Application No. 3 of 2015

IN THE SECURITIES AND FUTURES APPEALS TRIBUNAL

IN THE MATTER OF a Decision made by the Securities and Futures Commission under section 194 of the Securities and Futures Ordinance, Cap. 571

AND IN THE MATTER OF section 217 of the Securities and Futures Ordinance, Cap. 571

BETWEEN

HSBC PRIVATE BANK (SUISSE) SA	Applicant
and	
SECURITIES AND FUTURES COMMISSION	Respondent

Tribunal: Mr. Michael John Hartmann, Chairman

Mr. Vincent Chin, Member

Ms. Helen Zee, Member

Date of hearing : 4 to 7 May, 9 to 12 May and 12 to 15 September 2016

Date of determination : 21 November 2017

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REASONS FOR DETERMINATION

Introduction

1. The applicant in this matter, HSBC Private Bank (Suisse) SA ('HSBCPB' or 'the bank'), has at all material times been an authorised financial institution pursuant to the provisions of the Banking Ordinance, Cap. 155, falling under the supervision of the Hong Kong Monetary Authority ('HKMA'). To the extent, however, that it carries on business in securities[1], the bank has been registered pursuant to the provisions of the Securities and Futures Ordinance, Cap. 571 ('the Ordinance') to pursue two forms of regulated activity. They are, first, dealing in securities (a Type 1 activity) and, second, advising on securities (a Type 4 activity).

2. As a private bank, HSBCPB has at all material times "engaged in bespoke wealth management"[2] for its clients who are high net worth individuals.

3. As a private bank with an 'open architecture', the bank has at all material times marketed (in the sense of having available for sale and selling to its clients) not only proprietary investment products but a range of products issued and guaranteed by third party institutions. These have included structured financial products - also known as derivative products -

[1] And in so far as it is relevant to this review.

[2] A phrase employed by Mr. Alexander Wynd, Head of Business Management at the Applicant.

which enhance potential returns through leverage but at the same time integrate higher levels of risk.

4. When the Tribunal uses the phrase 'at all material times', it is in the present case speaking essentially of the period of time between the beginning of January 2003 and the end of December 2008.

5. It was in the latter part of that period, essentially from early 2007, that what is now known as the Global Financial Crisis occurred. That crisis has formed the backdrop for certain of the issues that fall to be determined in this review.

6. Looking briefly at the development of the Global Financial Crisis, the first to feel the effects of the mounting financial contagion were those institutions with heavy exposure to the United States sub-prime mortgage market. An illustration of the mounting contagion is to be found in the fate of the venerable investment bank, Bear Stearns. At the end of July 2007, Bear Stearns was forced to liquidate two of its mortgage security hedge funds. In November, the rating agency, Standard & Poor's, downgraded Bear Stearns from A+ to A. At the very end of the year, Bear Stearns reported its first ever quarterly loss, driven by the need to write down US$1.9 billion in bad debt. In March 2008, just three months later, JP Morgan agreed to buy Bear Stearns, a firm that had been valued at US$20 billion, for just US$2 a share : a sum of US$236 million. In order to facilitate the purchase, the Federal Reserve Bank agreed to lend JP Morgan US$30 billion.

7. As the crisis developed, in early September 2008 the United States Government was forced to take control of mortgage giants, Fannie

Mae and Freddie Mac, and a few days later, on 15 September 2008, having failed to find a buyer, Lehman Brothers, the fourth-largest United States investment bank, was forced to file for bankruptcy. The United States Government did not intervene by offering any form of 'bail out'. According to some estimates it was at the time the largest bankruptcy in history.

8. In the days that followed, American International Group, the world's largest insurer, and two further investment banks, Goldman Sachs and Morgan Stanley, all being on the brink of collapse, were – by various means - rescued by Government intervention.

9. Between January 2006 and September 2008, HSBCPB had distributed to its clients a total of 480 Lehman Brothers structured financial products for a total sales volume of some HK$12.1 billion. There were, for the purposes of this review, two types of Lehman Brothers products distributed : first, what were known as 'callable daily accrual notes' ('CDAs'), 427 series being distributed, and, second, what were known as 'equity-linked notes' ('ELNs'), 53 series being distributed. During the course of proceedings before the Tribunal, these have together been referred to as 'LB-Notes'.

10. Between January 2003 and December 2008 the bank also marketed structured financial products originally called 'accrual preferred investment schemes' and later referred to as 'shares forward accumulators' ('FAs'). In that time period, HSBCPB distributed a total of 17,034 series of FAs, generating a total gross profit of some HK$2.19 billion.

11. The nature and workings of Lehman Brothers' CDAs and ELNs, and the nature and workings of FAs, more especially their

complexity and the risks inherent in such structured financial products, are of central relevance and are considered in the body of this judgment.

12. In the wake of the Lehman Brothers' collapse, clients of HSBCPB who had purchased the two types of Lehman Brothers' structured financial products detailed above – LB notes – complained to the bank which sought in the Lehman Brothers' liquidation proceedings to make recovery on their behalf. The Tribunal is told that all clients have received at least part of their principal and further payments are expected.

13. In addition, certain clients complained to the HKMA and, in the period between January 2010 and January 2013, a number of the clients gave statements to the Authority. Thereafter the Authority referred those complaints to the Securities and Futures Commission ('the SFC') which took up the matter.

14. In a Notice of Proposed Disciplinary Action dated 23 March 2015, the SFC informed HSBCPB that it was of the preliminary view that, in respect of its sale of LB-Notes and FAs to a significant number of bank clients during certain specified periods of time, it had fallen below the standards of professionalism required of it and had thereby been guilty of misconduct. As to the nature of the misconduct alleged, it was said to be essentially systemic in nature and of such breadth that, in the provisional opinion of the SFC, it brought into question the bank's fitness to remain registered to deal in securities (Type 1 regulated activity) and to advise in respect of securities (Type 4 regulated activity).

15. Concerning the nature of the alleged misconduct, it may be said that it fell into three broad areas; two concerning the marketing and sale of

LB-Notes and one concerning the marketing and sale of FAs. By way of an overview, those areas - which became the central issues for determination by the Tribunal - may be described as follows :

I. The first LB-Notes issue - failing to inform clients that the credit worthiness of the issuer of certain derivative instruments (LB-Notes) was in question

16. It was asserted by the SFC that over a relatively limited period of time, that is, between 15 July and 3 September 2008, while marketing Lehman Brothers derivatives, specifically LB-ELNs, the bank had failed to disclose relevant and material information to clients who purchased those notes during that period of time, specifically the fact that Lehman Brothers was the issuer of the notes and that – at that time – its credit worthiness was in doubt, that being a material issue related to risk.

17. The findings of the SFC were based on a detailed consideration of 15 complaints made by clients of the bank, its investigations revealing what appeared to be an undisputed fact, namely, that each of the 15 clients, when each of them purchased the notes, was not informed that Lehman Brothers was the issuer.

18. By way of illustration, in respect of one complaint, that of Mr. K who made a purchase on 28 July 2008, the bank's relationship manager accepted that she did not know the issuer's identity when she sold the note to him. When she introduced the product, she knew only that the bank would use investment grade issuers. It was only on the day *after* the execution of the order that a trade confirmation containing issuer information would be sent to the client by post. Mr. K himself was recorded as saying that he was never informed that there was issuer risk. Nor, at the

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date of purchase, was he informed that the issuer was Lehman Brothers. He said that, when Bear Stearns had collapsed in or about March 2008, a personal concern as to the matter of 'issuer risk' had arisen but at that time he had assumed that the bank itself would be responsible for ensuring the suitability of individual issuers.

II. The second LB-Notes issue - failing to ensure suitability of product for bank clients

19. Between January 2006 and September 2008, HSBCPB distributed to its clients a total of 53 series of LB-ELNs and a total of 427 series of LB-CDAs. This involved a total of 3961 transactions with a total sales volume of HK$12.1 billion. In its response to the SFC Notice of Proposed Disciplinary Action, solicitors for the bank said that the gross revenue from these transactions came to HK$94.6 million with a total estimated profit of HK$50.6 million.

20. It was asserted by the SFC that over this period of time, particularly when marketing LB-CDAs (to which the bank gave its highest risk rating of level 5), the bank had failed to take appropriate measures to ensure that the sale of these LB-Notes was in each case suitable for the individual bank clients who purchased the product and did not constitute an unjustified risk mismatch. More particularly, in this regard, the SFC asserted that it had identified a number of material deficiencies in the bank's internal processes which undermined the ability to ensure suitability of product. These asserted deficiencies, fell into three broad categories. They were to be found, first, in the process of due diligence essential to fully understanding the parameters of each client's risk profile, the methodology by which rational appetite for risk could be judged : the 'know-your-client'

process; second, in the process of due diligence to ensure that the particular product at that time would constitute a suitable purchase by the client and, third, in the process of supervising and monitoring the sales process itself in order to avoid unjustified risk mismatch.

21. In respect of this second LB-Notes issue, it was the SFC case that the records of the bank revealed that in respect of a total of 672 outstanding transactions, in 549 of those transactions which involved the sale to clients of LB-CDAs, it was shown that the risk profiles of those clients - profiles compiled by the bank itself - made it suitable for them to assume a 'low' or 'medium' level of risk and not, without prior prudent discussion and consideration as to suitability, an instrument carrying the bank's highest risk rating.

22. The findings of the SFC were, however, focused on a detailed consideration of complaints lodged by 55 clients of the bank. These 55 complaints, it was said, revealed systemic failings on the part of the bank. By way of illustration, they included the following :

i. The existence of a mismatch between the risk tolerance levels of 'low' or 'medium' assessed for the clients by the bank and the purchase of derivatives carrying the highest product risk rating of '5'. This mismatching, it was said, was to be considered in light of the bank's own acceptance that, as a general rule, a client's risk tolerance level should be in line with a product's risk rating, a client's risk tolerance level, if assessed as 'medium' to be considered to be in line with a products risk rating of '4' but not '5'.

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ii. In respect of a number of clients, the total CDAs held by them, when assessed as a percentage of their portfolio, exceeded the maximum percentage portfolio of high risk investments stated in their accounts.

iii. In respect of a number of clients, single purchases of derivative instruments with the bank's highest risk rating constituted more than 5% of their investment portfolios, even though the bank's own manual stated that clients should be advised to have no more than 5% of their portfolio in a single such product.

iv. In respect of a number of clients, they were recommended to purchase CDAs with underlying stocks which were endorsed in the bank's own recommended list to the effect that they should *not* be recommended to clients and should only be sold to them if there was a specific request.

v. While it was accepted that there was no rigid limitation on the purchase of high risk investments by clients, there was however an almost complete absence of records revealing that staff of the bank had actually assessed the suitability of CDA transactions, as they were obliged to do, and had discussed that matter with the clients.

III. The FAs issue - again, failing to ensure suitability of product for bank clients

23. It appears to have been accepted that in or about 2006 into 2007 clients of HSBCPB began to trade aggressively in FAs (forward accumulators). The cause, it was suggested, was the low interest climate coupled with a bull market. In purchasing forward accumulators, clients purchased the underlying stock at a discount. In a buoyant market, with that stock rising in value, it meant that on every settlement date when more shares had to be purchased they were being acquired at an even greater discount. In the result, despite the risk of exponential losses should the market go into retreat, the evidence shows that the bank received a great many enquiries concerning the purchase of forward accumulators, and no doubt direct requests to purchase, from enthusiastic clients : many knowledgeable, many not.

24. The evidence shows that between January 2003 and December 2008, HSBCPB distributed to its clients over 17,000 series of forward accumulators, this involving in excess of 55,000 transactions apparently generating a gross profit of some HK$2.19 billion.

