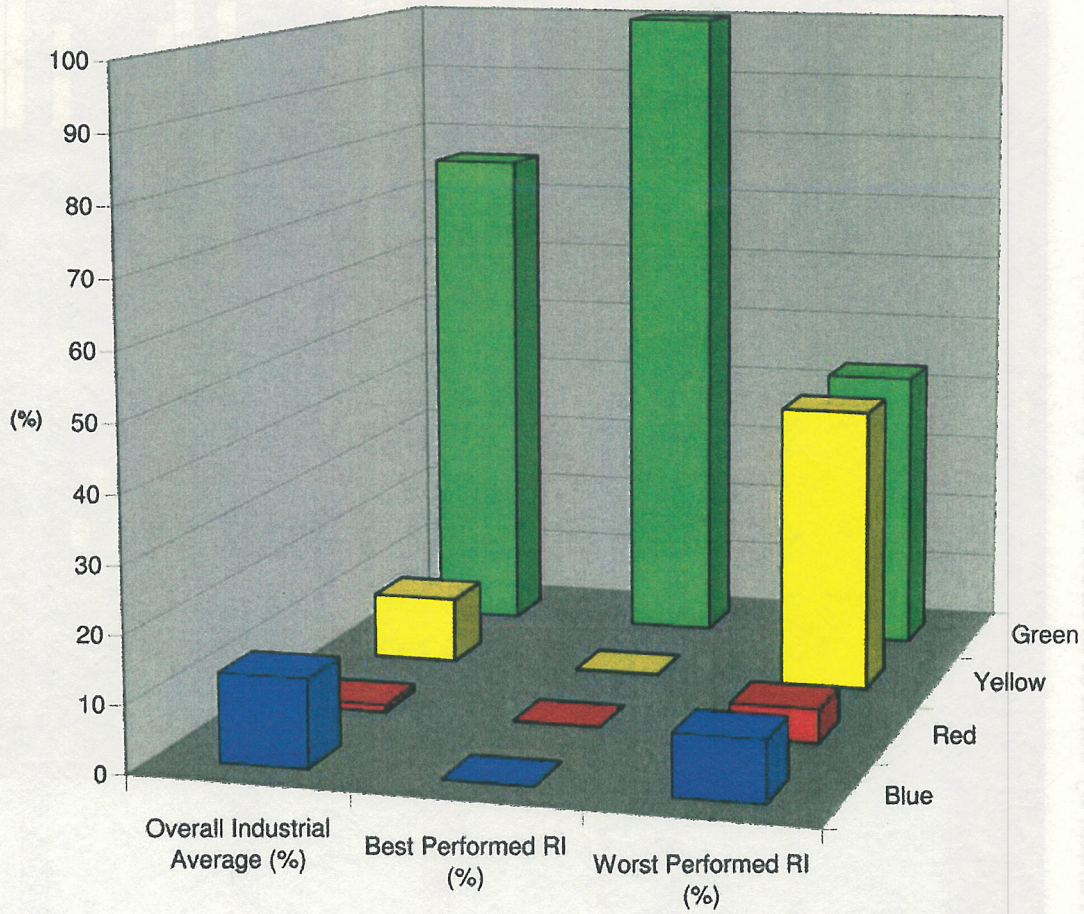
Yours faithfully,

Shu-Pui Li
Head(Banking Supervision)

Encl.

c.c. SFC (Attn: Mr Stephen Po, Senior Director,
Intermediaries and Investment Products Division)

Annex 1: Overall Self-Assessment Results by Assessment Area



	Overall Industrial Average (%)	Best Performed RI (%)	Worst Performed RI (%)
■ Blue	13	0	9
■ Red	1	0	5
■ Yellow	10	0	43
■ Green	76	100	43

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Annex 2: Compliance self-assessment results by control area for 1 Apr to 30 Jun 2005

