



Our Ref: B1/15C  
G16/1C

20 January 2012

The Chief Executive  
All Authorized Institutions

Dear Sir/ Madam,

**Applicability of Enhanced Measures to Sales of Investment Products to Private Banking Customers**

In view of the differences in the nature of the clientele and the mode of operations of private banking business in comparison with retail banking business, the Hong Kong Monetary Authority (“HKMA”) and the private banking industry engaged in detail discussions and worked out a flexible version of the enhanced measures that were set out in the HKMA’s circular of 25 March 2009. This version, set out in the Annex, applies to authorized institutions (“AIs”) which operate as private banks or have dedicated private banking units (collectively “private banks”) in their dealings with private banking customers.<sup>1</sup>

The HKMA expects compliance with these measures no later than four months from the date of this circular. However, private banks should, as always, ensure that they put in place adequate controls on the sale of investment products to customers.

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<sup>1</sup> As set out in the HKMA’s circulars of 20 May 2010 and 18 April 2011, an AI should classify an individual as a “private banking customer” only if (i) he/ she maintains a personalized relationship with the AI; (ii) receives personalized banking services or portfolio management services from the AI; and (iii) has assets under the AI’s management (“AUM”) of at least US\$1 million. The HKMA expects private banks to observe the AUM threshold requirement on a reasonable basis, and will look at the real substance of the banking relationship to ensure that it is personalized management rather than retail wealth management being disguised as private banking. Following this spirit, private banks may, in exceptional scenarios, have clients with AUM that is below the US\$1 million threshold due to market movements or other practical justifications (e.g. relatives or friends referred by existing prominent clients and have genuine private banking relationship with the institution).

If you have any questions regarding this letter, please feel free to contact Ms Florence To at 2878-1582 or Ms Angela Wong at 2878-1604.

Yours faithfully,

Meena Datwani  
Executive Director (Banking Conduct)

Encl.

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

**Applicability of the measures set out in the HKMA’s circular “Implementation of recommendations in the HKMA’s Report on Issues Concerning the Distribution of Structured Products Connected to Lehman Brothers” dated 25 March 2009 to private banks**

Recommendations	The flexible version
<b><i>Annex 1 of the 25 March 2009 HKMA circular</i></b>	
<p>5 “Health-warnings” should be attached to retail structured products with embedded derivatives or to retail derivative products generally.</p>	<ul style="list-style-type: none"> <li>• To adopt the health warnings below for sales of structured products with embedded derivatives<sup>1</sup> to private banking customers:           <p><b>“This is a structured product which involves derivatives. Do not invest in it unless you fully understand and are willing to assume the risks associated with it. If you are in any doubt about the risks involved in the product, you may clarify with the intermediary or seek independent professional advice.”</b> or</p> <p><b>“此為涉及衍生工具的結構性產品。除非閣下完全了解及願意承擔所涉風險，否則切勿投資此產品。閣下如對此產品所涉及風險有疑問，應詢問有關中介人或徵詢獨立專業意見。”</b></p> </li> <li>• The health warning statement (“HWS”) should be incorporated in the term sheets of structured products where practicable and provided to the customer before the sales is concluded, regardless of whether such products are sold to professional investors. For structured products without term sheets, private banks should provide or send to the customer, before transaction, the product brochure with the HWS incorporated or attached. Appropriate audit trail should be maintained for this purpose.</li> <li>• The HWS requirement is not applicable in cases where the private bank has provided its customers with Product Key Fact Statement in accordance with the Securities and Futures Commission (“SFC”)’s requirements.</li> </ul>

<sup>1</sup> All exchanged-traded products as well as fixed income securities (such as convertible bonds and convertible preference shares) will be excluded from the definition of “structured products with embedded derivatives” for the purpose of the HWS requirement. However, if a private bank advises a customer to trade in these investment products, the HKMA expects the private bank to conduct appropriate suitability procedures and make appropriate risk disclosures, including advising the customer the HWS.