25. Following an investigation by the HKMA, 13 complaint cases - all related to the purchase of forward accumulators - were referred to the SFC. Using these 13 complaint cases as a body of evidence, the SFC identified what it considered to be further failings in the internal systems of the bank, failings, that is, that were specific to the sale of forward accumulators and were in addition to the systemic failings already identified in respect of the marketing and sale of LB-Notes generally. These specific failings may be summarised as follow; first, as part of the 'know-your-client'

process, a failure to reliably estimate the net worth of clients seeking to purchase forward accumulators; second, a failure to ensure that clients had sufficient net worth to assume, that is, to take on, the risks of purchase of these derivatives and were not thereby potentially over exposed; third, a failure to ensure the suitability of the product for each client and, fourth, a failure to ensure that the key features of forward accumulators were explained, more especially the exponential risks that could be involved if the underlying equities lost value.

A brief word as to the complaints

26. The SFC case was therefore founded on 83 discrete complaints: 15 complaints in respect of the first LB-Notes issue, 55 complaints in respect of the second LB-Notes issue and 13 complaints in respect of the FAs issue. In order to substantiate each complaint, a detailed dossier was drawn up in respect of each one, each dossier summarising the known records of the bank (credit assessments, transcripts of telephone conversations and the like), interviews with bank staff, the substance of the complaints made and the basis upon which, in respect of each complaint, the SFC believed the bank to have been culpable.

27. As the Tribunal has understood it, to a large extent the specific factual assertions set out in each individual dossier have not been the subject of disagreement. The same, of course, cannot be said of how those dossiers are to be read in their broader context.

The SFC's overall findings

28. Although the SFC's Notice of Proposed Disciplinary Action was specifically focused on the 83 complaints, it came to the finding that these individual cases revealed a broader malaise in the bank, what it described as "serious and systemic weaknesses in respect of the management systems and internal controls in relation to HSBCPB's overall investment selling and advisory business". These systemic weaknesses, in the opinion of the SFC, constituted the basis for the provisional finding that the bank's registration to carry on Type 1 and Type 4 activities should be reviewed.

29. The SFC's provisional determinations of misconduct were founded on what the SFC determined to be a failure by HSBCPB to meet the principles-based regulatory standards expected of it in the discharge of its professional banking services, the greatest substance of those standards being set out in the following documents :

i. The Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission ('the Code of Conduct' or 'the Code'), this being the core document.

ii. The Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the Securities and Futures Commission ('the Management Guidelines').

iii. Various circulars, guidance and 'frequently asked questions' giving general advice to licensed and registered persons as to

their obligations issued by the SFC and/or the HKMA ('the Guidance Circulars').

30. As to the issue of sanctions, the SFC came to the provisional finding that there should be revocation of certain of the bank's regulated activities and that in addition the bank should be subjected to financial penalties. In setting out its approach to the matter of financial penalties, the SFC said that, in light of the relevant factors set out in the Disciplinary Fining Guidelines made under section 199(1)(a) of the Ordinance, it proposed a fine of HK$5 million for each misconduct identified. The SFC went on to say :

> "We consider this approach and the level of fine appropriate. The identified misconduct arises from separate obligations under the Code of Conduct. More pertinently, each misconduct was equally operative and serious in endangering the interests of HSBCPB's clients. We have also taken into account the scale of investments and/or losses suffered by HSBCPB's clients in determining the individual and total amount of the financial penalty."

31. Accordingly, as to sanctions to be imposed, in its Notice of Proposed Disciplinary Action the SFC ruled provisionally that :

i. HSBCPB's registration for Type 4 regulated activity (advising on securities) be revoked.

ii. HSBCPB's registration for Type 1 regulated activity (dealing in securities) be partially revoked to the extent that the bank be allowed only to handle listed securities trading for clients and to provide advice incidental to that trading.

iii. pursuant to section 196(2) of the Ordinance, HSBCPB be subjected to a pecuniary penalty of HK$620 million : later, after recalculation of the number of clients who had lodged complaints in respect of their dealings with the bank, this was reduced to HK$605 million. A detailed explanation of how this figure of HK$605 million was calculated is set out in paragraphs 422-424 of this judgment.

32. In a comprehensive response dated 12 June 2015, HSBCPB disputed both the merits of the SFC's provisional findings and the nature and extent of the sanctions provisionally imposed.

33. In respect of the sanctions provisionally imposed, the bank informed the SFC that such sanctions appeared to be "the most serious sanctions by far ever to be issued against any financial institution in Hong Kong"[3]. It was said that the severity of the sanctions was wholly disproportionate to the findings of the SFC, even if such findings were correct.

34. The SFC was not persuaded by the bank's submissions, either as to the merits or the penalties. In the result, in its Decision Notice of 9 July 2015 (the 'Decision Notice'), the SFC determined that its provisional findings of fact should be confirmed and, aside from the reduction of the fine from HK$620 million to HK$605 million (for the reasons set out in paragraph 31(iii) of this judgment), the penalties should also remain unaltered.

[3] See paragraph 13 of the bank's response dated 12 June 2015.

35. HSBCPB issued a notice of application for review on 29 July 2015, filing its detailed grounds on 23 October 2015.

36. By way of a broad overview, the bank's application for review, as spelt out by its leading counsel, Mr. Anthony Neoh, SC, was to the following effect :

i. that the bank was not culpable of any of the various forms of misconduct asserted by the SFC.

ii. that if it had been in breach of its regulatory obligations, such breach did not prejudice, or did not seriously prejudice, the interest on any of the clients concerned in this review.

iii. that, in respect of penalty, the revocations were unwarranted and excessive.

iv. that the financial penalty imposed by the SFC was *ultra vires* the Ordinance and in any event, disproportionate and wrong in principle.

Looking to the nature and extent of the governing regulatory standards

37. The decision of the SFC was founded on the assertion that HSBCPB had failed to live up to, that is, had been in breach of various provisions of the Code of Conduct as read with ancillary guidelines in force at the relevant time. In particular, in its Notice of Proposed Disciplinary

Action[4] the SFC identified as being relevant to its findings the following provisions of the Code : General Principles 2, 3, 5 and 7.

38. In looking to the general principles, the Tribunal has taken note of the fact that the Code introduces, and gives context to, those principles by stating that the SFC has modelled the Code on principles developed and recognised by the International Organisation of Securities Commissions and other principles that the SFC believes to be fundamental to the undertaking of a registered person's business.

General Principle 2 (headed 'Diligence')

39. This general principle directs that, in conducting its business activities, a registered person should act with due skill, care and diligence, in the best interests of its clients and the integrity of the market.

40. In this regard, the SFC has relied in particular upon paragraph 3.4 of the Code which expands upon General Principle 2, the paragraph stating that –

> "When providing advice to a client a … registered person should act diligently and carefully in providing the advice and ensure that its advice and recommendations are based on thorough analysis and take into account available alternatives."

[4] See paragraph 6 of the Notice of Proposed Disciplinary Action.

General Principle 3 (headed 'Capabilities')

41. This general principle directs that a registered person should have and employ effectively the resources and procedures which are needed for the proper performance of its business activities.

42. In respect of this general principle, the SFC relied in particular upon paragraphs 4.2 and 4.3 of the Code which direct that –

> "A … registered person should ensure that it has adequate resources to supervise diligently and does supervise diligently persons employed or appointed by it to conduct business on its behalf."
>
> and
>
> "A … registered person should have internal control procedures and financial and operational capabilities which can be reasonably expected to protect its operation, its clients and other licensed or registered persons from financial loss arising from … professional misconduct or omissions."

General Principle 5 (headed 'Information for clients')

43. This general principle directs that a registered person should make adequate disclosure of relevant material information in its dealings with clients.

44. In respect of this general principle, the SFC relied in particular upon paragraphs 5.1, 5.2 and 5.3.

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45. Paragraph 5.1 (under the heading 'Know your client : in general') directs that –

> "A … registered person should take all reasonable steps to establish the true and full identity of each of its clients, and of each client's financial situation, investment experience, and investment objectives."

46. Paragraph 5.2 (under the heading 'Know your client : reasonable advice') directs that –

> "Having regard to information about the client of which the … registered person is or should be aware through the exercise of due diligence, the … registered person should, when making a recommendation or solicitation, ensure the suitability of the recommendation or solicitation for that client is reasonable in all the circumstances."

47. Of particular relevance in the determination of this review, paragraph 5.3 (under the heading 'Know your client : derivative products') directs that –

> "A … registered person providing services to a client in derivative products, including futures contracts or options, or any leveraged transaction should assure itself that the client 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."

48. It was the SFC case that paragraphs 5.2 and 5.3 of General Principle 5 were of particular relevance. In respect of the second LB-Notes issue and the FAs issue, paragraph 5.2 required the bank to ensure product suitability for each of its clients. In respect of the first LB-Notes issue and the FAs issue, paragraph 5.3 required the bank to ensure that each client

understood the nature and risks of the products and had sufficient net worth to assume those risks and bear potential losses.

General Principle 7 (headed 'Compliance')

49. This general principle directs that a registered person should comply with all regulatory requirements applicable to the conduct of its business activities so as to promote the best interests of clients and the integrity of the market.

50. In respect of this general principle, paragraph 12.1 directs that –

> "A … registered person should comply with, and implement and maintain measures appropriate to ensuring compliance with the law, rules, regulations and codes administered or issued by the Commission, the rules of any exchange or clearing house of which it is a member or participant, and the requirements of any regulatory authority which apply to the … registered person."

51. Turning to the Guidance Circulars, the Tribunal is of the view that a number of the guidelines in force at the material time would have assisted registered persons in obtaining a fully rounded, holistic understanding of the intent and the nature and extent of the provisions contained in the Code of Conduct. The following examples are illustrative :

i. In a circular dated 29 December 2003 addressed by the SFC to intermediaries dealing with clients who invest in structured products the following was said :

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> "We write to remind you that, pursuant to the requirements under the Code of Conduct … you should assure yourselves that your clients understand the nature and risks of the products and have sufficient net worth to assume the risks and bear the potential losses of trading in the products. You should also ensure the suitability of your advice and recommendations for your clients in these products are reasonable in all the circumstances."

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ii. In a report issued by the SFC on 23 February 2005[5], the SFC said that investment advisers are obliged to help clients make informed decisions by giving them a proper explanation of the basis of the investment recommendation, the nature of the product recommended and the nature and extent of the risks it bears. In particular, the SFC stated :

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> "In our view, it is not enough for an investment adviser to hand over documents saying "read these, they explain the product and its risk". Instead of just focusing on the good points of a financial record, the investment adviser should always present a balanced view, drawing clients' attention also to the disadvantages and risks as well. Our investigations have shown that in some cases documents given to clients do not adequately explain the risks inherent in products. The onus is on the investment adviser to ensure that it provides a full explanation to clients. It is also not enough that the investment adviser relies on brochures and offers documents as being self-explanatory. Frequently, they are not, and clients have every right to expect investment advisers to explain the contents to them."

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[5] *Report on Selling Practices of Licensed Investment Advisers.*

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iii. In a document dated 7 May 2007 issued by the SFC[6] the following guidance was given in respect of expected 'documentation standards' :

> "Investment advisers should document and provide a copy to each client of the rationale underlying investment recommendations made to the client.
>
> To demonstrate compliance with regulatory requirements, investment advisers 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 investment adviser. In addition, investment advisers should keep sufficient documentation on all client transactions including orders placed to product providers."

How are the Code of Conduct and ancillary guidelines to be understood by the Tribunal?

52. Section 4 of the Ordinance sets out the regulatory objectives in respect of which the SFC is constituted. These objectives include the following :

i. to maintain and promote the fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry.

ii. to provide protection for members of the public investing in or holding financial products.

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[6] *Questions and answers on suitability obligations of licensed and registered persons who are engaged in financial planning and wealth management business activities.*

iii. to reduce systemic risks in the securities and futures industry.

53. Section 5 of the Ordinance sets out the functions and powers of the SFC. Such functions and powers not only include promoting the efficiency and competitiveness of the securities and futures industry but also promoting and, when necessary, enforcing professional conduct (that is, the appropriate competence and integrity) of those who discharge regulated activities in the industry.

