Our Ref: B1/15C
G16/1C

22 December 2010

The Chief Executive
All Authorized Institutions

Dear Sir / Madam,

Selling of Accumulators

Triggered by recent market conditions, there have been signs of renewed activities in AIs' selling of accumulators, including stock accumulators and foreign currency accumulators, to investors. I am therefore writing to remind authorized institutions (AIs) to ensure compliance with the relevant regulatory requirements when selling accumulators to customers.

In general, accumulators are derivative products associated with significant investment risks. AIs should adopt a cautious selling approach and ensure that accumulators are only sold to customers who can fully understand the structure and risks, have the risk appetite for acquiring the underlying assets (e.g. stock, foreign currency) with leverage (where applicable), and have the ability to withstand the potential financial loss. When making a recommendation or solicitation to a customer in respect of accumulators, AIs should ensure that the suitability of the recommendation or solicitation for the customer is reasonable in all the circumstances. AIs are required to comply, and maintain adequate documentary evidence to demonstrate compliance, with the relevant regulatory standards including those set out in **Annex**. There should be proper controls and procedures to ensure that the responsible sales staff fully understand the nature and associated risks of the product.

AIs should review and where necessary enhance their management supervision, internal controls, training to staff and independent compliance monitoring to ensure that they comply with all relevant regulatory requirements. The HKMA will assess the compliance of AIs in the supervisory process.

If you have any questions on this letter, please feel free to contact Ms Alice Lee at 2878-1603 or Mr James Tam at 2878-8043.

Yours faithfully,

Meena Datwani
Executive Director (Banking Conduct)

Encl.

c.c. Securities and Futures Commission (Attn: Mr Stephen Po, Senior Director of Intermediaries Supervision)

Annex

Control Measures for Selling Accumulators

Product and customer suitability

Given that accumulators are associated with significant investment risks, AIs in general should assign the highest risk rating to such products. In addition, as a general principle, the HKMA expects that AIs should only sell these products to customers with experience in investing in structured investment products or writing options. AIs should know their customers and ensure that when making a recommendation or solicitation to a customer in respect of accumulators, the suitability of the recommendation or solicitation for the customer is reasonable in all the circumstances. AIs should also assure themselves that the customer understands the nature and risks of the products and has sufficient net worth to be able to assume the risks and bear the potential losses of trading in the products.

When considering the customer's suitability, AIs should ensure that the potential financial impact on the customer, particularly in adverse market conditions, is fully taken into account, in addition to their own credit risks and commercial interests. AIs should refrain from making any solicitation or recommendation of accumulator contracts to customers who already have high concentration in accumulator contracts (taking into account the customers' total maximum exposure as well as their ability to withstand loss and fulfil potential margin obligations under adverse market conditions) or in the specific underlying asset, e.g. a particular stock. Guidance should be provided by AIs to their sales staff on the criteria for identifying such customers. AIs should also provide customers with reasonable alternative investment products with lower risks and/or less complex structure for addressing their investment needs. Given the nature and structure of accumulators, there will be very little room to justify risk-mismatch transactions. If there are any risk-mismatch transactions at all, they need to be strongly justified and reviewed by a senior officer and/or an independent internal control unit (other than a credit control unit).

As a general principle, the HKMA expects that AIs should only sell such products to professional investors (PI) as defined in Part 1 of Schedule 1 to the Securities and Futures Ordinance. It is important to note that even for selling of accumulators to PIs, AIs have to take all reasonable steps to ensure compliance with the applicable regulatory standards, such as customer suitability and proper disclosure of the product features and risks. In order to prevent abuses, AIs should have adequate controls to ensure that their staff do not adopt improper practices against the spirit of the PI requirements. For instance, they should not recommend customers to borrow money/securities or draw credit facility for the purpose of satisfying the portfolio threshold to become PIs.

In addition, if an AI treats any customer as a PI for the purpose of any of the waivers in paragraph 15.5 of the SFC Code of Conduct[1], the AI should ensure that it has properly adhered to the relevant requirements in paragraph 15 of the SFC Code of Conduct.

If AIs receive enquiries from non-PI customers who indicate interest in accumulators, extreme caution should be exercised in handling the enquiries. In view of the high risk associated with accumulators, the HKMA expects AIs to adopt a very stringent standard of customer suitability assessment for transactions involving such products. AIs should alert their sales staff accordingly.

Pursuant to the recently added paragraph 5.1A of the SFC Code of Conduct which will take effect on 4 June 2011, even if no solicitation or recommendation is made, when a customer (other than a PI for the purpose of paragraph 15 of the SFC Code of Conduct) who has been characterised by the AI as without knowledge of derivatives wishes to purchase accumulators, the AI should, among other things, warn the customer about the transaction and provide appropriate advice as to whether the transaction is suitable for the customer.[2]

Disclosure of product features and risks to all customers

AIs should properly disclose and explain to customers the key features and risks of accumulators. Accumulators, for example, should not be misrepresented or described as mere schemes of buying / accumulating the underlying asset on discount throughout the contract period if this is not the case. AIs should ensure that their sales staff always present balanced views, drawing the customer's attention to the structure, disadvantages and downside risks (including the worst case scenario) as well. Moreover, AIs should have adequate arrangements to ensure that the product features and risks as well as the terms and conditions for the accumulator contract and the related credit facility are clearly disclosed and explained to each customer in a language and manner that he/she understands.

