

Responses to Follow-up Issues Arising from the Hearing on 12 June 2009

1. Please indicate the provisions in the relevant guidelines, circulars and codes issued by the Securities and Futures Commission (SFC) and the Hong Kong Monetary Authority (HKMA), which are mirrored in the regulatory items under the heading “D: Advising on investments” in the sample thematic examination checklist (Annex 2B of M2(C)).

1.1 The relevant sections or paragraphs of the guidelines, circulars and codes, which are issued by the Securities and Futures Commission (SFC) or the Hong Kong Monetary Authority (HKMA), are set out in abbreviation under the “Provisions” column in the assessment table of the sample thematic examination checklist (Annex 2B of M2(C)). The abbreviations and the corresponding full names of the relevant guidelines, circulars and codes can be found under the heading “Abbreviation” on page 2 of the sample thematic examination checklist.

1.2 Except for the SFC’s Report on Selling Practices of Licensed Investment Advisers (issued on 23 February 2005), the guidelines, circulars and codes applicable to section D of the sample thematic examination checklist have already been provided to the Subcommittee and the related SC reference numbers are set out in Table 1 below. The SFC’s Report S20
on Selling Practices of Licensed Investment Advisers issued on 23 February 2005 (abbreviated as “SFCIARep” in the checklist) is attached as Annex 1.

Table 1

Name of Document	SC Reference Number	
Code of Conduct for Persons Licensed by or Registered with the SFC (abbreviated as "CoC" in the checklist)	Annex 4(A) of W6(C)	S1-Appendix 11
Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the SFC (abbreviated as "ICG" in the checklist)	Annex 4(B) of W6(C)	S1-Appendix 12

2. *Whether HKMA has, during its on-site examinations of Registered Institutions (RIs) since April 2003, identified any cases in which the Relevant Individuals (ReIs) withdrew their investment recommendations to their clients as the latter did not show adequate understanding of the risks associated with the products being recommended.*

2.1 The internal records of the HKMA's on-site examinations do not contain any information about whether there were any cases in which relevant individuals (ReIs) withdrew the investment recommendations to their clients because the recording of such information is not a regulatory requirement. It should be noted that the key objective of the HKMA's on-site examinations is to ensure registered institutions' (RIs) compliance with the relevant legal and regulatory requirements. To achieve this, our focus is to examine, among other things, transaction records of completed sale of investment products. Cases where ReIs have withdrawn the investment recommendations to their clients and therefore the transaction was not completed would not be covered by our on-site examinations.

3. *Please provide the following information relating to the mock selling tests conducted by HKMA during its on-site examinations of the sale of investment products by RIs since April 2003:*
- (a) whether the on-site examination checklists for Tier 1 and Tier 2 examinations and the thematic examination (Annexes 2A and 2B of M2(C)) have specified any requirement for HKMA's examination teams to conduct mock selling tests on ReIs;*
 - (b) the number of such tests conducted;*
 - (c) the number of RIs and ReIs involved;*
 - (d) the minimum time required by a ReI during such a test to adequately explain the nature and risks of an equity-linked note and a credit-linked note; and*
 - (e) the merit(s) and limitation(s) of such tests.*

Items (a), (b) and (c)

- 3.1 The on-site examination checklists for Tier 1 and Tier 2 examinations and the thematic examinations on Investment Advisory and Dealing Activities in Credit-linked Investment Products ("CLN thematic examinations") (Annexes 2A and 2B of M2(C)) have specified the requirement for the HKMA's examination teams to conduct interview with ReIs to assess, among other things, their knowledge in relation to investment products and their awareness on compliance with regulatory requirements during on-site examinations as set out in Table 2 below.