54. Section 194 of the Ordinance gives to the SFC the power to take disciplinary action against a registered institution such as HSBCPB when it is satisfied that it is, or was at any time, guilty of misconduct or when the SFC is satisfied that it is no longer fit and proper to remain registered.

55. 'Misconduct' is defined in section 193 of the Ordinance and includes an act or omission relating to the discharge of any regulated activity which, in the opinion of the SFC is, or is likely to be, prejudicial to the interests of the investing public or to the public interest.

56. So that registered institutions such as HSBCPB will have an understanding of the matters which the SFC will take into account in furthering its regulatory responsibilities, section 399 of the Ordinance gives to the SFC the power to publish codes of conduct and guidelines. Such codes of conduct and guidelines do not constitute subsidiary legislation. They are, however, admissible into evidence before this Tribunal and may be taken into account in determining any question that is before it.

57. In the course of his submissions to the Tribunal, Mr. Neoh, for HSBCPB, emphasised that the framework within which the SFC has chosen to fulfil its regulatory objectives has at all times been "principles-based". The Tribunal agrees with this submission.

58. In June 2011, the SFC published a document entitled *Regulatory Framework for Intermediaries* in which the SFC's approach to the discharge of its regulatory obligations was articulated. Although the publication came well after the period of time which is the focus of this review, on any ordinary reading it is apparent that the document has not sought solely to articulate the SFC's future approach but has sought equally to set out its *established* approach. It is therefore of assistance in the present matter.

59. The Tribunal considers paragraphs 21 and 22 to be important, more especially as the issues now before it relate to dealing in structured financial products – derivatives – which are instruments often only truly understood by sophisticated and experienced investors and which inherently contain hidden levels of downside risk. In paragraphs 21 and 22, the SFC recognises that risks are inherent in any competitive market and that investors benefit from competitive markets. That said, however, it is recognised that there must be proper management of such risks by those discharging regulated activities in the industry. This includes –

> " … having in place effective risk management systems and internal controls, which provide the necessary checks and balances to guard against excessive risk-taking."

60. The Tribunal notes that risk management systems and internal controls are required to be 'effective'; that is, they must be efficient in the sense that they must provide the necessary checks and balances to guard against excessive risk-taking by clients. The mere existence of controls, therefore, is not sufficient. Those controls, in the manner of their architecture, must be capable of providing the necessary checks and balances and, in addition, importantly, if they are to be effective, they must be operated in an efficient manner by members of registered institutions.

61. In paragraphs 25 and 26, the SFC looks to the need for a balanced approach in the discharge of its regulatory functions –

> "25. The Commission constantly aims to achieve a proper balance in regulation. On the one hand, it strives to maintain order to ensure appropriate safeguards for investors, with adequate regulation to ensure as far as possible sound business practices and market confidence. On the other hand, it strives to provide a regulatory environment that allows enough impetus for market development, without stifling innovation and competition.
>
> 26. The Commission avoids setting burdensome standards for intermediaries, as they may create unnecessary regulatory barriers to entry, impose prohibitive compliance costs, lower market efficiency, and constrain market innovation and competition. Conversely, overly lenient standards and too much emphasis on market discipline offer inadequate assurance for market stability and confidence. Standard-setting therefore involves striking a proper balance between these competing considerations. To achieve this balance, the regulatory framework builds in an important element of transparency for policy-making."

62. One of the mechanisms for achieving that transparency lies in the publication of codes of conduct, bolstered when appropriate by guidance circulars.

63. Paragraphs 28, 29 and 30 of the document are also of particular relevance. They read :

> "28. As markets evolve, so must their regulatory regimes. The Commission is acutely aware of the need to remain vigilant in responding to developments in the financial regulatory landscape and in the wider economic context. This is imperative to ensure a high degree of confidence among stakeholders that the Commission's regulatory objectives are being fulfilled.
>
> 29. To address the fast changing market circumstances and practices, the Commission believes that, generally speaking, principles-based regulation that focuses on a higher level of articulation of what the Commission expects intermediaries to do is more appropriate than a large volume of detailed standards. In particular, completely prescriptive standards are unlikely to be appropriate for governing business conduct as they may not be able to cover all the possible scenarios and complexities in today's financial markets. The above notwithstanding, prescriptive rules setting the minimum standards are still necessary for critical areas of the regulatory framework, such as segregation of client assets, to ensure adequate levels of consistency, certainty and investor protection.
>
> 30. With principles-based regulation, intermediaries are responsible for deciding how best to align their business objectives within the boundaries of applicable rules and regulations. This requires

> exercise of proper judgment by intermediaries, having due regard to the nature, size and complexity of their business."

64. In light of these pronouncements, the Tribunal is satisfied that, being obliged to determine matters before it as if it is the original decision-maker, it too must adopt a balanced approach. In doing so, the Tribunal has recognised that this approach is one that, in order to guarantee the reputation and integrity of the market, imposes on registered institutions the obligation not simply to act as selling agents, putting their own interests first, but rather to supply a professional service to clients, a service that ensures, even if a sale is not made, that clients are fully informed of the nature and risks inherent in products that may be purchased by them and that they are, in light of their individual financial circumstances, advised as to the suitability of such products for them. This approach, professional in nature in that it seeks to ensure that clients are given sufficiently comprehensive advice, nevertheless recognises that risks are inherent in any competitive market and that, subject to appropriate advice given and recorded, client investors must be permitted freedom of choice. In the judgment of the Tribunal, ensuring a professional approach of this nature, in enhancing the reputation and integrity of the market, gives impetus to market development.

Looking to certain preliminary issues related to compliance with the Code of Conduct

65. It was emphasised on behalf of HSBCPB that it had at all material times attempted to comply fully with the Code of Conduct and the guidance circulars. Indeed, as indicated earlier, it was the bank's case that it had complied fully with all its obligations under the Code. That said, it was submitted on behalf of the bank that, the Code being principles-based - as

opposed to imposing 'black letter', prescriptive standards - with intermediaries (such as the bank) being responsible for deciding how best to align their business objectives within the boundaries of the applicable principles, it was directly relevant, when considering whether there had been due compliance, to have regard to a number of factors, more particularly, the following :

i. the suggested characteristics of HSBCPB's private banking clients.

ii. the contractual relationship existing between HSBCPB and its clients.

66. More specifically, it was submitted by Mr. Neoh on behalf of the bank that the Code of Conduct must be understood and applied, having regard to the realities of the bank's business. The Code, being principles-based is not insensitive to context, to the contrary it must be read as being "a fluid *ad generic* concept dependent on the nature of the relationship between the regulated entity and its customers". In complying with the 'high level' principles set out in the Code, the bank was therefore entitled to take into account a number of matters. First, that its clients were all of substantial net worth and were - in large measure at least - reasonably financially sophisticated. Second, in light of the agreement reached with each client, the bank's compliance with the Code would be complemented by the clients' own due diligence in (a) understanding their own tolerance to risk and the risk of each product sold by or through the bank; (b) by reading the materials provided to them by the bank in relation to each product so as to better understand the nature of it, and the risk imposed; and (c) in seeking the advice of their own relationship manager at the bank when they were in

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doubt or indeed, when extra prudence was required, by seeking independent advice.

67. In considering these issues, the Tribunal was assisted by two senior officers of the bank, first, Mr. Alexander Wynd who in February 2016 was Head of Business Management at the bank and, second, Mr. Kevin Herbert, who, in the same month, was Co-Head of North Asia business at the bank. Both gave comprehensive statements (both signed in February 2016) and both testified before the Tribunal.

(i) The suggested characteristics of the bank's private banking clients

68. In describing the nature of the bank's business, Mr. Wynd said that the bank has at all material times engaged in bespoke wealth management for its clients, those clients having assets under management ('AUM') with the bank of "not less than US$3 million-US$5 million", many clients, however, having accounts with other banking institutions, their net worth often therefore being greater than the assets managed by the bank. As Mr. Wynd expressed it[7] :

> "HSBCPB maintained, at the start of 2007, an average account balance of US$4.3 million. Many relationships had multiple accounts and therefore at relationship level, clients could have tens or even, in respect of our wealthiest segment, hundreds of millions of AUM booked with the bank.
>
> Private banking clients must therefore have sufficient financial status and net worth as a pre-requisite to setting up an account with a private bank. For these clients, private banks offer dedicated relationship managers, credit and investment advisers and specialists and support teams and

[7] See paragraphs 12 and 13 of Mr. Wynd's statement.

provide a more tailored advisory service specific to the clients' wealth needs."

69. Mr. Wynd emphasised that many of the bank's clients[8] :

> " … are sophisticated, often very experienced in dealing with complex products, used to having relationships with multiple banks, and very adept at shopping around for the best terms for unlisted structured investment products and structured notes e.g. ELNs, CDAs, FAs. These are clients who have either long experience and familiarity in trading in these products taking on larger risks for a smaller proportion of their assets or they are business owners and entrepreneurs who are savvy individuals who understand fully that higher returns can only be achieved with higher risks."

70. In the same paragraph, Mr. Wynd observed that :

> "Banks are often competing with each other to win business from clients who are shopping around and it has been the bank's experience that most of its clients are multi-banked."

71. While the Tribunal accepts that (at all material times) many of the bank's clients were "business owners, entrepreneurs, professionals and senior executives", in short, persons reasonably educated in matters of finance and (perhaps) securities investment, it does not accept - and nor did the bank ever suggest - that all of its clients were persons of such sophistication. Indeed, it must be the case that one of the reasons why private banks such as HSBCPB offer credit and investment advice and the dedicated services of a relationship manager is precisely because the bare

[8] See paragraph 16 of Mr. Wynd's statement.

fact of the acquisition of wealth does not thereby imply the acquisition of knowledge and wisdom in areas of investment. As Mr. Wynd said, clients may be second and third generation beneficiaries, there being no suggestion that they would necessarily have the same financial knowledge and wisdom of the person who created the wealth in the first place. Clients may be persons who have come into wealth by reason of the death of a spouse or a relative, persons who are essentially untutored and for that reason persons who seek the assurance of the professional and prudent advice that they expect to receive within the portals of a private bank. Nor, as a general observation, can it be assumed that sophistication in one area of business or entrepreneurship, for example, international trade, assumes sophistication in all areas of investment, particularly in regard to more exotic, structured financial instruments.

72. As Mr. Ambrose Ho SC, leading counsel for the SFC, pointed out during the course of his submissions, a private banking customer has been defined by the HKMA[9] in the following terms :

> "An authorised institution ('AI') may classify an individual as a private banking customer if he/she maintains a personalised relationship with the AI and receives personalised banking services or portfolio management service from the AI and has : (a) at least US$3 million or its equivalent in any other currency in investable assets; or (b) at least US$1 million or its equivalent in any other currency in investable assets under the AI's management."

73. In light of this definition, said Mr. Ho, it can be seen that the nature of private banking business is characterised, first, by the level of

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9 See the HKMA circular dated 12 June 2012.

wealth of the customers and, second, the mode of the services provided to those customers. There is no indication in that definition that private banking clients are to be presumed to have a certain level of sophistication and/or experience in investment matters.

74. In any event, in the opinion of the Tribunal, even clients who hold out that they have experience in investment matters, are entitled to the same levels of prudent advice. In this regard, in the course of his testimony Mr. Wynd accepted that it was not the case that the bank owed different duties to its clients depending on perceptions of their sophistication. Mr. Wynd accepted that the bank has to "comply with the Code of Conduct irrespective of the level of sophistication".

75. One matter in particular arises from these observations. In his witness statement, Mr. Wynd commented[10] that "most, if not all, private banking clients would qualify for 'professional investor' status under the Securities and Futures (Professional Investor) Rules." In this regard, during the course of submissions, it was made known to the Tribunal that 'professional investor' declarations had been included in account opening documents after 2003 and that, of the 83 accounts which are the subject of this review, 55 were classified as being the accounts of 'professional investors' : including all 13 accounts related to the purchase of FAs.