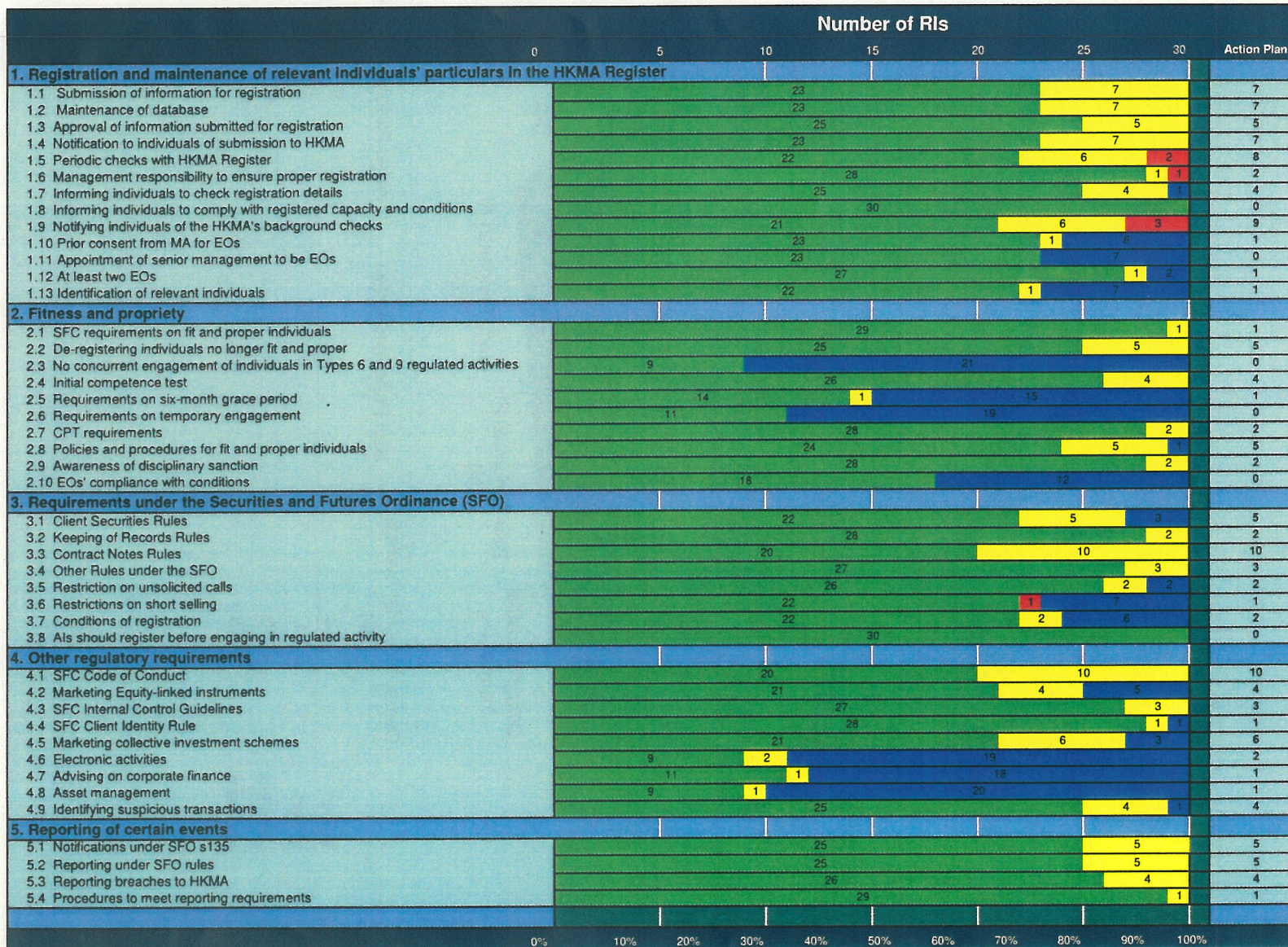


Table 1: Compliance self-assessment results by control area for 1 Apr to 30 Jun 2005

Annex 3: Analysis of Common Issues - identified by $\geq 20\%$ or 6 RIs

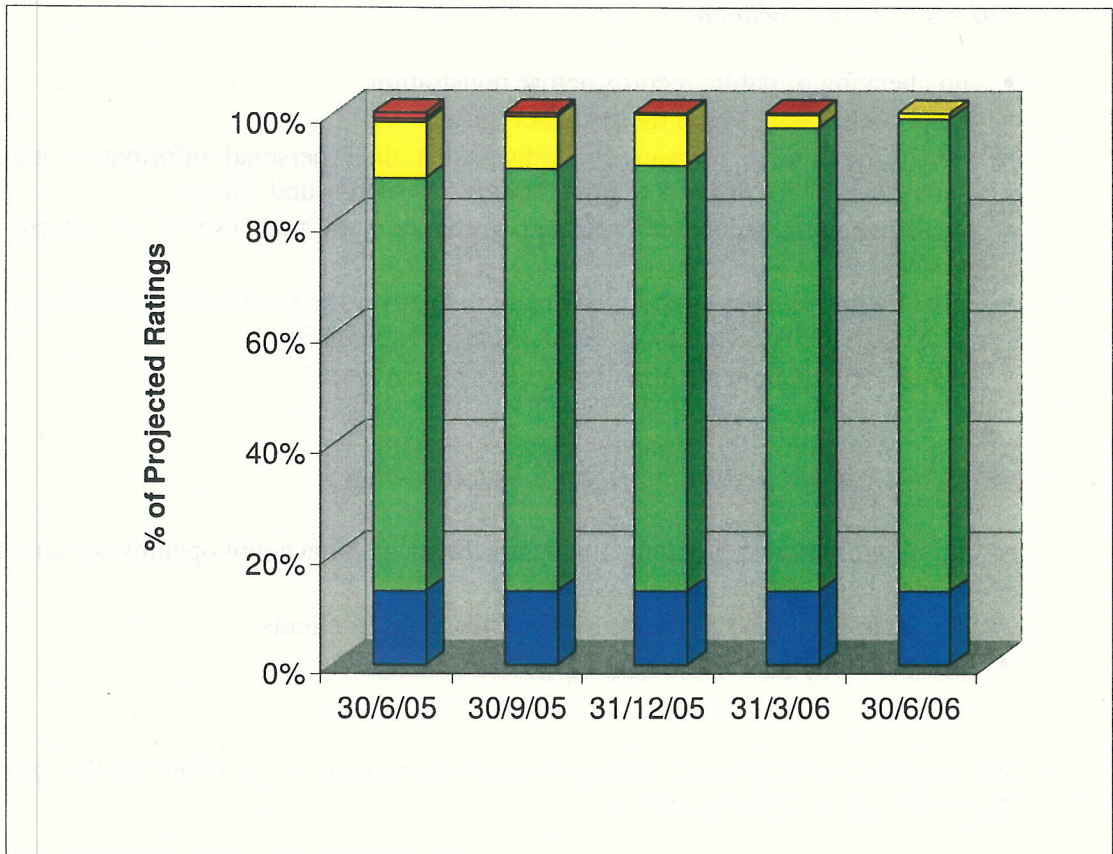
- *Administrative measures to ensure accuracy of information on HKMA register [20 RIs or 67%], including*
 - no checking of public records before registration
 - no periodic checks with the HKMA register
 - no notification to relevant individuals that their personal information may be forwarded by the HKMA to other bodies for background checks
 - insufficient procedures for prompt notification to the HKMA on information updates
 - insufficient data captured in the database to cover the information required in para. 3.1.6 of HKMA Supervisory Policy Manual Module SB-1
 - insufficient documentary evidence of steps performed