Table 2

Checklist	References to the checklist
<p>Tier 1 Examination Checklist</p> <p>(see Annex 2A of M2(C))</p>	<p><u>Pages 72-73 under section 2 (Competence of ReIs)</u></p> <p>Paragraph 2.1:</p> <p><i>“...Select both new and existing ReIs ... and interview to assess their knowledge in relation to investment products, such as unit trust, guaranteed funds, structured products and bonds, etc. and the awareness on compliance with regulatory requirements ...”</i></p>
<p>Tier 2 Examination Checklist</p> <p>(see Annex 2A of M2(C))</p>	<p><u>Pages 13-14 under section 2 (Competence of ReIs)</u></p> <p>Paragraph 2.1:</p> <p><i>“... Select both new and existing ReIs and interview to assess their knowledge in relation to investment products, such as unit trust, guaranteed funds, ELDs and bonds, etc. and the awareness on compliance with regulatory requirements ...”</i></p>
<p>CLN Thematic Examination Checklist</p> <p>(see Annex 2B of M2(C))</p>	<p><u>Page 14 under section F (Competency and Registration)</u></p> <p>Item 2:</p> <p><i>“Discuss with selected staff members to ascertain their knowledge in products, applicable regulatory requirements and internal policies.”</i></p>

- 3.2 Although the three checklists do not specifically mention mock selling test, as a general practice, in respect of Tier 2 and thematic examinations covering selling practices of retail banks, the examination team typically conducts mock selling test on frontline staff during the interview process. During these examinations, the examination team typically would discuss with around 20 to 30 relevant staff at different levels of the examined RI to assess the adequacy of controls over the sale of investment products and more generally their knowledge about regulatory requirements and products. The areas covered in the interview process normally include management oversight of selling practices, the product approval process, staff training, operational and selling practices, and regular monitoring by the independent Compliance and Internal Audit Departments. The staff to be interviewed will include a few frontline staff selected from the head office and individual branches, and the discussion with such frontline staff will normally cover mock selling tests on a product selected by the examination team. The purpose is to assess the adequacy of their knowledge of the relevant regulatory requirements, operational processes and investment products, and ability to explain the nature and risks of products during the selling process.
- 3.3 With regard to Tier 1 examinations, although the examination team also discusses existing operational practices with relevant management and staff of the examined RI at different levels, and interviews frontline staff to assess their knowledge in relation to investment products and their awareness on compliance with regulatory requirements, a mock selling test is normally not conducted during the interview process.
- 3.4 As regards the number of staff interviewed previously, the working papers of a significant proportion of the securities-related on-site examinations are no longer available and the HKMA is unable to

ascertain the number of frontline staff with whom the mock selling tests have been performed.

Items (d) and (e)

3.5 As mentioned in paragraph 3.2 above, when conducting an interview of the selected frontline staff of the examined RI during Tier 2 and thematic examinations covering selling practices, the examination team normally:

- assesses the adequacy of the frontline staff's knowledge of regulatory requirements in relation to regulated activities (including the requirements set out in the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission ("Code of Conduct"), the SFC's Questions and Answers on Suitability Obligations, and supplementary guidelines issued by the HKMA) and the internal policies and procedures of the RI examined; S1-Appendix 11
M4
- requests the staff to explain and walk through the relevant operational processes including account opening and client risk profiling processes; and
- conducts a mock selling test on product(s) selected by the examination team to assess the adequacy of the staff's knowledge of the investment product(s) and ability to explain the nature and risks of the product(s) distributed by him/her. During the test, the examination staff will specifically ask a number of related and technical questions to test whether the staff has adequate knowledge and correct understanding of the areas that should be covered in a selling process.

3.6 Since there is no regulatory requirement governing the duration required by a ReI to adequately explain the nature and risks of an investment product, the HKMA has not imposed any time limit or maintained any records on the time taken for conducting such interview during on-site examinations. In addition, during an interview, the staff of the RI is allowed to take sufficient time to clearly respond to the questions raised by the examination team. The duration of time therefore will vary depending on the individual staff interviewed, the complexity of the product selected and the number and nature of follow-up questions raised by the examination team. According to the recollection of the examination teams, on average, the whole process of interviewing a staff of a RI normally lasts between one and two hours. In some cases, it might take several hours or several sessions to complete the process. As the mock selling test only forms part of the whole interview process, it is difficult to isolate and estimate the time required for conducting a mock selling test.

3.7 The HKMA believes that the mock selling test is a useful tool for assessing, among other things:

- the adequacy of the frontline staff's knowledge on investment products and ability to explain the nature and risks of products distributed;
- the frontline staff's knowledge on relevant regulatory requirements of regulated activities and relevant internal policies and procedures of the RIs in relation to sale of investment products; and
- the effectiveness of RIs' training and guidance provided to their staff.