76. That may be so. However, it must be noted that –

i. Under the relevant rules, an individual is defined as a 'professional investor' if he or she, either alone or in a joint

[10] See paragraph 13 of Mr. Wynd's witness statement.

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account, has a portfolio of HK$8 million. Similarly, a company or partnership is so defined if it has a portfolio of HK$8 million or total assets of HK$40 million. In summary, as Mr. Ho, for the SFC, expressed it, "the only prerequisite for an investor to be a 'professional investor' under the Ordinance is the investor's financial resources". Knowledge of investment matters is not a prerequisite.

ii. In the present case, the bank has disclaimed reliance on the waivers provided for under paragraph 15 of the Code of Conduct[11].

77. That being the case, in the opinion of the Tribunal, the definition of 'professional investor' - and whether or not any of the bank's clients were so classified - does not (and did not) shift the standards of professionalism owed by the bank to those clients.

(ii) The contractual relationship existing between HSBCPB and its clients

78. During the course of submissions, considerable emphasis was placed by Mr. Neoh, for the bank, on the nature of the contract entered into by each client with the bank at the time each client was 'on boarded'.

79. Each standard account opening agreement, the Tribunal was told, was contained in an account opening booklet in which, after any necessary explanation by the relationship manager, was signed by the new account holder. In signing, the new account holder acknowledged that his

[11] In this regard, see the letter from Linklaters dated 27 May 2013 addressed to the SFC.

account would at all times be subject to the terms and conditions contained in the booklet, more especially the Risk Disclosure Statement, the general terms and conditions relating to the various services provided and also relevant product condition booklets. The acknowledgement further confirmed that the client had been invited to ask questions concerning the Risk Disclosure Statement and to take independent advice in respect of it should he or she wish to do so.

80. The Risk Disclosure Statement is a fairly lengthy document which begins with the following explanatory statement :

> "Please read this risk disclosure statement carefully. This statement is provided to you in accordance with the Code of Conduct for persons licensed by or registered with the Hong Kong Securities and Futures Commission… and forms an integral part of the bank's account mandate and the terms and conditions governing your account. By executing the account mandate you, the customer, acknowledge that you have read this risk disclosure statement and understand the risks applicable to the banks' various services and products."

81. The statement continues with the following warning to the client :

> "The risk of loss in Trading Assets, including leveraged foreign exchange, foreign exchange, options, securities, commodity, debt instrument or derivative or in the other trading or investment transactions can be substantial. You should therefore carefully consider whether such trading or investment, whether directly by you through us on a discretionary managed basis is suitable for you in light of your investment objectives, financial condition, your tolerance to risks and your investment experience…"

82. The statement ends with the following two disclaimers :

> "9.1 No Investment or Tax advice Please also note that we do not offer investment or tax advice of any nature and whilst we may provide information or express opinions from time to time, such information or opinions are not offered as investment or tax advice. You should decide upon any dealing only after having made all such enquiries and assessments as you consider appropriate, and you should place no reliance on us to give advice or make recommendations.
>
> 9.2 Independent advice If you are in any doubt about the risks involved in any trading or investment arrangements or you are uncertain of or have not understood any aspect of this Risk Disclosure Statement, you should seek independent professional advice."

83. The Disclaimer ends with a broad 'wrap-up' statement, informing the client that the bank cannot cover all the risks that may be encountered by the client in the course of investing and that the client should therefore –

> " … carefully study leveraged foreign exchange, foreign exchange, options, derivatives, securities, commodity or debt instruments and/or any other relevant trading arrangements before you trade."

84. What is the result of these contractual terms? The result, as the Tribunal understood the submissions to be, was that, even though advice was given to clients by their relationship managers and other professionals in the bank, the clients understood that in respect of each decision to invest any advice given was non-binding in the sense that they had contracted with

the bank for an "execution-only" service. In doing so, they acknowledged that they have understood the risks in the type of instruments purchased and further acknowledged a responsibility to independently make their own investment decision.

85. That being the case, it was submitted, in taking steps to comply with the Code, the bank was at all times entitled to assume that the client has understood the risks of each investment purchased and has actively and independently assessed those risks.

86. That said, it was never suggested that the contract entered into between the bank and each client should determine this Tribunal's judgment. It was accepted that the bank could not contract out of its regulatory obligations and indeed, as Mr. Neoh put it, the bank had at all times used its utmost endeavours to comply with such obligations. Nevertheless, said Mr. Neoh, the touchstone in applying the Code must be the contractual relationship between the bank and each client because it was this relationship which defined the scope of the services the bank had undertaken to provide and the client had undertaken to buy. It is to be remembered, said Mr. Neoh, that the Code does not prohibit a financial institution (such as a private bank) from defining the scope of the services it will provide to its clients. The Code therefore, being principles-based, must naturally be applied in the context of the services that have been agreed, it being remembered that the contracts reflected the sophisticated nature of a private banking relationship and an acceptance by clients of the basis upon which that relationship is founded.

87. How, in practical terms, was this to work? Mr. Neoh submitted that it was not merely to be persuasive in some indefinable way but was to

have concrete consequences. Mr. Neoh gave examples by looking to the provisions of the Code.

88. Mr. Neoh referred, by way of illustration, to paragraph 5.2 of the Code which has been cited in paragraph 46 of this determination. Under the heading of 'Know your client : reasonable advice', this provision places an obligation on a registered institution to ensure the suitability of any investment recommendation in light of the information about the client which the registered institution has or should be aware of through the exercise of due diligence. As Mr. Neoh submitted, this obligation to ensure suitability of product is to be judged on what the bank knows about the client. In respect of HSBCPB, what it knew is that the client has confirmed that he or she understood the product risk and in case of any doubt would have conducted his or her own independent investigation or relied on independent advice. In such circumstances, it was not open to the SFC to comment that the client as a matter of fact did not know the true nature and extent of product risk.

89. By way of further illustration, Mr. Neoh referred to paragraph 5.3 of the Code which has been cited in paragraph 47 of this determination. This provision, which relates to derivative products, places an obligation on a registered person to assure itself "that the client understands the nature and risks of the products". As Mr. Neoh put it, the bank has assured itself that the client understands the nature and risks of the product when the client unequivocally confirms that to be the position in terms of his written acknowledgement in the Account Opening Booklet.

90. Mr. Neoh summarised his submission by saying that it follows that there is no factual basis for the SFC to contend that there was any risk

mismatch unless it can be shown that the bank provided inaccurate information as to the product. Whether there was any risk mismatch is a question of fact. If each client has confirmed with the bank that he was fully aware of the product risk after considering the information provided by the bank, and would have conducted his own independent enquiry in case of doubt, there is no room for the SFC to go behind such confirmation and maintain the products did not in fact suit the client's risk profile. Mr. Neoh concluded by saying that, to put it another way, a client's after-the-event assertion (upon suffering a loss) that the products were not suitable for him or her could not sensibly survive a prior contemporaneous written acknowledgement of non-reliance.

91. The Tribunal has a fundamental difficulty with these submissions - as illustrated by their concrete consequences - in that, in the view of the Tribunal, if the submissions are to be accepted, it means that, for all practical and meaningful purposes, a registered institution is able to 'contract out' of its obligations under the Code and other complementary instruments published by the SFC.

92. The Code does not constitute subsidiary legislation. However, it does constitute a clear guide, one that is admissible into evidence before this Tribunal, as to the principles that the SFC have the statutory authority to take into account, and to act in accordance with, in furthering its regulatory responsibilities. By way of illustration, paragraph 5.3 of the Code lays down (in part) a guiding principle that, when a registered institution provides services to a client in derivative products, it must assure itself that the client understands the nature and risks of those products. Risks change according to changing circumstances. The guiding principle, therefore, is that the registered institution must take on the direct obligation, as part of its

regulatory responsibilities, to assure itself that a client purchasing a derivative product at any time is aware of the risks that come with that product at *that* time. Is that obligation - one that comes into operation each time a client seeks to purchase a derivative product that has features that are new to him - capable of being diminished pursuant to a private contract concluded between the registered institution and the client at the time of account opening, perhaps many months earlier? The Tribunal does not accept that this is permissible in law.

93. The principles set out in the Code act as a clear guide to the boundaries of a regulatory scheme. It may be a scheme which the SFC has fashioned in order to maintain appropriate safeguards for investors without stifling innovation and competition but the Tribunal is unable to see how, by that fact - in order to accord, in large measure at least, with its own commercial interests - a registered institution is able itself to alter the principles in terms of which it is obliged to conduct its business affairs.

94. In the judgment of the Tribunal, when considered as a whole, the account opening contract upon which the bank has relied is neither neutral in respect of, nor supportive of, the regulatory principles that fall for consideration in this matter. To the contrary, it is satisfied that, on a plain reading, the account opening contract seeks to materially diminish the responsibilities of the bank under the regulatory principles.

95. As the Tribunal sees it, if the submissions advanced on behalf of the bank are correct, it would mean that differing financial institutions, to differing degrees, would be able to discharge their regulatory obligations under the regulatory principles - in large if not absolute measure - by means of contractual arrangements.

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96. The Tribunal is of the view that there is force in Mr. Ho's submission that it is in principle neither appropriate nor practical for different standards to be applied to different institutions depending on their respective individual contractual arrangements with their clients. As Mr. Ho put it, this will severely undermine the effective regulation of the securities and futures industry pursuant to the Code.

97. In the view of the Tribunal, what must determine the reach of the SFC's regulatory powers is not a formal 'non-reliance' contract entered into at the time of account opening but the factual nature of the services provided and the regulatory obligations imposed upon the registered institution as a result.

98. During the course of submissions, reference was made by Mr. Neoh to the first instance judgment of *Kwok Wai Hing Selina v HSBCPB*[12] in which the plaintiff had sued HSBCPB for losses incurred in investing in derivative products on the apparent advice (and encouragement) of her relationship manager. In dismissing the claim, Reyes J made reference to the regulatory standards set out in the Code of Conduct in the following context :

> "133. Mr. Fung sought to bolster his case that HSBC had assumed core duties towards Ms. Kwok by reference to regulatory standards in the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission. However, I am unable to derive much assistance from the Code for the purposes of this case.

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[12] [2012] 4 HKC

> 134. As Mr. Jat submits, the Code sets out 'high-level' general principles without distinction as to the near infinite variety of relationships which might exist between bankers and customers. The Code expressly states that it is not to be treated as law, although it is admissible as evidence of the content of duty.
>
> 135. The Code cannot override express contractual provisions. It cannot impose a contractual duty which, by the clear terms of the Account Opening Booklet and Risk Disclosure Statement, HSBC has not undertaken."

99. The matter before Reyes J was one in which he had to determine whether HSBC had breached any contractual or other private law obligations to the plaintiff. The judgment was given through that prism, its light focused on private rights and obligations arising out of contract. It was said that the Code of Conduct cannot impose a *contractual* duty which the bank had never assumed. The Tribunal accepts that non-reliance contracts of the kind set out in the Account Opening Booklet and Risk Disclosure Statement may provide commercial certainty in contractual relationships and may therefore serve a commercial purpose in private law. The Tribunal, however, was concerned with issues of a regulatory nature and, as such, distinct from the private rights and obligations of parties arising out of contract. Put simply, the issue before this Tribunal was whether, as a registered institution which, pursuant to the provisions of the relevant legislation, had accepted the responsibility of meeting certain regulatory obligations, it had or had not failed to meet those obligations.

The structured financial instruments relevant to this review

100. As earlier indicated, there are three structured financial instruments – derivatives – relevant to this review. The first two are products that were issued by Lehman Brothers, namely, LB-ELNs (equity-linked notes) and LB-CDAs (callable daily accrual notes). The third are FAs (commonly called forward accumulators).