- *The SFC Code of Conduct [10 RIs or 33%], including*
 - missing of required contents in client agreements or account opening documents
 - inadequate staff dealing policies
 - no time-stamp records of securities instructions of clients
 - malfunctioning of voice-logging systems

- *The Securities and Futures (Contract Notes, Statements of Account and Receipts) Rules [10 RIs or 33%], including*
 - Not containing some required information
 - Input error or system problem
 - Insufficient procedures to ensure compliance

- *Procedures for marketing of collective investment schemes [6 RIs or 20%], including*
 - Non-compliance with internal procedures
 - Insufficient procedures for more vulnerable customers
 - No distribution of SFC leaflet

Annex 4: Quarterly Projection of Corrective Actions of Participating RIs



SECURITIES COMPLIANCE SELF-ASSESSMENT PROCESS FEEDBACK FORM

Please complete and return the form by 21 April 2006 via fax (2878 1899) to the HKMA Securities Supervision Team.

Name of Registered Institution
<ul style="list-style-type: none"> • Do you find the Compliance Self-Assessment ("CSA") process useful? In particular: <ul style="list-style-type: none"> ➤ Assisting the HKMA in prioritising its supervisory resources and focussing on issues of higher risk having regard to CSA results ➤ Providing your institution with a tool in assessing the state of regulatory compliance and the adequacy of relevant controls ➤ Sharing and understanding of the common compliance issues in the banking industry. <p> <input type="checkbox"/> Very useful <input type="checkbox"/> Useful <input type="checkbox"/> May be useful <input type="checkbox"/> Not very useful <input type="checkbox"/> Not useful </p>
<ul style="list-style-type: none"> • How effective is the HKMA's CSA process in assessing your institution's state of regulatory compliance and the adequacy of relevant controls? <p> <input type="checkbox"/> Very effective <input type="checkbox"/> Effective <input type="checkbox"/> Marginally effective <input type="checkbox"/> Not very effective <input type="checkbox"/> Not effective </p>
<ul style="list-style-type: none"> • Generally, how well was the roll-out of the CSA process managed? <p> <input type="checkbox"/> Professional <input type="checkbox"/> Effective <input type="checkbox"/> Acceptable <input type="checkbox"/> Improvement needed <input type="checkbox"/> Unsatisfactory </p>
<ul style="list-style-type: none"> • Do you have any other suggestions for the CSA process? <hr/> <hr/> <hr/>

Contact person of the Registered Institution:

Name _____ Post. _____

Tel. no. _____

Thank you for your co-operation.

Our Ref.: B9/70C

29 March 2007

The Chief Executive
Registered Institutions participating in
the Compliance Self-Assessment process

Dear Sir/Madam,

**Summary Results of 2006 Self-Assessment on
Compliance with the HKMA Supervisory Policy Manual SB-1
and Other Requirements over Regulated Activities**

I am writing to express my gratitude to you and your colleagues for participating in the compliance self-assessment process on regulated activities in 2006. This letter is to share with you a summary of the assessment results.