In addition, it provides an additional source of useful information for the HKMA to assess the adequacy of the RI's internal controls over the sale of investment products, supplementing the review of related documentation and records conducted by the examination team.

- 3.8 Regarding the limitations, the mock selling test admittedly is not a real selling process involving customers. In addition, mock selling test is conducted only on a sampling basis which does not cover all the frontline staff of the RI examined or all the investment products distributed by the RI.

4. *With reference to the first item under the heading “Note: Common controls include-” on page 8 of Annex 2B of M2(C), please provide, where practicable, copies of the sales and marketing guidelines provided by RIs to their frontline staff involved in the sale of credit-linked notes (particularly Minibonds and other Lehman Brothers (LB)-related credit-linked products) regarding all applicable regulatory requirements and necessary techniques to avoid possible violations.*

4.1 Section 120 of the Banking Ordinance (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 AI being ascertained from it.

4.2 To assist the Subcommittee in its inquiry, the general scope of the sales and marketing guidelines provided by the RIs to their frontline staff involved in the sale of credit-linked notes is summarised below. In general, the sales and marketing guidelines covered, among other things, the following areas:

- Eligibility of staff for selling investment products;
- Know-your-customer / account opening procedures;
- Customer suitability assessment requirements and processes;
- Handling customers’ purchase orders (including distributing prospectus or offering documents to customers; explaining the nature of the products and the risks involved, and processing customer orders);
- Procedures for dealing with vulnerable customers;

- Regulatory requirement for private placement, where applicable; and
- Documentation requirement.

4.3 In addition to the guidelines above, the RIs in general also issued internal sales memo and training materials for the reference of their sales teams prior to the launch of credit-linked notes. Such sales memo and training materials normally contained, among other things, the following information:

- key product features (e.g. issuer, offering period, investment return, tenor, reference entities, whether principal protected or not, credit events, early redemption etc.);
- risk factors (e.g. issuer risk, liquidity risk, market risk, swap counterparty risk, risk of losing substantial part of principal, credit risk of reference entities etc);
- product risk rating;
- fees and charges; and
- target customers/selling restrictions.

5. *Of the cases of suspected mis-selling of LB-related structured financial products referred to SFC by HKMA, details of the cases, if any, in which the products were sold by staff of RIs who were not qualified as ReIs.*

5.1 As of 11 June 2009, a total of 482 Lehman Brothers (LB)-related cases have been referred by the HKMA to the SFC for further action. None of the referred cases involves any prima facie case of selling of securities products by RI's staff who were not registered as ReIs.

5.2 In addition, I would like to take this opportunity to clarify my response to the Subcommittee at the hearing of 12 June 2009 regarding whether persons registered for type 1 regulated activity (dealing in securities) are not permitted to make solicitation or recommendation in relation to securities products if they do not have registration for type 4 regulated activity (advising on securities). Under the Securities and Futures Ordinance, type 1 regulated activity is broadly defined to include, among others and subject to certain exemptions, inducing or attempting to induce another person to enter into or to offer to enter into an agreement for acquiring or subscribing for securities. Accordingly, type 1 regulated activity is not merely restricted to the passive receiving of instructions from clients for execution of transactions in securities products. For instance, a person who is registered with the HKMA as a ReI for type 1 regulated activity (and not other types of regulated activities) may, subject to his compliance with the relevant regulatory requirements, make solicitations or recommendations to clients in relation to securities products.

6. *With reference to paragraph 1.1 (pages 10 and 11) of the checklist at Annex 2B of M2(C) relating to the financial plan or recommendation provided to every client, please provide clarification on the following:*
- (a) *the documentation standards required on ReIs when offering investment advice to their clients, in particular the ReIs' explanation of the risks associated with the recommended investment products;*
 - (b) *Having regard to question 6 of SFC's Questions and Answers on Suitability Obligations (M4), whether it is HKMA's regulatory requirement that the explanation given by ReIs at (a) above has to be put in writing and copied to their clients; if no, please advise whether this is consistent with the requirement in question 6 of M4 and the five regulatory items under paragraph 1.1 in the checklist; and*
 - (c) *whether a RI is required to provide a financial plan or recommendation to its clients in writing and to keep a copy on file, as specified in paragraph 1.1 in Annex 2B of M2(C), in its sale of investment products (including Minibonds and other LB-related credit-linked notes). If such a requirement is not applicable to the sale of specific investment products, please explain how HKMA can ascertain whether the five regulatory items under paragraph 1.1 have been complied with by the RI concerned.*