101. According to Mr. Herbert's evidence, clients who purchased ELN's and CDAs potentially stood to earn a better yield than prevailing money market rates. For example, during 2007 to 2008, he said, ELNs and CDAs on average yielded from 10% per annum to 20% per annum, this being contrasted with the money markets which yielded around 5% per annum.

102. During the course of the hearing, a number of definitions of these structured financial instruments were placed before the Tribunal. These definitions have been of considerable assistance. In light of these definitions, the Tribunal has focused its attention on making an assessment of the level of the complexity of these instruments and, arising out of that complexity, the level of ease with which their inherent risks would have been understood by the ordinary investor.

103. What must first be understood is that all three structured financial instruments fell under the generic description of derivatives. For purposes of this judgment, a derivative may be described as a contract between two or more parties, the value of that contract being based on one or more underlying assets, for example, a single equity listed on the Hong

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Kong Stock Exchange or a basket of equities. The value of the contract is determined by fluctuations in the value of the underlying asset or assets.

104. When addressing the Tribunal, Mr. Neoh described all three derivative instruments as being essentially "vanilla-type, garden variety instruments".

105. To the same effect, when describing the nature of FAs - forward accumulators - it was said on a number of occasions on behalf of the bank that they were not complicated investment products. In essence, it was said, they were simply a means to make a regular purchase of shares at a price agreed at the time the contract was entered into. The risk, it was said, lay in the fact that if the shares increased in value above a certain price, the issuer of the FA was able to terminate, cutting its losses. If, however, the shares dropped in value, the purchaser of the contract – the investor – would have to continue buying the shares at a loss and would in addition be required to accumulate an extra number, usually double the number. An FA, it was said, was for investors who were bullish as to the shares that were the subject of the contract.

106. Mr. Ho, for the SFC, was of the opposite view. All three instruments, he said, were products of considerable complexity that contained material elements of risk.

107. The issue is of importance. This is because, in all common sense, it must follow that the greater the complexity of a financial instrument being marketed by the bank, the more onerous the burden under the Code of Conduct to ensure that the client contemplating purchase understands the true nature of that instrument. Equally, the greater the level

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of risk in the product, especially if that risk cannot easily be ascertained prior to purchase, the greater the requirement to ensure that the client understands his or her potential liability.

108. In the view of the Tribunal, whatever the blandness of their outward appearance, all three derivatives were in their own way complex instruments, more especially forward accumulators, that is, FAs. The Tribunal rejects the suggestion that FAs were in essence no more than vehicles for purchasing shares over a period time spiced with an element of risk. In this regard, the Tribunal notes that, in or about the time relevant to this determination, on the trading floors of the securities and futures industry, forward accumulators became known as "I will kill you later" contracts : a cynical recognition of the fact that behind their outward attractiveness to unwary investors these derivatives had the potential, if the markets turned, to cause disproportionate loss, indeed ruin.

(i) ELNs

109. An ELN is structured upon a zero-coupon note, that is, a short term debt instrument paying no interest. The duration of the note is relatively short, usually between 1 to 6 months. The note is paid for in full - therefore fully funded upfront - by the investor who buys the note at a discount to its face value. Each ELN is linked to the price of a stock. At maturity, if the price of the underlying stock closes at, or higher than, a pre-determined 'strike price, the issuer (Lehman Brothers) would redeem the ELN at par, that is, at its face value. As the investor has purchased the note at a discount, that discount represents a profit or return on investment. However, at maturity, if the price of the underlying stock closes below the strike price, the investor is then obligated to buy the underlying stock at the

strike price in a quantity equivalent to the face value of the note. In this instance, the investor would suffer a loss, the loss being the difference between the strike price and the closing market price of the underlying stock. In this second instance, the issuer (Lehman Brothers) transfers the shares to the investor.

(ii) CDAs

110. A CDA shares most of the basic features of an ELN. The note, however, is not traded at a discount, it is traded at par. The note, however, pays interest – coupon payments – subject to a number of conditions. The duration of the note is typically between 1 to 2 years. As with an ELN, the note is paid for in full by the investor. It is therefore fully funded upfront. A CDA note is invariably divided into 'observation periods'. Typically, there is a guaranteed coupon payment in the first observation period or the first few. Thereafter, coupon payments are variable and depend on the extent to which the underlying stock trades at or above the agreed 'strike price'. In each observation period, there is a call date and if the underlying stock closes at or above an agreed knockout price at that date, the issuer is entitled to buy back the note. If the note is not knocked out, at maturity, if the underlying stock closes at or above the strike price, the issuer (Lehman Brothers) would redeem the note at par, the investor being entitled to keep the interest already received, that interest being the investor's profit or return on investment. If, at maturity, the underlying stock closes below the strike price, the investor is then obliged to buy the underlying stock at the strike price for an amount equivalent to the par value of the note. As with an ELN, in this instance the loss suffered by the investor is the difference between the strike price and the market price of the underlying stock that must be purchased.

(iii) What of those who were obliged to buy stock?

111. As Mr. Herbert explained it, if clients were required under the terms of the notes to receive the underlying stock (which meant that they were receiving it at a higher price than its current market value), it was in their discretion whether to sell or keep the shares. If it was decided immediately to sell the shares, the client would realise a loss, representing the difference between the strike price and the market price (after taking into account relevant transaction costs). A client may, however, decide to keep the shares and allocate them to his investment portfolio, looking to sell later at a profit.

112. Mr. Herbert emphasised that the ability of clients to hold shares (which they had obtained at a loss) in their investment portfolios was carefully monitored by the bank, the relationship managers keeping in touch with the clients to enable them to manage their positions in accordance with their risk appetites and ability to meet any credit requirements.

(iv) The principal risks in the notes

113. What were the principal risks for the investor in purchasing these structured financial instruments? As the Tribunal understands it, there were two principal risks : the 'market risk' in the underlying stock and the 'issuer risk', that is, the risk that the issuer may not upon maturity have the ability to pay the principal amount due to the investor or to transfer to him the underlying stock.

114. In respect of the market risk in the underlying stock, because the investor pays the full amount upon purchase of the note and at all times

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knows the pre-determined strike price, the extent of the downside risk can (by means of a relatively simple mathematical calculation) be ascertained. That said, as emphasised by Mr. Ho, on behalf of the SFC, if the underlying share price moves very substantially against the investor during the currency of the note, the investor can potentially lose up to (but not exceeding) the full principal amount that he invested when he purchased the note.

115. In respect of the issuer risk, should the issuer have gone into liquidation or should it simply not have the necessary financial reserves, it would be unable to redeem the notes at maturity or to deliver the underlying stock. Put simply, the loss suffered by the investor in terms of the note would be total.

116. In respect of issuer risk, it was emphasised on behalf of HSBCPB that this risk was mitigated by the bank's policy of ensuring that all issuers had an investment grade rating. In settled times, the Tribunal accepts that this would no doubt be sufficient unto itself. However, investment-grade ratings are not fixed and absolute. Ratings change over time as a corporation's financial strength changes. In times of crisis, the financial strength of a corporation – its credit worthiness – may be materially changed before rating agencies are able to conduct the necessary and prudent assessment in order to issue a new rating. In short, in times of high market volatility, investment grade ratings constitute an aid to assessment, yes, but they cannot stand entirely on their own with no attention being given to other market indicators.

117. In his submissions to the Tribunal, Mr. Ho, for the SFC, pointed out that there was no active secondary market in ELNs and CDAs save for a limited issuer-made market. This, in the view of the Tribunal,

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added a further risk in that it meant that the liquidity of the instruments was low. In this respect, Mr. Wynd commented : "The secondary market is the issuer. So, if you want to buy the note, you buy it from the issuer. If you want to sell the note, you sell it to the issuer. The issuer is the market maker."

118. This does not mean, however, that the issuer of a note has any contractual obligation to repurchase the note. But even if invariably it will seek to repurchase, it still adds to the issuer risk in that, if the issuer has gone into liquidation or simply does not have the financial reserves, there would be no 'market maker' to buy back notes.

(v) FAs

119. An FA - a forward accumulator - is a contract in terms of which the investor agrees to buy and the issuer to sell an ascertainable quantity of a named stock (or basket of stocks) at an agreed 'strike price' over a defined period of time. The contract is not purchased up front. Instead, the purchaser of the contract is obliged to pay for the underlying stocks as and when they fall due for purchase. Payment is therefore made at regular intervals over the life of the contract. The 'strike price', that being the agreed price at which the underlying stocks will be purchased, is set at a discount to the prevailing market price at the time when the contract is entered into, that is, when the note is purchased by the investor. An FA typically has a duration period of say one year divided into set (often bi-weekly) periods. The investor is obliged in respect of each period to purchase an amount of the underlying stock, that amount being defined by a mathematical formula which produces different results depending on the fluctuation of the stock price.

120. The bank gave FAs their highest risk rating. In the view of the Tribunal, that it should do so is entirely understandable. The bank itself produced a document setting out the risks inherent in forward accumulators. These risks included the following :

i. The investor is obliged to accumulate the underlying stock at the strike price even if the prevailing market price is trading below the strike price. In this event, the investor is purchasing at a loss.

ii. As, however, the transaction is leveraged, when buying at a loss the investor is obliged to do so on a multiplied basis, for example, to purchase double the stock.

iii. Subject to certain limited conditions, the investor is obliged to hold the contract until maturity. The issuer, however, in order to limit its own loss, is able to terminate the contract if the underlying stock rises above an agreed level : the 'knockout price'.

iv. If the investor wishes to terminate the contract, HSBCPB is under no obligation to do so.[13] Should it permit termination there are significant break costs, those costs to be determined by the bank. The secondary market in FAs is highly limited. Accordingly, in difficult market conditions, it may not be possible to unwind.

[13] As explained by Mr. Wynd (for the bank) during the course of the hearing, the bank could only redeem an FA if it was able to find a market counterparty active in the market and that could not be guaranteed.

121. The FAs sold by the bank were sold on margin. Accordingly, in order to trade in the instruments, clients of the bank had to obtain an investment trading line (an 'ITL') and agree to pledge their full investment portfolio held with the bank as collateral. The client's ITL would be monitored by the bank's Credit Department.

122. Clients would be required to maintain sufficient cash or other forms of collateral in their accounts with the bank as an initial margin. The amount of the initial margin would be determined by the bank, based on the perceived risk level of the underlying stocks. Once an FA had been purchased, the contract would be valued daily on a marked-to-market ('MTM') basis. If, during the currency of the FA, the market price of the underlying stock closed below the strike price, the client would have to provide additional margin to cover the MTM loss.[14] That being the case, the collateral value in the client's account would have to be maintained at a level sufficient to cover the initial margin and, in the event of MTM losses, those losses also.

123. If the collateral coverage fell below 95%, a margin call would be triggered requiring a top-up to make good the shortfall. If a client failed to meet the margin call (or submit an acceptable plan of action to the bank), it was open to the bank to unwind the FA and to liquidate the collateral in the client's account. In the result, in a strongly declining market, losses could be very substantial.

[14] The MTM loss was determined by the following formula : *MTM loss = (strike price – market price) x number of shares per day x number of remaining trading days x leverage factor)*

124. However, as Mr. Herbert put it, if the holding of an FA was not going well for a client, he or she would be assisted in making the best possible investment decision in consultation with the relationship manager and the Credit Department.

(vi) The Tribunal's conclusion

125. Having considered the nature of the three structured financial instruments which are the subject of this judgment, the Tribunal is satisfied that, in respect of the non-sophisticated investor, quite clearly, they would not have been simple 'garden variety' instruments, readily understood as to how exactly they operated and the nature and level of their inherent risks. They may have been popular at the time - in a buoyant market the subject of considerable recommendation - but that, of itself, does not mean that they were understood by all who purchased them. In summary, the Tribunal is satisfied that all three, according to their different construction, were complex derivative instruments each containing significant risk.