Summary of the assessment results

40 registered institutions (RIs) participated in the compliance self-assessment process in 2006. The exercise covered 31 review areas that were developed based on the HKMA Supervisory Policy Manual module SB-1 and relevant circulars. On the whole, the assessment results have shown improvement since the roll-out of the process in 2005 (See Annex 1). The proportion of control procedures rated as Red or Yellow by the participating RIs has reduced from 11% in 2005 to 7% in 2006. The overall 2006 results are summarised below (see Annex 2 for industry benchmarking results):

- 84% of the control procedures were reported with a Green rating;
- 7% of the control procedures were rated either Yellow or Red; and
- the remaining 9% were rated Blue.

To help the participating RIs better prioritise their resources in ensuring compliance with legal and regulatory requirements on regulated activities, further details of the assessment results and a list of common issues are set out in Annex 3 and Annex 4 respectively for your reference.

- 2 -

According to individual RIs' self-assessment, corrective actions for 76% of the Red and Yellow issues will be completed before Q2 2007 while no further action will be undertaken for the remaining 24% issues because the identified risk can be mitigated by existing effective compensating controls. A projection on the progress of corrective actions on a quarterly basis is set out in Annex 5.

I would like to remind your institution to ensure that the rectification of all the outstanding Red or Yellow issues is implemented in accordance with the reported corrective action plans.

Actions to be taken by the HKMA

The HKMA will follow up with RIs on yellow or red issues through on-site examinations or the on-going supervisory process. Disciplinary action will be considered in case of major breach of regulatory requirement.

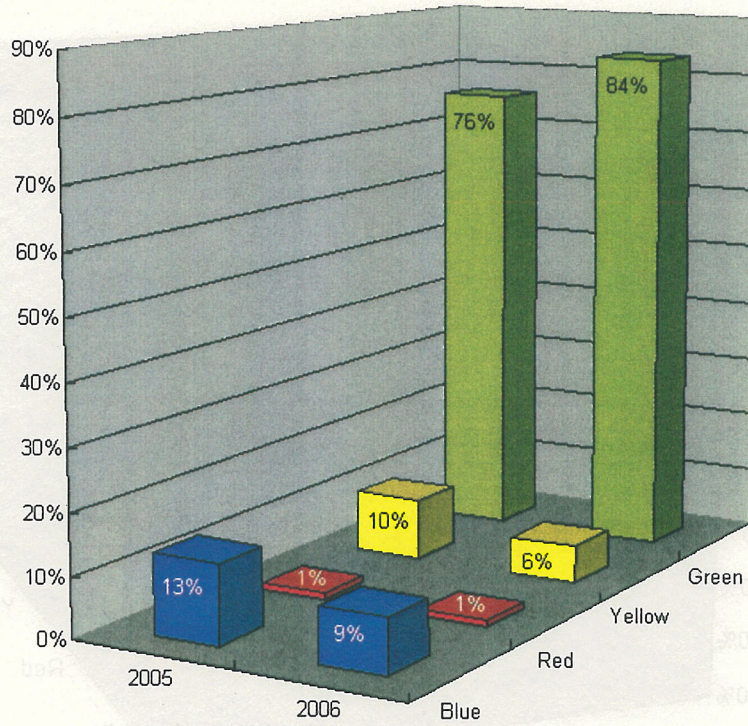
Yours faithfully,

Shu-Pui Li
Head(Banking Supervision)

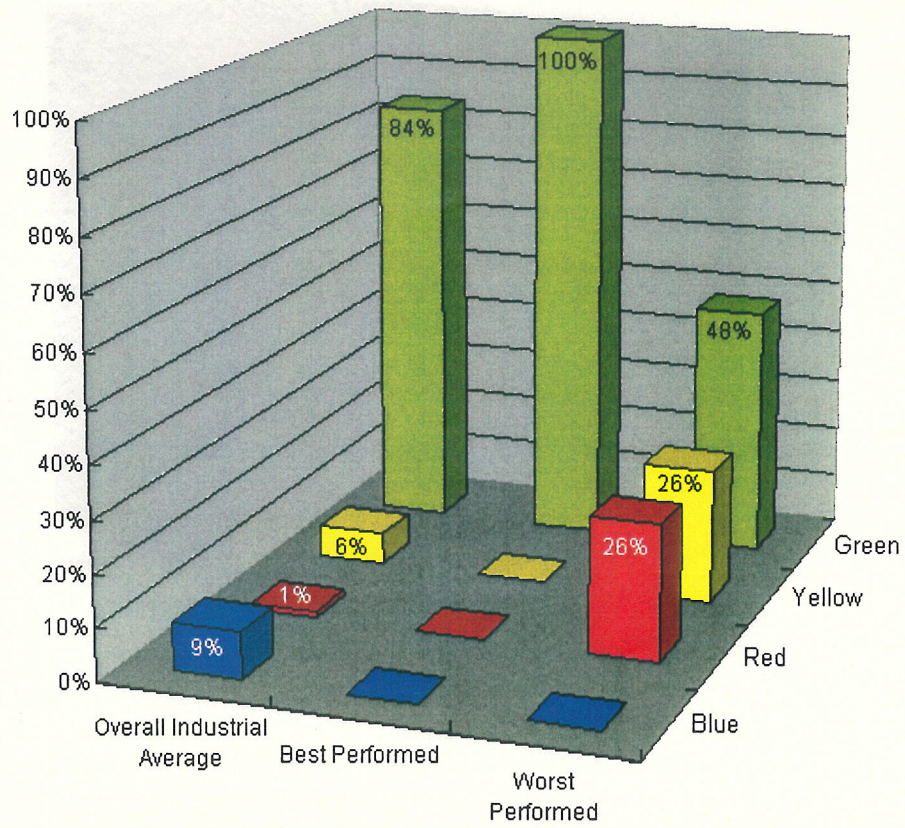
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c.c. SFC (Attn: Mr Stephen Po, Senior Director,
Intermediaries and Investment Products Division)