In addition to market risk of the underlying assets and counterparty risk of the contract counterparty, the features and risks of accumulators that should be specifically disclosed to customers include but are not limited to the following (where applicable):

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[1] "SFC Code of Conduct" refers to the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission.

[2] There may be proper justification for selling foreign currency accumulators to such customers such as for hedging of the customer's risk exposure, subject to proper controls within the AI to safeguard the customers' interests.

(a) **Knock-out:**

- For those accumulator contracts that have a knock-out clause, AIs should clearly disclose to the customers that when the market price of the underlying asset is at or above the knock-out price, the accumulator contract will terminate (i.e. the investor will cease to accumulate any further underlying asset from the knock-out date). The customer's potential profit therefore is capped by the knock-out feature.

(b) **Potential losses are magnified and can be very substantial**:

- Customers may suffer substantial loss as they are bound by the accumulator contract to take up periodically (e.g. daily) the agreed amount of the underlying asset (at the strike price) when the market price falls below the strike price.
- AIs should draw to their customers' particular attention any "multiplier" condition (i.e. the customers are required to take up twice or multiple times of the agreed amount of the underlying asset when the market turns against them) and the customer's maximum exposure after fully taking into account the "multiplier" condition.
- For customers to make well informed decisions, AIs should also inform customers of their total maximum exposure arising from the proposed contract together with all other outstanding accumulator contracts of the same underlying asset type (e.g. all stock accumulators contracts or all foreign currency accumulators contracts).
- AIs should ensure that their customers are aware that they may not be able to early terminate the accumulator contracts, and even if the AIs consent to the customers' request for early termination, the customers would likely need to bear unexpectedly high exit costs and losses.
- In case of stock accumulators, AIs should alert their customers that the share price of a company could move substantially in particular on corporate specific news/developments and this could pose significant risk to the customers. Similarly for foreign currency accumulators or stock accumulators involving exposure to a foreign currency, the exchange rate of the relevant foreign currency may go up or down.

(c) **Contract tenor**:

- AIs should make sure that customers are aware of the contract tenor and the implications of a long contract period. In order to facilitate customer's decision of the contract tenor, AIs should explain to customers that accumulator contracts with a longer tenor will be associated with higher risks and usually higher costs of early termination.

(d) **Additional risks associated with margin trading or use of credit facility:**

- For customers who plan to enter into accumulator transactions on a margin basis or with the use of credit facility, AIs should disclose clearly to the customers that they need to be prepared for paying interest cost for the margin/credit facility and meeting margin calls which require them to make top-up payment to cover the full marked-to-market losses for the remaining period of the contract. Such payment can be substantial in poor market conditions and/ or when the contract has a long remaining period.
- In addition, AIs should explain to the customers that in poor market conditions, the customers may have to meet margin calls at short notice while their ability to make top-up payments may be much worse than during normal times, due to the significant fall in market value of other financial assets. If the AI reserves absolute discretion to raise the margin level, the AI should inform customers of this fact, as this can add further liquidity pressure on the customers.
- AIs should ensure that their customers understand that when they fail to meet margin calls, the contracts may be closed out without the customers' consent and the customers will have to bear the consequential losses and costs which could be very substantial.
- When the AI intends to reduce or stop another existing credit facility (e.g. trade finance facility) of a customer to cover the AI's exposure to the customer, e.g. as a result of the customer's marked-to-market loss, it should promptly inform the customer.

(e) **Customers with hedging needs:**

- For customers who intend to enter into foreign currency accumulator contracts for hedging purpose, AIs should put in place proper procedures to establish whether the accumulator is indeed a suitable instrument to serve this purpose and even if so, whether the maximum exposure of the customers is appropriate for such purpose. For example, if the proposed maximum exposure associated with foreign currency accumulator contracts (or the resulting total maximum exposure after taking into account other outstanding accumulator contracts as well) for a customer is materially higher than his/her positions or anticipated cash outflows in the relevant foreign currency, the customer will be over exposed and the AI should warn the customer accordingly.
- AIs should ensure that their staff do not misrepresent or give any impression to investors that accumulators can be a hedging tool for decumulators.

Audit trails

AIs should maintain adequate and unambiguous (written and audio) records to demonstrate that they have conducted proper suitability assessment and risk disclosures in accordance with the regulatory requirements. AIs should also maintain proper audit trail evidencing that sufficient independent monitoring is performed to identify and prevent non-compliance.

Decumulators

In general, AIs should observe the above standards and principles in the selling of decumulators. AIs should ensure that their staff do not misrepresent or give any impression to investors that decumulators can be a hedging tool for accumulators. Moreover, for stock decumulators, AIs should have adequate controls and procedures to ensure that they and their customers do not breach any short selling restrictions as result of such contracts.

Hong Kong Monetary Authority
22 December 2010