Items (a), (b) and (c)

- 6.1 As stipulated in the first sentence of subsection 1 under section D "Advising on investments" of the checklist for retail CLN thematic examinations (Annex 2B of M2(C)), section D of this checklist is

applicable where the RI subject to the HKMA's examination is in the business of offering investment advice. Whether a RI is in the business of offering investment advice depends on the facts of each case (including the scope of the agreed services to be provided in accordance with the client agreement). While it is not possible to provide an exhaustive list of examples of the business of offering investment advice, a common example is found in some RIs which offer investment advisory services to their private banking clients. While the actual mode of operations may vary among institutions, in general, when offering investment advisory services to their private banking clients, these RIs:

- propose investment strategy to each relevant client in a portfolio context;
- make customised investment proposal to the client covering different asset classes, markets and financial products; and
- monitor the performance of the client's portfolio under the RI's management on an on-going basis and keep the client regularly apprised of the performance of his/her portfolio.

The documentation standards expected of institutions that are in the business of offering investment advice are mainly set out in the Management, Supervision and Internal Control Guidelines for Persons S1-Appendix 12 Licensed by or Registered with the SFC (paragraph 3 of section VII and paragraph 3 of Appendix), the SFC's Report on Selling Practices of S20 Licensed Investment Advisers issued in February 2005 (item 4 of Appendix 3), and the SFC's Questions and Answers on Suitability M4 Obligations¹ (question 6).

¹ The SFC's Questions and Answers on Suitability Obligations clarify the suitability obligations under the Code of Conduct.

6.2 According to the HKMA's supervisory experience, the securities-related services provided by retail banks to retail customers are generally not classified as a business of offering investment advice. Retail banks and their ReIs concerned are in any event required to comply with the Code **S1-Appendix 11** of Conduct as clarified by the SFC's Questions and Answers on **M4** Suitability Obligations. These activities are captured in Section C (know-your-customer, marketing and selling process) instead of Section D (advising on investment) of the checklist for retail CLN thematic **M2(C)** examinations. Regarding the documentation standards applicable to this **Annex 2B** type of activities, as set out in question 6 of the SFC's Questions and **M4** Answers on Suitability Obligations, the registered person should document and record contemporaneously the information given to each client and the rationale for recommendations given to the client, including any material queries raised by the client and the responses given by the registered person. In addition, the registered person should keep sufficient documentation on all client transactions including orders placed to product providers.

6.3 It should be noted that the assessment of the adequacy of documentation for each transaction will also need to take into account the actual circumstances in each case. The general regulatory expectations on documentation that would be applicable to a bank's retail wealth management business activities for retail customers in relation to the making of recommendation / solicitation are broadly described below.

- (a) The RI should establish and document the client's personal circumstances (including the client's investment objectives, investment horizon, risk tolerance, and financial circumstances, etc) through the client profiling exercise.

- (b) With regard to the suitability assessment performed, the frontline staff should match the risk return profile of the investment product being recommended / solicited with the client's profile. Where no mismatch exists, it would be acceptable if a copy of the client profile established by the RI, together with the product documents issued by the issuer, is given to the client. In case of mismatch between the product risk return profile and the client profile, no solicitation or recommendation of such product should be made to the client by the RI. If, however, the client insists on purchasing such a product despite the mismatch, the RI should alert the client of such mismatch, obtain the client's signed acknowledgement of the mismatch, and the rationale for the product being sold to the client should be properly documented and copied to the client. The RI should also keep sufficient documentation on the client's instruction for the transaction and the order placed to the product provider.
- (c) The frontline staff should provide relevant product documents (including prospectuses, if applicable) to the client. In making explanation of the nature and risks of the product, the frontline staff should follow the standard information related to the particular investment product as set out in the RI's internal sales and marketing guidelines and training materials as well as relevant product documents (including prospectuses, if applicable) provided by the issuer. These explanations are usually given to clients orally and not in writing. Any material queries raised by the client that fall beyond the contents of the above documents and the responses given to the client should be properly documented. The RI is expected to have documentary evidence such as the client's signed acknowledgement to show that the client has received sufficient explanation and understood the nature and risks of the relevant product, and has obtained a copy of the relevant product documents.