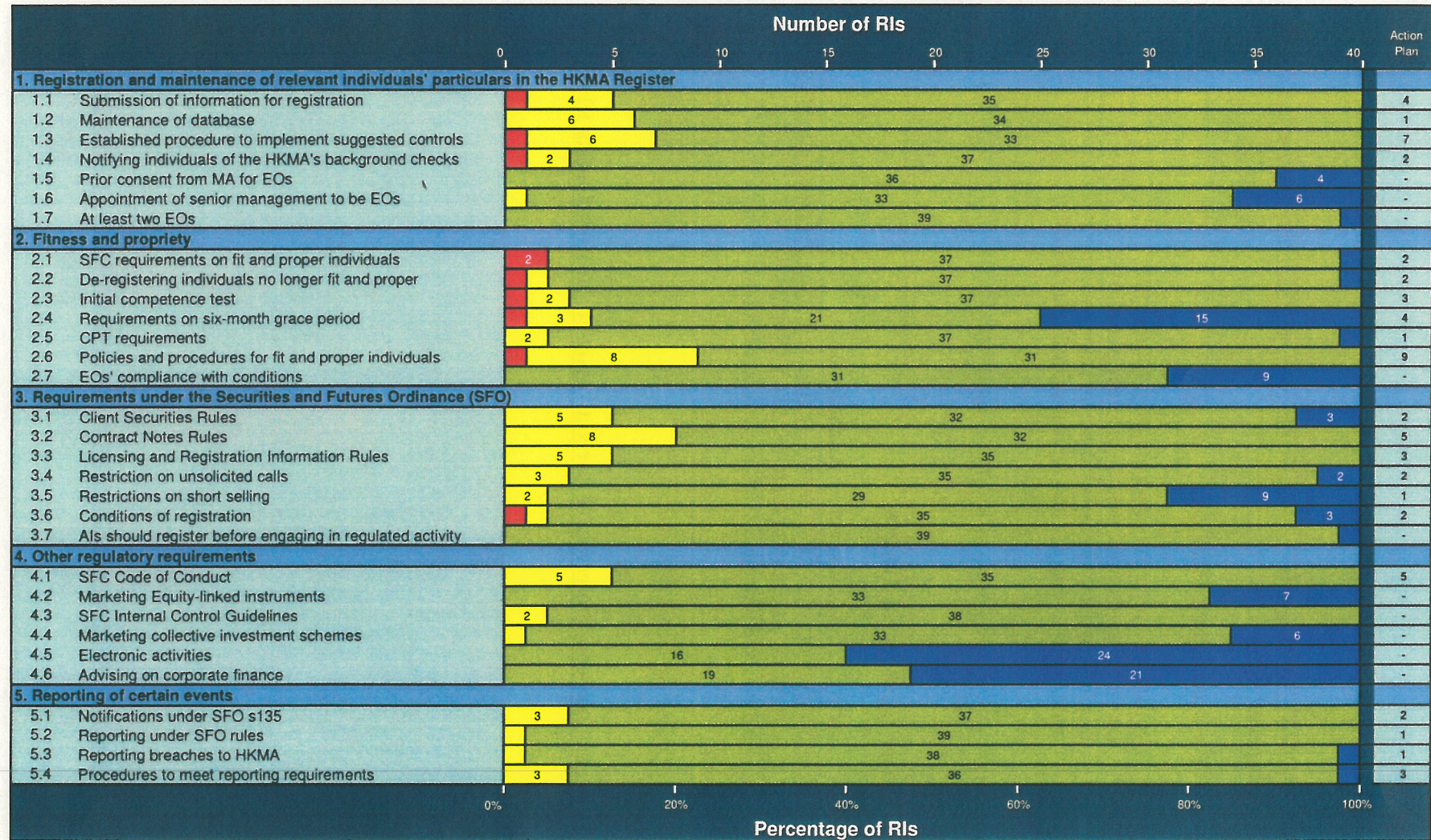
Annex 1: Improvement in Self-Assessment Ratings