The nature of the proceedings before the Tribunal

126. Although HSBCPB's application for review is in respect of a decision of the SFC, it is now well settled that this Tribunal is not required to conduct a form of appeal but is required to make a full merits review pertinent to the matters that were the subject of the SFC findings, conducting that review as if it is the original decision-maker : see *Tsien Pak Cheong David v Securities and Futures Commission*.[15] This approach was not in any way the subject of dispute. What was the subject of dispute, however, was whether the proceedings were civil in nature, that being the

[15] [2011] 3 HKLRD 533

submission of the SFC, or criminal in nature, that being the submission of HSBCPB. If civil in nature, it fell to the SFC to establish its case according to the civil standard, that is, on a balance of probabilities. If criminal in nature, it fell to the SFC to establish its case to a higher standard; it fell to the SFC to establish its case beyond a reasonable doubt.

127. Part XI of the Securities and Futures Ordinance, Cap. 571, establishes the Tribunal and endows it with powers. In respect of applications for review, s.218 (7) provides that the standard of proof required to determine any question or issue put before the Tribunal (excluding matters relating to punishment for contempt) shall be the standard of proof applicable to civil proceedings in a court of law. The statute is unequivocal in its direction to the Tribunal.

128. On behalf of HSBCPB, however, it was submitted that, whatever the statutory direction, the proceedings before this Tribunal involved the determination of a criminal charge within the meaning of articles 10 and 11 of the Hong Kong Bill of Rights. This arose from the fact that, on a true reading, the draconian nature of the monetary penalties imposed by the SFC - HK$605 million - were of a punitive and deterrent nature, there being no discernible relationship with a regulatory need to protect the integrity of the banking profession and, importantly, those who, as banking clients, invest in it.

129. In support of his submissions, Mr. Neoh, for the bank, relied on the judgment of the Court of Final Appeal in *Koon Wing Yee v Insider Dealing Tribunal*[16] in which it was held that, in determining whether

[16] [2008] 11 HKCFAR 170

proceedings which might result in the imposition of penalty for wrongful conduct would involve the determination of a criminal charge, three factors were to be considered; first, the classification of the offence by the legislature; second, the nature of the offence and, third, the nature and severity of the potential sanction. In looking to those three factors, the Court of Final Appeal held that the first factor : namely, the classification of the offence under domestic law, while important, was a starting point and that the second and third factors carried greater weight.

130. In giving the judgment of the Court, Sir Anthony Mason NPJ said (at paragraph 37) that –

> " … proceedings which may result in the imposition of a penalty for wrongful conduct will involve the determination of a criminal charge, unless they have a character which is neither criminal nor penal. Disciplinary proceedings, which do not concern the public at large, usually have such a non-criminal, non-penal character. Proceedings under regulatory legislation whose purpose is essentially protective rather than punitive and deterrent may also have such a character … So also with proceedings that have a preventive rather than a punitive or deterrent purpose. Likewise, proceedings for a penalty which is compensatory in nature have a non-criminal and non-penal character."

131. It is important to recognise that the particular form of misconduct under consideration by the Court of Final Appeal in *Koon Wing Yee* was that of insider dealing. The legislation prohibiting insider dealing applied to the public at large and not merely to a limited group of persons who had submitted themselves to a regulatory regime.

132. In looking to the first factor, namely, the classification of the offence under Hong Kong law, while it was classified as a form of civil misconduct, the Court of Final Appeal took into consideration that, in passing the legislation, a public policy decision had been made to classify insider dealing as a form of civil misconduct 'for the present' rather than an offence under criminal law, the position to be reviewed at some later stage in light of the experience of the increased sanctions available to the relevant tribunal. This decision had been made in light of the fact that prosecutions under criminal law had proved ineffective in other jurisdictions because of the difficulties of securing convictions.[17]

133. In looking to the second factor, namely, the nature of the offence, Sir Anthony Mason NPJ, who gave the judgment of the court, said that insider dealing, amounted to very serious misconduct, it being a species of dishonest misconduct. Moreover, he said, insider dealing was a form of misconduct readily characterised as 'criminal conduct'[18].

134. As to the third factor, namely, the nature and severity of the potential sanction, the Court of Final Appeal noted that an insider dealer who has made no profit himself from his insider dealing may nevertheless be subject to potentially swingeing penalties. In the view of the Court, having regard to the construction of the relevant statutory provisions, the imposition of such penalties amounted to punishment for very serious conduct.

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[17] See paragraph 40 of the judgment of Sir Anthony Mason NPJ in which he referred to the speech of the Financial Secretary in moving the second reading of the Bill.

[18] See paragraph 47 of the judgment.

135. In the judgment of the Tribunal, however, when viewed in context, the present matter is of a very different nature.

136. As to the first factor, as stated earlier, s.218(7) of the Ordinance provides that the standard of proof required to determine any question or issue before this Tribunal shall be the civil standard.

137. As to the second factor, namely, the nature of the misconduct, it arises out of an alleged failure to meet certain principles-based obligations imposed upon registered institutions in order to professionally discharge their business activities, doing so to ensure the broader integrity of the market and, in particular, in respect of individual clients, to protect their interests by understanding their financial circumstances and giving to them full and balanced advice. An institution only becomes liable to meet these obligations if it has chosen to become registered. The essential focus, therefore, is the maintenance of a level of due diligence in the discharge of business activities by institutions which, in becoming registered, have agreed to maintain that standard in order to ensure the integrity of the market and the best interests of their clients. A failure to maintain the required level of due diligence is a matter of professional default; it does not, by way of essential focus, speak of criminal conduct.

138. Having considered the essential nature of the obligations and the fact that only registered institutions (and not the public at large) are liable to maintain them, the Tribunal is satisfied that the present proceedings are disciplinary in nature. How then are such disciplinary proceedings to be classified : as civil or criminal?

139. In *R v The Securities and Futures Authority Ltd ex parte Fleurose*[19], Morison J, giving judgment as first instance, said :

> " … the disciplinary process stems from an individual's particular activities and his or her willingness to become susceptible to the disciplinary system; it does not apply to all members of society; it only applies to 'volunteers'. Although in the loosest sense there is a 'charge', a 'trial' and a determination of the defendant's guilt, there is no distinction in principle between this type of disciplinary process and, say, the disciplinary procedures of other professionals under their own rules. The fines imposed are civil debts recoverable only by civil process, unlike the collection of criminal fines, which is pursuant to statute and includes the court's coercive jurisdiction to imprison a defaulter. There is no right to a trial by jury; no risk imprisonment and no State involvement, such as by the police or the Crown Prosecution Service. *By English law standards, the process would be firmly categorised as civil rather than criminal…*" [emphasis added]

140. The judgment of Morison J was upheld on appeal[20], Schiemann LJ making reference to the authority of *Han v Commissioners of Customs and Excise*[21] to underscore the principle that disciplinary proceedings which apply to a limited group of specified persons or institutions are unlikely to be classified as criminal proceedings unless they may lead to a loss of liberty –

> " … the Court considers whether or not, under the law concerned, the 'offence' is one which applies generally to the public at large or is directed to a specific group. If the former, then, despite its

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[19] [2001] IRLR 764

[20] [2002] IRLR 297

[21] [2001] 1 WLR 2253

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> 'decriminalisation' by the national law, it is apt to be regarded as criminal. Further, if a punitive and deterrent penalty is attached, it is likely to be regarded as criminal in character, even in cases where the penalty is in the nature of a fine rather than imprisonment. On the other hand, where the offence is limited to a restricted group, as is generally the case in relation to disciplinary offences, the Court is unlikely to classify a charge under the applicable disciplinary or regulatory code as criminal, at least, unless it involves or may lead to loss of liberty."

141. As to the third factor, that is, the nature and severity of the potential sanction, s.196 of the Ordinance directs that, if a registered institution (such as HSBCPB) is found to be culpable of misconduct or if the SFC is of the opinion that it is not a fit and proper institution to continue its regulated business activities, it may revoke or suspend its registration, limit the scope of its regulated activities or issue a public or private reprimand. It may also, pursuant to s.196(2), order the regulated institution to pay a pecuniary penalty which is the greater of HK$10 million or three times the amount of the profit gained or loss avoided by the regulated institution as a result of its misconduct or such conduct which has led the SFC to form the opinion that it is not a fit and proper institution to continue its regulated business activities. The financial penalties that may be imposed are therefore potentially substantial.

142. It was submitted on behalf of the bank that the SFC has been unable to provide any justification as to why a financial penalty of a maximum of HK$10 million "per breach per complaint" is capable of serving a protective purpose rather than to deter and then to punish any breach by a registered institution. The magnitude of such penalties, it was contended, must plainly point to the fact that they are penal in nature.

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143. These financial penalties are, of course, the maximum penalties that may be imposed under the statute. Beneath those maximums lie a full range of lesser financial penalties to be chosen in the discretion of the SFC and, on review, by this Tribunal. In passing, the Tribunal also notes that the penalties set forth under s.196 relate to the securities and futures industry, an industry not only of central importance to Hong Kong's welfare - it being recognised as a major financial centre - but also an industry which permits registered institutions to generate huge profits. Seen in that light, a maximum HK$10 million financial penalty for a single breach - depending of course on the nature of the breach - may be considered to be entirely proportional : essentially protective and not essentially punitive.

144. What is also to be noted is that it is now established that the potential imposition of substantial penalties - such as disqualification or financial penalties - will not, by that fact alone, necessarily render the relevant disciplinary proceedings criminal in nature.[22]

145. Of course, when a penalty is identified as being punitive in nature that will be sufficient to show that it is a criminal sanction. But what is punitive and what is essentially protective is not always the easiest matter to determine. The underlying purpose of the Ordinance is to protect the integrity of Hong Kong's financial markets by imposing a system of regulation. For that system to function it must be enforceable which means that it must be backed by appropriate sanctions. Those sanctions must, as

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[22] See for example the reference by the Court of Appeal in *R v The Securities and Futures Authority Ltd ex parte Fleurose* to *Han v Commissioners of Customs and Excise* : " … it is plain that the imposition of a substantial fine in disciplinary proceedings will not in itself render charges criminal in nature." See also *Lee On Ming Paul v SFC* (SFAT No. 4 of 2007, a judgment by Mr. Justice Stone sitting as Chairman : in particular, paragraphs 57 and 58.

with all penalties, carry with them an element of deterrence. Mr. Neoh protested that a maximum pecuniary penalty – a fine – of HK$10 million for a single breach manifestly had to be punitive. The Tribunal, however, does not accept that it can be viewed in such an absolutist manner. In the present case, those who participate in the private banking industry as investors are entitled to expect a high level of diligence and professionalism from those to whom their funds are entrusted. It must also be recognised that large financial institutions have literally billions of dollars under their control. In that context, a pecuniary penalty of HK$10 million may not be seen as draconian; indeed, when contrasted with the cost of creating and managing effective management systems of oversight, it may be seen by some as the cheaper option or, as many commentators have put it, no more really than the cost of doing business. In that context, the punitive effect of severe penalties may properly be judged as being incidental and subservient to their essential purpose, namely, the protection of the market.

146. It is also relevant, in the view of the Tribunal, to take into account that financial penalties imposed under s.196(2) of the Ordinance constitute civil debts[23]; they are not to be collected as fines may be collected in criminal matters by way of direct state coercion.

147. Before concluding, there is one further matter raised during the course of argument that must be considered; namely, Mr. Neoh's submission that the nature of the proceedings under review must be dependent on the sanction that the SFC seeks to impose in any particular case. As it was put by him in closing submissions : "If the SFC (or the Tribunal) imposes a sanction which is not criminal in nature - in the present

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[23] In this regard, see s.196(5) of the Ordinance.

context, either only revocation or suspension of the licence without any fine, or a fine to a level commensurate with the non-criminal nature of the sanctions (e.g. disgorgement of profits) - then clearly the review proceedings can proceed as a civil proceeding. If, however, the level of the fine to be imposed against the bank is such that it crosses the civil threshold and renders the sanction criminal in nature, the Tribunal would have to treat this review as a criminal proceeding…"

148. Mr. Neoh criticised the SFC for taking what he described as an all or nothing approach. Either the nature of the proceedings – 'upfront' – are civil or they are criminal. This, suggested Mr. Neoh, did not take into account the Tribunal's power of remedial interpretation, that is, in the context of constitutional safeguards, to give a statutory provision an interpretation that is consistent with those constitutional safeguards, even if that interpretation was strained in the sense that it was not an interpretation which the statute was capable of bearing as a matter of ordinary common law interpretation.

