HONG KONG MONETARY AUTHORITY
香港金融管理局

Our Ref: B1/15C
G16/1C

5 January 2012

The Chief Executive
All Authorized Institutions

Dear Sir/ Madam,

**Selling of Investment Products**

I am writing to draw your attention to a number of conduct-related issues in relation to the sale of investment products by Authorized Institutions (AIs) that we have identified in the course of our supervisory work as requiring further guidance to ensure adequate protection of investors. AIs should take prompt action to implement enhancement of controls, where necessary, as a result of the guidance provided herein.

***Disclosure of product information***

AIs should make adequate disclosure of relevant material information, including the name of the product issuer and the issuer's affiliation with the AIs (if any), to customers prior to or at the point of sale. It is not sufficient to provide such information after a transaction has been executed.

In this connection, the risk disclosures in the Product Key Facts Statements (KFS) of publicly offered unlisted structured investment products are, in general, meant to provide a concise summary of the key risks. AIs should therefore not rely solely on the KFS for risk disclosure purpose. AIs should direct customers to the detailed risk disclosures in the offering documents applicable to the particular type of reference asset (especially Exchange-Traded Funds[1]), and ensure that the nature and risks of the product and of the particular reference assets are adequately explained to the customers. Sufficient guidance should be provided to frontline staff on each product issue and the applicable risk disclosures.

Furthermore, some special product features and risks of certain investment products may warrant particular attention. Listed below are examples of investment products with uncommon features and / or complex structure. The examples of the products and their

[1] See the HKMA circular "Synthetic Exchange-Traded Funds (ETFs) and Related Products" dated 3 September 2010.

55th Floor, Two International Finance Centre,
8 Finance Street, Central, Hong Kong
Website: www.hkma.gov.hk

香港中環金融街8號國際金融中心2期55樓
網址：www.hkma.gov.hk

features and risks are non-exhaustive. AIs should have a thorough understanding of each investment product they offer and provide customers with proper disclosure and explanation in each case.

- Subordinated debentures: AIs should specifically draw to their customers' attention the credit information in relation to the product, highlight and explain the implications of its "subordinated" nature. They should ensure that the customer understands that holders of subordinated debentures will bear higher risks than holders of senior debentures of the issuer due to a lower priority of claim in the event of the issuer's liquidation. Disclosure and representation relating to credit information should be clear and not misleading. For example, the credit rating of the guarantor should not be confused with that of the issuer or the debenture.

- Perpetual debentures: AIs should highlight to their customers that such debentures do not have a maturity date, and the coupon payments may be deferred or even suspended subject to the terms and conditions of the issue. Furthermore, as perpetual debentures are often callable and / or subordinated, AIs should disclose and explain the reinvestment risk, and / or a lower priority of claims (e.g. on liquidation of the issuer), as the case may be.

- Contingent convertible[2] or bail-in[3] debentures: Given contingent convertible and bail-in debentures are hybrid debt-equity instruments that may be written off or converted to common stock on the occurrence of a trigger event, AIs should explain the product nature, the trigger events, and implications of any trigger to the customers.

- Basket equity-linked products: An investor of basket equity-linked products with bull structure is obliged to buy at the strike price (or suffer a financial loss with reference to) the worst-performing stock in the basket of linked stocks, if the final price of the worst-performing stock is below the strike price. AIs therefore should ensure that the investor understands the fact that he/she is exposed to the risks of the basket of stocks especially the stock having the worst performance.

***Product due diligence***

AIs should also ensure that, among other factors, the above special features and risks including the issuer's credit risk, the hybrid debt-equity nature, priority of claim, and the risks and price volatility of the reference asset (especially for equity-linked product linked to the worst performing stock), where applicable, are properly taken into account in their product due diligence process.

---

[2] "Contingent convertible debentures" refer to debentures that contain a clause requiring them to be written off or converted to common stock on the occurrence of a trigger event. These debentures generally absorb losses while the issuer remains a going concern (i.e. in advance of the point of non-viability).

[3] "Bail-in" generally refers to (a) contractual mechanisms (i.e. contractual bail-in) under which debentures contain a clause requiring them to be written off or converted to common stock on the occurrence of a trigger event, or (b) statutory mechanisms (i.e. statutory bail-in) whereby a national resolution authority writes down or converts debentures under specified conditions to common stock. Bail-in debentures generally absorb losses at the point of non-viability.

***Pre-sale disclosure of benefits and sales related information***

AIs are reminded to give adequate pre-sale disclosure to customers of sales related information, including monetary and non-monetary benefits received in selling investment products regulated under the Securities and Futures Ordinance, in accordance with the requirements of paragraphs 8.3 and 8.3A of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission ("Code of Conduct"), both of which have been effective since 4 June 2011.

***Concentration risks***

AIs are reminded that they should make reference to the paragraphs 5.2 and 5.3 of the Code of Conduct, the Questions and Answers on Suitability Obligations[4], and take into consideration all relevant factors including the customer's concentration risk, in performing suitability assessment. AIs should put in place reasonable methodology and threshold(s) for assessing such risk. While there may not be a single threshold that suits each and every circumstance, it is advisable to adopt a prudent approach. AIs may take into account relevant factors like product type and nature, product risk rating, customer's investment objectives and risk tolerance level etc. and consider setting a lower threshold for higher risk products, and using cumulative basis instead of per transaction basis in calculating the concentration level. If an intended investment will result in a mismatch between the customer's circumstances and the concentration level, AIs should alert the customer of this and ask the customer to reconsider whether in these circumstances he/she wishes to continue to invest the original amount. AIs should justify that the transaction is suitable for the customer in all the circumstances before proceeding to effect the transaction. Proper documentation in this regard should be maintained.

***Maintenance of order records***

AIs are reminded to maintain proper records of client orders. Use of mobile phones for receiving client order instructions is discouraged. Where client order instructions are accepted through mobile phones, the time of receipt and the order details should be recorded immediately, for example by a call to the office's audio recording system or in writing, as required under paragraph 3.9 of the Code of Conduct. The SFC is currently consulting the public on amending paragraph 3.9 of the Code of Conduct[5]. For the avoidance of doubt, AIs should follow any new requirements of the SFC as and when paragraph 3.9 of the Code of Conduct is amended.

AIs should promptly review their existing controls, policies and procedures and staff training taking into account the issues discussed in this circular, and implement enhancement measures where necessary. AIs have the duty to ensure that proper controls are in place to ensure compliance with relevant regulatory requirements at all times. The HKMA will assess the compliance of AIs with this circular in its supervisory process.

---

[4] Issued by the SFC in May 2007.

[5] Consultation paper on proposals to amend the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission in relation to the establishment of the Financial Dispute Resolution Centre Ltd and the enhancement of the regulatory framework, November 2011.

If you have any questions on this letter, please contact Ms Alice Lee at 2878-1603 or Ms Florence To at 2878-1582.

Yours faithfully,

Meena Datwani
Executive Director (Banking Conduct)

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