Annex 2: Overall Self-Assessment Results by Assessment Area



Annex 3: Compliance Self-Assessment Results by Control Area for 1 April to 30 June 2006



Annex 4: Common Control Issues – Identified by $\geq 20\%$ or 8 RIs

- *Policies and Procedure to ensure all relevant individuals are and continue to be fit and proper [9 RIs or 23%]*

Major issues reported include:

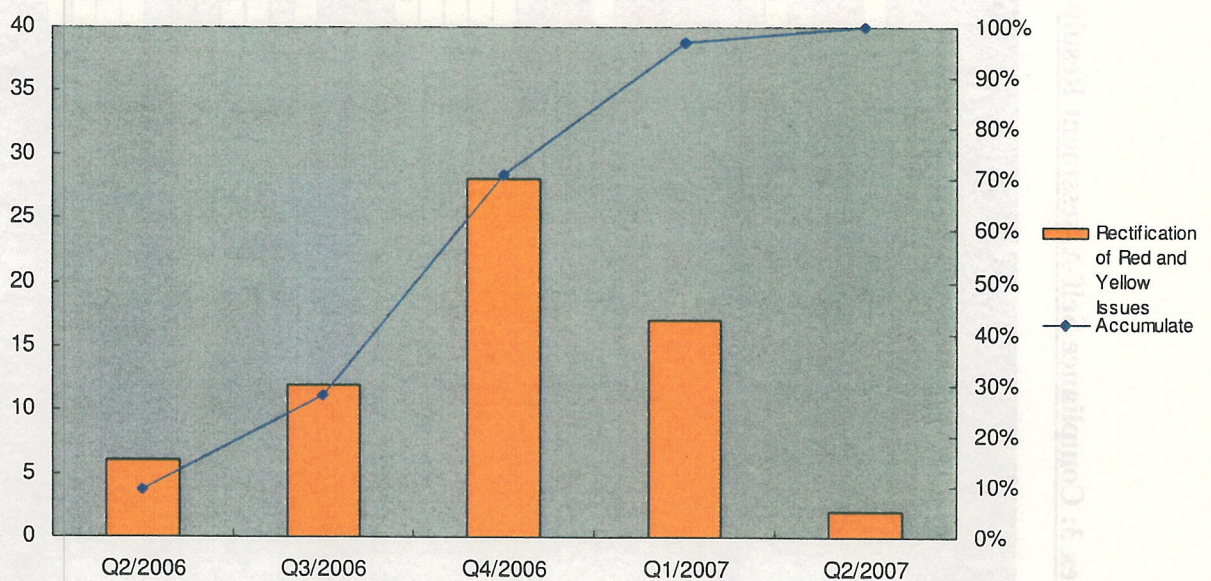
- policies and procedures not properly documented
- no checking of public records before registration
- insufficient documentary evidence of steps performed
- deficiencies in records and supporting documentation

- *The Securities and Futures (Contract Notes, Statements of Account and Receipts) Rules [8 RIs or 20%]*

Major issues reported include:

- not containing some required information
- late delivery of contract notes/ statements due to operation deficiency
- inaccurate information contained in contract notes
- policies and procedures not properly documented

Annex 5: Quarterly Projection of Corrective Actions of Participating RIs



Our Ref.: B9/70C

14 January 2008

The Chief Executive
Registered Institutions participating in
the Compliance Self-Assessment

Dear Sir/Madam,

**Summary Results of 2007 Self-Assessment on
Compliance with the HKMA Supervisory Policy Manual SB-1
and Other Requirements over Regulated Activities**

I am writing to express my gratitude to you and your colleagues for participating in the compliance self-assessment on regulated activities in 2007. This letter is to share with you a summary of the assessment results.

Summary of the assessment results

45 registered institutions (RIs) participated in the compliance self-assessment process in 2007. The exercise covered 32 review areas that were developed based on the HKMA Supervisory Policy Manual module SB-1 and relevant circulars. On the whole, the assessment results have shown improvement compared with 2006 (See Annex 1). The proportion of control procedures rated as Red or Yellow by the participating RIs has reduced from 7% in 2006 to 4% in 2007. The overall 2007 results are summarised below (see Annex 2 for industry benchmarking results):

- 87% of the control procedures were reported with a Green rating;
- 4% of the control procedures were rated either Yellow or Red; and
- the remaining 9% were rated Blue.

To help the participating RIs better prioritise their resources in ensuring compliance with legal and regulatory requirements on regulated activities, further details of the assessment results and a list of common issues are set out in Annex 3 and Annex 4 respectively for your reference.

- 2 -

According to individual RIs' self-assessment, corrective actions for 67% of the Red and Yellow issues will be completed by Q1 2008, while no further action will be undertaken for the remaining 33% issues because the identified risk can be mitigated by existing effective compensating controls. A projection on the progress of corrective actions on a quarterly basis is set out in Annex 5.