149. In the opinion of the Tribunal, the essential difficulty that these submissions present is that, if accepted, they would give to proceedings a chameleon-like nature; one set of proceedings being civil in nature, another criminal in nature, on each occasion the definition being determined by what occurs not at the beginning of the proceedings but at the end; namely, the nature of any sanctions imposed.

150. *Koon Wing Kee* spoke of three identifying factors, those factors going to the inherent nature of the proceedings under consideration. As the Tribunal has read it, those factors, when considered as a whole, define the nature of the proceedings *for all purposes*. That being the case, the insider

dealing proceedings considered by the Court of Final Appeal were found to be criminal in nature and, as the Tribunal has understood it, would remain as such while the relevant legislation remained unamended.

151. As the Court of Final Appeal made clear in *Koon Wing Kee*, the three identifying factors must be considered as a whole. There is no absolute hierarchy. For example, the fact that misconduct is not punishable by imprisonment is not decisive of the classification of that misconduct; it is a factor to be taken into account, a persuasive factor perhaps but not of itself decisive. In the judgment of the Tribunal, after careful analysis of the nature and impact of the three factors, it becomes very much a matter of impression; put another way, it requires the Tribunal to step back, to have regard to all the factors in an objective manner and by this process to seek to identify the true nature of the proceedings.

152. Viewing the identifying factors as a whole, and for the reasons given, the Tribunal has had little difficulty in concluding that the true nature of the proceedings under review are civil and not criminal.

153. In the result, it is for the SFC to establish its case on a balance of probabilities. This standard has been defined by the Court of Final Appeal[24] in the following terms :

> "The balance of probability standard means that a court is satisfied an event occurred if the court considers that, on the evidence, the occurrence of the event was more likely than not."

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[24] *Solicitor (24/7) v The Law Society of Hong Kong* (2008) 11 HKCFAR 117

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154. As this Tribunal has noted in previous determinations, there has in recent years been discussion as to whether the civil standard of proof may vary according to the gravity of the misconduct alleged or the seriousness of its consequences. In this regard, it was submitted on behalf of HSBCPB that it was the task of the Tribunal to ask itself whether the SFC had satisfactorily discharged the burden of proof upon it with "clear and cogent evidence". As to the qualification that the evidence must be clear and cogent, it was submitted that our courts have stressed that clarity and cogency of evidence must particularly attend cases of severe consequence. As the Tribunal understands it, however, the burden of proof remains at all times the same. In any given case, the inherent improbabilities are matters to be taken into account, and given appropriate weight, in deciding where the truth lies. A clear illustration of this direct and transparent approach is contained in the speech of Baroness Hale in *In re B (Children) (Care Proceedings: Standard of Proof)*[25] in which she said :

> "Neither the seriousness of the allegations nor the seriousness of the consequences should make any difference to the standard of proof to be applied in determining the facts. The inherent probabilities are simply something to be taken into account, where relevant, in deciding where the truth lies."

Drawing inferences

155. In reaching its determination, it has been necessary for the Tribunal to draw inferences from facts it is satisfied have been proven. In this regard, the Tribunal has directed itself that any conclusions reached by it must be plainly established as a matter of inference from facts it is

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[25] [2009] 1 AC 11 at 35 G-H

satisfied have been proved. The proceedings being civil in nature, it would not be right to say that the requisite standard prescribes that any inference drawn is to be the only inference that can be drawn, that being the standard which applies to criminal matters. However, an inference must be established as a compelling inference.

The dangers of hindsight

156. The failure of Lehman Brothers in September 2008 was a major cause of the financial turmoil triggered in Hong Kong and globally. The losses sustained by (often untutored) retail investors who held structured products issued by Lehman Brothers and other investment houses was the cause of much discontent. Understandably, in the wake of the crisis, financial regulators internationally moved to try and ensure more effective controls.

157. It is not, however, for this Tribunal to proceed on the basis that, because history has revealed failures, by that fact alone HSBCPB is to be held liable. During the course of submissions, the Chairman emphasised on a number of occasions that the Tribunal was aware of the danger of judging HSBCPB solely through the prism of hindsight. In preparing its judgment, the Tribunal has reminded itself of this danger.

An overview of HSBCPB's management systems related to client service

158. The determinations that the Tribunal are required to make in this matter arise out of a consideration of HSBCPB's management systems in so far as those systems at the material times governed the relationship

between the bank and its clients. First, it is the SFC's case that the discrete failures identified – 83 in number - arose out of a systemic failure in those management systems, including a failure of bank staff to manage those systems to best advantage in order to protect the interests of clients. Second, and more fundamentally, it is the SFC's case that the shortcomings in these management systems, compounded by the failure of bank staff to manage them to best advantage, justified the SFC in revoking the bank's registration for Type 4 regulated activity, that is, advising in respect of securities, and partially revoking the bank's registration for Type 1 regulated activity, that is, dealing in securities.

159. An initial overview of the management systems is therefore essential, that overview, taking into account the role of the bank's employees in ensuring their effective operation.

The relationship managers

160. The bank's relationship managers were at all times the first and principal point of contact between the bank and its clients. The relationship managers were required to be licensed in respect of the services they provided to clients and in addition were required to undertake regular in-house training. In his statement, Mr. Wynd, for the bank, said that it was in the nature of private banking that relationship managers were required to keep in close contact with their allocated clients, seeking to understand their investment preferences and their tolerance for risk, and, when necessary, to introduce them to investment and credit advisers, wealth planners and other specialists in the bank who could help them to develop the most appropriate investment strategies. Mr. Wynd said that it was through the relationship managers that investment solutions were delivered to individual clients,

moulded to suit their level of financial sophistication, their investment needs and their risk profile: in short, a bespoke service. It followed, of course, that the giving of advice was not a mechanical box-ticking exercise but had to be tailored to the individual needs of the client.

161. On a consideration of all the evidence, including transcripts of conversations between relationship managers and their clients, the Tribunal has had no difficulty in concluding that, whatever the nature of the contractual arrangements entered into between the bank and each client, the relationship managers held themselves out as being more than mere 'order processors'. When approached by individual clients, they considered requests and made recommendations. Clearly, through their in-house training, relationship managers would have understood that they had an obligation to ensure that their clients comprehended the nature of the financial instruments in which they were investing and, of particular importance, especially in respect of derivative products, that they were aware of the inherent risks presented by investing in such instruments. That this was the case is supported by evidence of the existence of a number of manuals published by the bank for the guidance (among others), of relationship managers. As to the advisory duties of staff, the following offer an illustration –

i. The 'Private Banking and Trustee Functional Instruction Manual' stated that client executives (such as relationship managers) had to ensure that they were in regular contact with their clients, understanding their risk profiles and investment objectives. The needs of the clients, the level of their financial sophistication, their risk appetites and the suitability for them of particular financial products had to be assessed before any

recommendations were made. Client executives had to ensure that they did not recommend any investment considered to be unsuitable for the specific needs of clients. It was also stated that discussions with clients on investment strategy had to be documented and recorded on the client's profile.

ii. As to the important issue of the concentration of risk – putting too many eggs into one basket - the manual directed that the portfolios of clients should be managed in a manner that ensured that they were generally diversified in terms of risk and that no client should be advised to have more than 10% of an investment portfolio in any single stock, bond, fund or any single structured product. In this regard, the manual directed that if a client chose to invest more than 10% in any one product, the relationship manager should document the fact that the client had insisted on doing so in the face of cautionary advice.

iii. Another manual, the 'Private Banking Operations Manual', directed that client executives must ensure product suitability for individual clients, must explain the features of such products, including their inherent risks, and must be satisfied that the clients are fully aware of those risks. The manual went on to say that client executives must familiarise themselves with clients' portfolio mix, including concentration risks and the presence of high risk investment instruments, and must give appropriate advice to the clients in regard to these matters.

162. In summary, in the view of the Tribunal, it would be accurate to say that the bank's manuals - which were there to ensure compliance with the Code of Conduct - gave clear guidance to client executives concerning the need to act always in accordance with clients' investment profiles, explaining the risks inherent in any new investment product being marketed by the bank.

163. Relationship managers, of course, did not carry out their duties unsupervised. Each relationship manager would have a portfolio of approximately 30 clients. Supervising the relationship managers were team leaders – 'desk heads' – who would supervise approximately 8 relationship managers. Desk heads would sit with a relationship manager at the initial client meeting in order to obtain a better understanding of that client's investment philosophy, risk tolerance and the like. When required, desk heads would participate in further meetings.

164. Both relationship managers and desk heads could look to professional backup supplied by investment advisers and other experts in the bank. In this regard, Mr. Wynd spoke of a process of employing 'multiple eyes' to ensure that each client account was effectively and efficiently managed.

165. Supervising these front line structures were risk and compliance departments, a Risk Management Committee and an Executive Committee. As it was summarised by Mr. Neoh, what the bank had in place was a system of governance, supervision and monitoring designed in good faith to ensure compliance with the Code of Conduct.

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The importance of the 'know-your-client' process

166. The evidence made clear that it was a fundamental responsibility of each relationship manager, working when necessary with the desk heads, to develop a thorough understanding of each client's investment aspirations and the level of risk to which they were able and prepared to be exposed in order to attempt to fulfil those aspirations; in short, it was of primary importance to obtain an understanding of the client's risk profile. Absent that understanding suitable investment advice could not be given. This was achieved by conducting client due diligence, referred to as the 'know-your-client' process.

167. In order to obtain an accurate risk profile, it was necessary to have an understanding of the client's net worth and credit worthiness. Understandably, this was not an exact science. Clients were not asked to produce a personal balance sheet. Many did not wish to share such detailed information with the bank. In the result, the assessment of net worth had to be an estimation, the quality of that estimate depending on the quality of the information that became available to the relationship manager.

168. On the evidence, it is apparent to the Tribunal that the construction of the 'know-your-client' profile was left to the subjective assessment of the relationship managers. There was no need to work with the client in that crucial process nor even the need, it would appear, to go through some process of confirmation with the client. It requires no particular forensic skills to appreciate the very real risk of misunderstanding arising.

169. Accordingly, the core assessment of net worth appears to have been conducted by the relationship managers at or about the time of account opening, the assessment remaining in the possession of the bank, not being shared with the client. The assessment would be reviewed, not on a regular basis but rather at the time of annual review or if the client volunteered information concerning a material change in financial circumstances.

170. In the judgment of the Tribunal, the assessment of net worth (and credit worthiness), constituting in so many ways the DNA of a client's risk profile, should be an on-going exercise, one conducted in close conjunction with the client, particularly when a client leverages with the bank.

171. How then did relationship managers go about the business of building a risk profile for each client? As the Tribunal understands it, between January 2006 and September 2008 client due diligence was focused on inputting all relevant data into an Electronic Client Relationship Management System (called the 'eCRM'). This process was commenced when the client's account was first opened and according to the evidence given on behalf of the bank, would be reviewed either annually or whenever the relationship manager became aware of some material change that might have an impact on the client's profile.