7. *With reference to paragraph 5.2 of the Deputy Chief Executive of HKMA's responses dated 10 June 2009 to the follow-up issues arising from the hearing on 5 June 2009 (M27), whether HKMA has identified, after the collapse of LB, any criminal element from cases of suspected mis-selling of LB-related structured financial products, and whether HKMA has referred such cases to the Hong Kong Police Force.*

7.1 Since the collapse of LB, the HKMA has so far identified 3 suspected cases which might involve forged signature on bank documents. All these cases have already been reported to the Hong Kong Police Force by the complainants concerned.

8. *With reference to the second round of the thematic inspection of licensed investment advisers conducted by SFC in 2006 (S27), please provide all the relevant written exchanges (including emails and other correspondence) between HKMA and SFC.*

8.1 A table summarising the relevant written exchanges between the HKMA and the SFC in relation to the second round of thematic inspection of licensed investment advisers conducted by the SFC in 2006 is set out below.

Table 3

Date	Form of written exchanges	Main points raised in the exchange
24 January 2005	Letter	The SFC mentioned that it has invited the HKMA to consider planning a round of theme inspections on the investment advisory activities of banks in parallel with the SFC's second round of theme inspections of selling practices of licensed investment advisers in the last meeting under the Memorandum of Understanding (MoU).
31 January 2005	Letter	The HKMA mentioned that it had set aside resources to conduct the proposed thematic examination of investment advisory activities.

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Date	Form of written exchanges	Main points raised in the exchange
2 May 2006	Email	The SFC proposed a sharing session to be held in late July / early August 2006.
10 May 2006	Email	The HKMA confirmed that the briefing session on inspection of investment advisers could be held in the first half of August 2006.
24 July 2006	Emails	The SFC notified the HKMA of the date and venue of a briefing session on investment advisory inspection for the HKMA staff.
1 August 2006	Email	The SFC provided the training materials for the sharing session and inspection program for the investment advisory inspection to the HKMA.
18 August 2006	Emails	The HKMA and the SFC confirmed with each other the name of staff and the period of secondment in an arrangement of exchange of staff.
21 August 2006	Email	The HKMA sent the curriculum vitae of its secondee to the SFC for reference.
23 August 2006	Email	The SFC sent the curriculum vitae of its secondee to the HKMA for reference.
31 August 2006	Letter	The SFC suggested the HKMA to consider covering some retail banks in the

Date	Form of written exchanges	Main points raised in the exchange
		forthcoming investment advisory inspection in addition to private banks.
29 September 2006	Email	The HKMA and the SFC agreed that “Progress of Theme Inspection on Investment Advisory Activities” should be added to the agenda of the meeting under the MoU between the SFC and the HKMA on 5 October 2006.
3 October 2006	Email	
25 January 2007	Email	The HKMA sought the SFC’s comments on the draft circular summarising the findings of the thematic examinations of investment advisory activities.
5 February 2007	Email	The SFC provided its comments on the HKMA’s draft circular summarising the findings of the thematic examinations of investment advisory activities.
27 February 2007	Email	The HKMA sent the final draft of the circular to the SFC for information and notified the SFC of its schedule of issuing the circular.
28 February 2007	Email	The SFC expressed that it did not have further comment on the final draft of the circular.

Date	Form of written exchanges	Main points raised in the exchange
21 May 2007	Letter	The SFC sent its Report on Findings of Second Round of Thematic Inspection of Licensed Investment Advisers to the HKMA for information and notified the HKMA of its schedule of issuing the Report.
31 May 2007	Email	The SFC sent its press release on the Report on Findings of Second Round of Thematic Inspection of Licensed Investment Advisers to the HKMA for information.

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