I would like to remind your institution to ensure that the rectification of all the outstanding Red or Yellow issues is implemented in accordance with the reported corrective action plans.

Actions to be taken by the HKMA

The HKMA will follow up with RIs on yellow or red issues through on-site examinations or the on-going supervisory process. Disciplinary action will be considered in case of major breach of regulatory requirement.

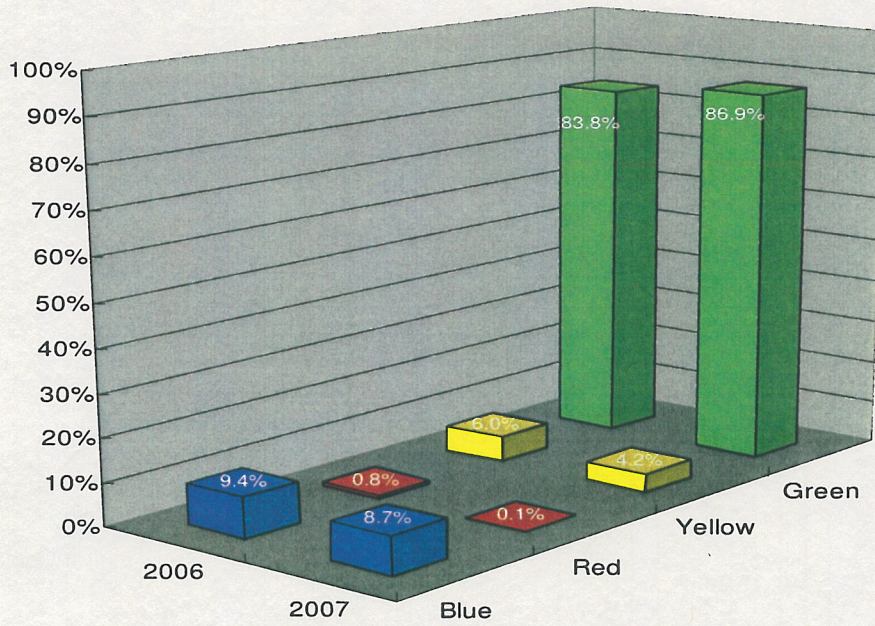
Yours faithfully,

Shu-Pui Li
Head (Banking Supervision)

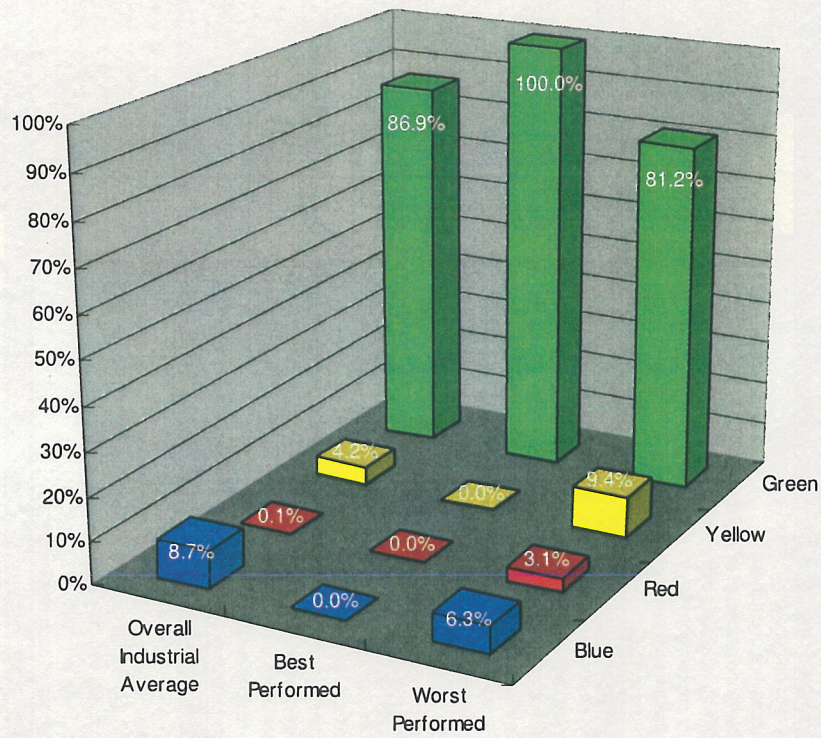
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c.c. SFC (Attn: Mr Stephen Po, Senior Director,
Intermediaries and Investment Products Division)