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	<ul style="list-style-type: none"> <li>• Private banks should help each customer make informed decisions through proper disclosure and explanation of the key features and risks of investment products (including the HWS), and such disclosure and explanation should be in a language that the customer can readily understand, especially if provided orally.</li> </ul>
<p>12 To provide further protection for investors, the assessment of a customer’s risk profile be separated from the sales process and be carried out by non-sales staff and that the customer be provided with a copy of the risk profile and asked to confirm his agreement that the risk profile is accurate. Mandatory requirements to audio record the assessment process should be introduced.</p>	<ul style="list-style-type: none"> <li>• Private banks should have adequate procedures in place to ensure compliance with the “know your client” (“KYC”) and suitability requirements (paragraphs 5.2 and 5.3 of the Code of Conduct<sup>2</sup>).</li> <li>• It is not mandatory for private banks to: <ul style="list-style-type: none"> <li>(i) separate the customer risk profile assessment from the sales process;</li> <li>(ii) carry out the customer risk profile assessment by a non-sales staff; and</li> <li>(iii) audio record the customer risk profile assessment process.</li> </ul> </li> <li>• Private banks should put in place adequate procedures to obtain customer’s acknowledgement of the result and receipt of a copy of the customer risk profile assessment, through the following methods: <ul style="list-style-type: none"> <li>(i) Seek the customer’s written acknowledgement in case of face-to-face discussions; or</li> <li>(ii) Mail a copy of the customer risk profile assessment to the customer, to be followed-up with a phone call, which should be audio recorded, to remind the customer of the importance of such document and that he/ she should review it and advise the bank of any disagreement or, inform the bank if he/ she has not received it.</li> </ul> </li> </ul>

<sup>2</sup> Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission

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	<p>Proper audit trail should be maintained to ensure relevant steps have been taken and to facilitate retrieval of records, e.g. when and by whom was the copy of the assessment sent to the customer and when and by whom was the follow-up phone call made.</p> <ul style="list-style-type: none"> <li>Private banks should put in place clear policy and procedures for setting the frequency of conducting a review of the customer risk profile. Frequency of review should be reasonable and could be set in accordance with individual customers' circumstances. In view that the predominant market practice is conducting a review in every one to two years, the HKMA expects that review of customer risk profile should be conducted at least once every two years, unless the customer concerned opts out from the review and confirms that there is no material change in his/ her circumstances that warrants updating of the customer risk profile. For the avoidance of doubt, the opt-out arrangement is only applicable to the current review. The private bank should approach the customer again for an update of the customer risk profile in the subsequent review cycles. The private bank should ensure that the customer's opt-out request and confirmation are properly recorded and maintained as evidence. Private banks are reminded that for the purposes of the Code of Conduct, they should comply with the SFC's requirement of undertaking a new assessment of the knowledge, expertise and investment experience of a Professional Investor under paragraph 15.2B of the Code of Conduct if the customer has ceased to trade in the relevant market or product for more than two years.</li> </ul> <p>In general, customers should be reminded to advise the private bank of any material change in the customer's circumstances that warrant updates to the customer risk profile.</p> <ul style="list-style-type: none"> <li>The correspondence and communication in the KYC and the suitability assessment processes should be in a language that the customer can readily understand to ensure effective communication.</li> </ul>
13	<p>The regulatory requirements at point of sale should be reviewed with a view to introducing mandatory requirements for the audio-</p> <ul style="list-style-type: none"> <li>It is a requirement under the Code of Conduct that registered persons conduct appropriate suitability assessment during the sales of investment products. The HKMA considers that it is important for private banks to have suitable procedures and records</li> </ul>

Recommendations		The flexible version
	recording of the sales process and ancillary arrangements.	<p>to demonstrate that they have complied with this requirement.</p> <ul style="list-style-type: none"> <li>As an alternative to audio-recording, private banks may document the basis upon which they consider the product is suitable for the private banking customer, and demonstrate that they have provided a copy of this document to the customer for record (i.e. in accordance with the SFC's FAQs on Suitability Obligations<sup>3</sup>).</li> </ul>
14	Where the continuous review by a registered institution ("RI") of the risk ratings of the investment products it sells results in a higher risk rating being attributed to a product, the institution should disclose this to customers to whom it recommended and sold the product.	<ul style="list-style-type: none"> <li>Private banks should perform product due diligence and continuous review of product risk ratings for all investment products (except for the products depicted in (i) and (ii) below) offered to customers. In particular, for products that are assigned with product risk ratings by a private bank, customers should be informed of any upward revision of product risk rating. <ul style="list-style-type: none"> <li>(i) Tailor-made investment products developed as per the request of the customer and where the products are not on the private bank's product list; or</li> <li>(ii) Investment products which have not been solicited from/ recommended by the private bank (i.e. where the private bank only performs the execution of the trade or where investment products are "transferred in" at the request of customers) <u>and</u> where the products are not on the private bank's product list.</li> </ul> <p>For the avoidance of doubt, where there is an ongoing relationship with a customer, private banks should ensure regular monitoring of the customer's investments and communicate any material changes to the customer as appropriate.</p> </li> <li>In determining whether a particular transaction can be regarded as a "tailor-made" or "transfer-in" or "execution only" for the purpose of not applying Recommendation 14, private banks should adopt a prudent approach, and ensure that the private banking customer's instruction contains sufficient specific details to identify the product concerned. For instance, if the product is covered by the private bank's product list, or if the customer only mentions some broad features that various products may match and</li> </ul>