Annex 1: Improvement in Self-Assessment Ratings



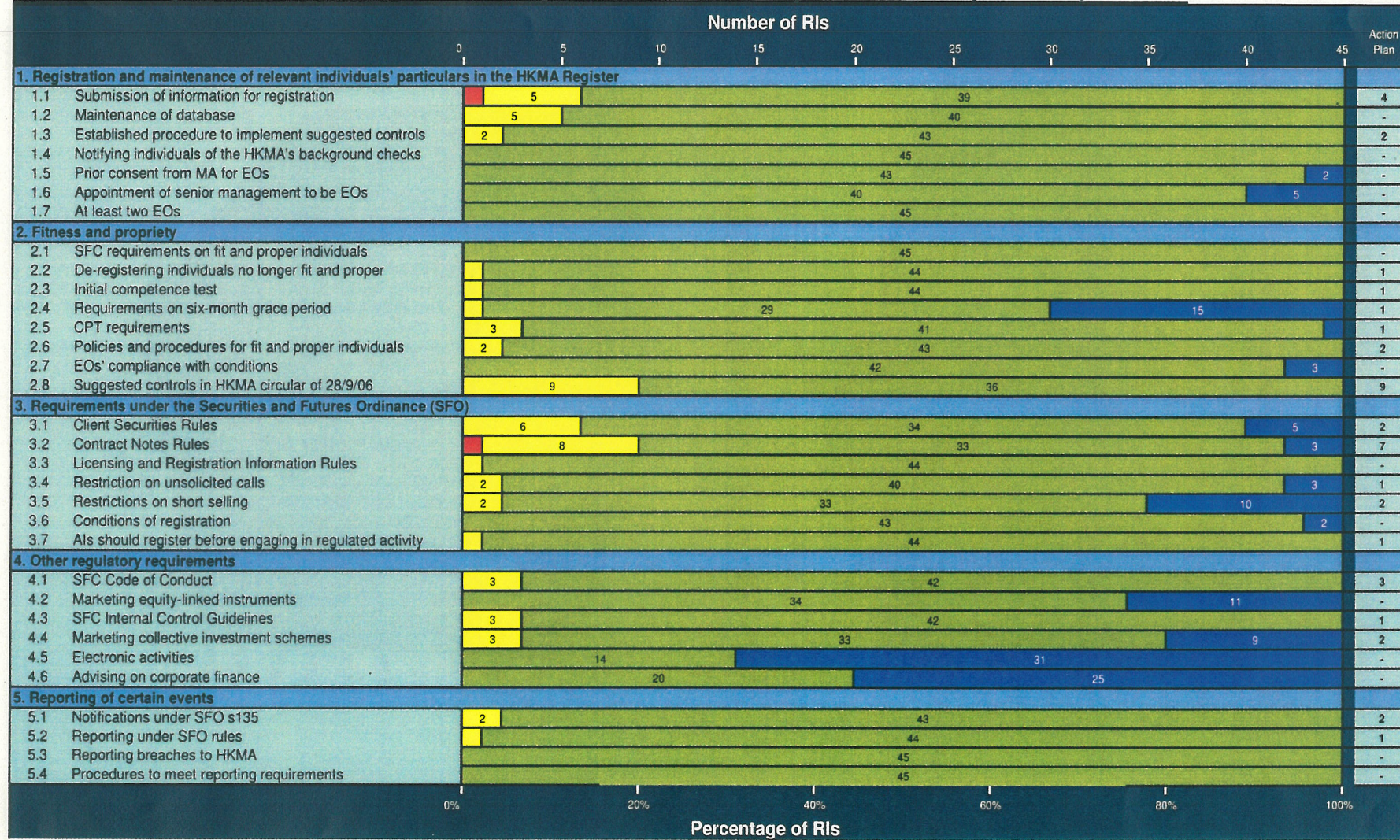
Annex 2: 2007 Overall Self-Assessment Results



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Annex 1: Compliance Self-Assessment Report for the Reporting Period 1 Year to 31 June 2007

Annex 3: Compliance Self-Assessment Results by Control Area for the period from 1 April to 30 June 2007



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Annex 4: Common Control Issues – Identified by $\geq 20\%$ or 9 RIs

- *Policies and Procedures to implement the suggested controls set out in Annex 1 and Annex 2 of the HKMA Circular “Controls to ensure the fitness and propriety of staff of authorized institutions” [9 RIs or 20%]*

Major issues reported include:

- in respect of fit and proper assessment:
 - no comprehensive checklist was adopted to document the assessment
 - lack of independent review
 - inadequate coverage of issues in staff self-declaration (e.g. did not require candidate to declare whether he had been terminated by previous employers)
 - registration before obtaining satisfactory result of background check for both local hires and overseas transferees
 - policies and procedures not properly documented
- *The Securities and Futures (Contract Notes, Statements of Account and Receipts) Rules [9 RIs or 20%]*

Major issues reported include:

- late delivery / non-delivery of contract notes / statements of accounts due to operation deficiency or oversight
- not containing some required information
- inaccurate information in contract notes / statement of accounts
- policies and procedures not properly documented

Annex 5: Quarterly Projection of Corrective Actions of Participating RIs