<sup>3</sup> Questions and Answers on Suitability Obligations issued by the SFC on 8 May 2007

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		<p>the private bank picks / recommends one of these products for the customer, the private bank should apply Recommendation 14.</p> <ul style="list-style-type: none"> <li>It is the private bank’s responsibility to justify that a product is tailor-made or acquired by a customer at his/ her initiative but not at the bank’s recommendation. Appropriate audit trail should be maintained for this purpose.</li> </ul>
15	<p>In cases of sales of investment products where there is a risk mismatch between the risk rating applied to the product and the customer’s risk profile, full and complete documentation should be retained of the reasons why the customers made the investment decision, the sales process should be audio-recorded, and endorsement should be sought from supervisory staff within the institution.</p>	<ul style="list-style-type: none"> <li>The principles for the applicability of Recommendation 13 set out above are also applicable to this recommendation.</li> <li>In the case of a risk mis-match, the reason why such product is still considered by the sales staff to be suitable for the private banking customer despite the mis-match, or in the case the product is advised to be not suitable, the reason why the customer insists on buying the product should be documented. The private bank should provide a copy of this document to the customer.</li> <li>For the avoidance of doubt, it should be noted that a mechanical matching of risk grades between customers and products per se might not necessarily satisfy the SFC’s suitability requirement. Private banks should have records to demonstrate that they have taken into account customers’ investment objectives, investment experience and financial situations (e.g. net worth, investment concentration, etc.), and assure themselves that the customers understand the nature and risks of the investment and have sufficient net worth to be able to assume the risks and bear the potential investment losses when the private banks consider whether a product is suitable for customers.</li> </ul>
17	<p>A mystery shopper programme be instituted periodically by the HKMA (as well as by RIs themselves) to test sales processes, and a pilot programme of customer surveys be commissioned by the HKMA to gauge whether such surveys can provide information useful for the examination of specific issues in the context of the longer-term customer</p>	<p>Private banks are excepted from introducing mystery shopper programme, given that private banking operations are based on personalised account relationship, and thus it will not be feasible to introduce such programme.</p>

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	relationship.	
18	Remuneration structures for staff engaged in AIs' securities business be subject to greater focus in the HKMA's on-site examinations and off-site surveillance of AIs' securities business.	Private banks should have adequate procedures and controls to ensure that frontline sales staff are not remunerated with bonuses calculated solely on the basis of financial performance but that other factors (including adherence to best practices guidelines and code of conduct) are in fact taken into account.
<b><i>Annex 2 of the 25 March 2009 HKMA circular</i></b>		
10	<p>AIs, which are RIs, continue to be permitted to undertake securities business (including selling investment products to retail customers), but steps should be taken to ensure clearer differentiation between traditional deposit-taking activities and retail securities business, including:</p> <ul style="list-style-type: none"> <li>• physical segregation of AIs' retail securities business from their ordinary banking business</li> <li>• a requirement that staff involved in selling investment products to retail customers should not be involved in ordinary banking business</li> <li>• a requirement that AIs make clear, through physical signs and warnings, the distinction between deposits and investments and particularly the risks attached to the latter</li> <li>• a requirement that there be complete information separation between a retail customer's deposit accounts and his investment accounts and a prohibition on</li> </ul>	Private banks are excepted from this requirement, given that the mode of operation of private banks differs from retail banks.



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11	• the above forms of segregation should apply to AIs' insurance activities and other investment activities. Private banks are excepted from this requirement, given that the mode of operation of private banks differs from retail banks.