172. It appears that the following matters were categorised in the eCRM database –

i. The client's *investment philosophy*, that philosophy falling into three categories, namely, 'conservative', 'balanced' and 'aggressive', the appropriate philosophy being assessed using a

system called PASS : the Portfolio Allocation Scoring System. This was a system developed at the McDonough School of Business at Georgetown University. The system required the relationship managers to determine a client's investment philosophy by assigning levels of agreement or disagreement in answer to seven set questions.

ii. The client's *risk tolerance level*, there being three levels, namely, 'low', 'medium' and 'high'. The levels would be selected by relationship managers and would be based on their professional judgment.

iii. The client's *portfolio strategy/investment objective*, there being six categories of portfolio strategy, namely, 'loan account', 'cash and bond', 'conservative', 'balance', 'growth' and 'aggressive'. To illustrate the categories, 'cash and bond' meant that the primary objective was current income, the secondary objective being stability of principal; 'growth' meant that the primary objective was growth of income, the secondary objective being appreciation of capital. Again, the strategy would be selected by relationship managers. As the Tribunal understands it, in the eCRM system the identification of the portfolio strategy would automatically produce the corresponding investment objective.

iv. The client's *investment horizon*, there being five different durations of time, the shortest being just one to three months, the longest being over three years.

v. As the Tribunal understands it, the eCRM system also made provision for data as to the maximum percentage of high risk investments that could be tolerated by a client. This, however, was not a mandatory field for the relationship managers to complete. If it was completed, it was for the relationship managers to make the necessary determination using their own judgment.

173. In April 2008, the bank enhanced its eCRM risk assessment procedures by introducing a paper-based Client Investment Profiling form: the CIP form. The existing practice in terms of which relationship managers prepared a client's investment profile on their own was discontinued. The client was now required to actively participate in the exercise of building the investment profile. In the CIP form, the existing three levels of risk tolerance were expanded to 5 levels, each given detailed descriptions. Upon completion of the form, the client would be sent a copy and in a covering letter would be requested to inform the bank if he or she was in disagreement with any of the results shown in the form.

174. Pausing for a moment, the Tribunal notes that, according to the SFC, while it was accepted that the CIP form did enhance the process of identifying the risk tolerance levels of clients, after its introduction in April 2008 relationship managers were only required to use the form when they 'on-boarded' a new client, opened a new account, conducted an annual review of an existing account or conducted an *ad hoc* review should there be a perceived change in circumstances. In the result, so it was said, only three clients who are the subject of this review, completed the CIP form before purchasing LB-Notes.

Giving investment instruments a risk rating

175. All investments bring with them a risk factor and, to reflect this fact, at all material times the bank applied a five-level classification of risk to all of its financial products. The lowest risk level – level 1 - was 'minimal', the level with the greatest risk – level 5 – was described as 'high'.

176. The bank gave its highest risk rating of '5' to LB-CDAs and to FAs. LB-ELNs were rated '4' or '5' depending on the nature of the underlying equities. A risk rating of '4' would generally apply if the underlying equities were blue-chip and '5' if they were not'.

Seeking product suitability

177. The bank's 'Compliance Manual' that was in circulation at all material times directed that –

> "Marketing staff must not make any recommendation to a customer unless the recommendation or transaction, as appropriate, is suitable for the customer concerned having regard to the customer's investment objectives, the degree of risk he/she is prepared to accept and any restrictions imposed by the customer and any other relevant facts known about the customer."

178. In short, relationship managers were at all times under an obligation to ensure that any investment recommendations made to a client were appropriate, that is, were suitable, one of the principal matters determining that suitability being that client's assessed level of risk tolerance.

179. To assist in the task of assessing suitability, relationship managers were required to complete a Product Suitability Checklist form : the PSC form, this being very much the case in respect of structured financial instruments such as ELNs, CDAs and FAs. The PSC form recorded, among other matters, the following : the client's experience in the relevant product, the client's risk tolerance level, whether the product features had been explained to the client, the client's understanding of the risks involved and the suitability of the product for the client.

180. From April 2008, an enhanced version of the PSC form was introduced. Of particular note, a new PSC form was required to be completed for each product sold to the client for the first time. In addition, relationship managers were required to provide reasons why a product was or was not suitable for a client, to record the product documents that were provided to the client (including details of the time and method of handing them over) and to seek their desk head's approval if the product held a risk rating of 4 or 5.

181. Internally, the general rule was that a client's risk tolerance level should be in line with the risk rating of the product in which the client was investing. It was for the relationship manager to determine whether that was in fact the case and whether a degree of leeway was in all the circumstances rational. Accordingly, the exercise of determining suitability - sometimes called 'risk mapping' - was not subject to any exact definition or written policy. A degree of discretion was granted to the relationship manager. Suitability assessment involved a holistic assessment of all relevant factors and not a mechanical, one-dimensional exercise.

182. A degree of discretion was essential, said Mr. Neoh. Client's wishes had to be taken into account – a fact with which the Tribunal takes no issue – advice being given in the light of those wishes considered in the context of all other relevant factors. In private banking, said Mr. Neoh, it was common for investment decisions to be 'strongly client directed'. Mr. Herbert complemented this when he said that between 2003 and 2008 equity-linked products were very popular with clients of the bank because of the combination of bull markets and low interest rates. Nevertheless Mr. Herbert emphasised that it was an important responsibility placed on the shoulders of the relationship managers to ensure that their clients understood the nature and risks of the products in which they were investing.

183. As the Tribunal understands it, on a consideration of all the evidence, it was also the responsibility of relationship managers to give appropriate advice if they considered that a client's desire to purchase a particular product was not suitable and, in the event that such advice was ignored, to record that fact.

The process of internal review by the bank

184. According to the bank, regular internal reviews were conducted by what became known as the Operation Risk and Internal Control Team : ORIC. In respect of structured products, these reviews included the following -

i. The random selection of taped conversations for review to ensure that clients' instructions were in place and that other

handling procedures had been properly performed in respect of structured products.

ii. In 2007 and 2008, on a monthly basis 20 samples were randomly selected of all high risk securities and derivative products that had been purchased in order to determine if the investments were in line with the risk profile, investment experience and investment objectives of the purchasers. In April 2008, the scope of this review was broadened to include checking the taped conversations to ensure, for example, that risks inherent in the products had been clearly explained.

Determining the issues

185. In light of the extensive background that has now been set out, the Tribunal turns to consider the individual issues.

186. As the Tribunal has noted earlier in this judgment, the SFC found that HSBCPB had fallen below the standards of professionalism required of it in its dealings at certain times with certain clients and was therefore culpable of misconduct. That misconduct, the Tribunal noted, fell into three broad areas, two concerning the marketing and sale of LB-Notes and one concerning the marketing and sale of FAs.

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I. The first LB-Notes issue - failing to inform clients that the credit worthiness of the issuer of certain derivative instruments (LB-Notes) was in question

187. In the introduction to this judgment, the Tribunal spoke of the fact that in 2007 there was a collapse in the United States sub-prime mortgage market, creating a financial contagion that grew in immensity until by late 2008 it constituted a profound financial crisis of global proportions. As earlier indicated, during the course of that crisis, a number of financial institutions that had previously been considered to have impeccable credit worthiness had to be rescued from collapse or were allowed to 'go to the wall'. Perhaps the most dramatic example of the latter was Lehman Brothers which was unable to find a buyer, or any form of government support, and – on 15 September 2008 – was forced into bankruptcy.

188. It is not disputed that, shortly before the Lehman Brothers collapse, in a period of just over six weeks, between 15 July and 28 August 2008 (inclusive), HSBCPB, acting as broker, sold Lehman Brothers equity-linked notes (LB-ELNs) to 15 different clients of the bank without disclosing to them that the issuer was Lehman Brothers and without letting it be known that, in respect of Lehman Brothers, there was intensifying 'issuer risk'. The various trades were conducted on the 15, 18, 23, 28, 29 and 31 of July and on the 1, 4, 7 and 8 of August - the last trade being on 28 August 2008, a little more than two weeks before Lehman Brothers, unable to find a buyer, went into bankruptcy. Indeed, it appears that the bank continued to market the notes until 3 September 2008.

189. As the Tribunal has noted earlier, there were at all relevant times two principal risks taken up by any purchaser of LB-Notes; first, the equity risk, that is exposure to the price risk of the underlying stock and, second, the issuer risk, that is, the risk of loss stemming from the inability of the issuer (Lehman Brothers) to meet its financial obligations under the LB-Notes, namely, repayment of the principal to the purchaser or delivery up of the relevant underlying stock. HSBCPB itself recognised these two principal risks. In an explanatory brochure entitled *Bull Equity Linked Notes*, it stated that the principal risks lay in the fact that "investors are exposed to the full price risk of the underlying stock and credit risk of the issuer."

190. In its Notice of Proposed Disciplinary Action, the SFC asserted that HSBCPB had failed to meet the required standards set out in the Code of Conduct by continuing to market LB-Notes until 3 September 2008, just days before the collapse of Lehman Brothers, without informing clients of the identity of the issuer and without being assured that clients were aware of, and understood, the intensifying issuer risk, this despite the fact that the bank was itself aware of the deteriorating financial condition and credit quality of Lehman Brothers and further despite the fact that it had itself (on 12 August 2008) cut back its own exposure to Lehman Brothers. As to the nature of HSBCPB's culpability, the SFC asserted that the bank had failed to meet the standards expected of it under the Code in the following respects –

i. General Principle 2 of the Code, requiring registered institutions to act with due skill, care and diligence in the best interests of their clients and the integrity of the market.

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ii. General Principle 5 of the Code, requiring registered institutions to make adequate disclosure of "relevant material information" in their dealings with their clients.

iii. Paragraph 5.3 of the Code, requiring registered institutions to assure themselves that clients understand the nature and risk of derivative products when providing services to them in respect of such products.

191. On what evidential basis did the SFC come to this provisional conclusion? By way of an overview, it was the SFC case that, well before July and August 2008, there had been disturbing indications in the market that Lehman Brothers was under increasing financial stress, it having been an integral player in the once burgeoning sub-prime mortgage market and thereby susceptible to the consequences of its collapse. These disturbing indications did not go simply to the fact that Lehman Brothers had fallen out of favour with stock markets but were indications of a more existential nature, indications that, along with a number of other major corporate institutions in the United States, unless rescued by way of some massive injection of capital or by way of some buyout or some form of government support, it was in danger of collapse. To support this assertion, the SFC, made reference to a number of evidential matters, the submission being made that, when taken together, they constituted compelling evidence of the existential threat to Lehman Brothers in the period of just over six weeks under consideration.

192. The SFC set out a number of evidential matters which may be summarised as follows –

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i. *Shares.* In early February 2008, Lehman Brothers shares stood at around US$65 per share. From that time, however, there was a marked decline. On 21 May 2008, the share price fell below US$40 per share and by the end of June 2008 had dropped below US$20 per share. Between 1 July and 8 September 2008, the share price fluctuated, ranging from US$22.66 (at the highest) to US$12.30 (at the lowest). In the days immediately before the declaration of bankruptcy, the shares fell precipitously.

ii. *Credit default swaps ('CDS').* More importantly perhaps - because it reflected the market's assessment of Lehman Brothers' credit worthiness - the price of CDS increased substantially in 2008. The price rose to a record high of 465 basis points on 18 March 2008, indications being that there were concerns in the market that Lehman Brothers might suffer a fate similar to Bear Stearns which had collapsed just a week before. Although the price dropped back in late April, it began to increase again, rising to 237 basis points in early June and from mid-August remaining above 300. A comparative illustration of 5-year CDS reveals that on 19 July 2008 Lehman Brothers CDS stood at 377.632 basis points, Morgan Stanley stood at 232.404, Goldman Sachs at 150.505 and Credit Suisse at 88.929. On 20 August 2008, Lehman Brothers stood at 371.667, Morgan Stanley at 236, Goldman Sachs at 159.667 and Credit Suisse at 84.167.

iii. *Credit ratings.* As earlier indicated, Lehman Brothers had been downgraded by three rating agencies in June and July

2008; being downgraded from A+ to A by Standard & Poor's in early June, from AA– to A+ by Fitch Ratings a week or so later and from A1 to A2 by Moody's in mid-July 2008.

iv. *Press reports.* Understandably, as the global financial crisis developed, there were numerous press articles concerning the viability of Lehman Brothers; and indeed other major financial corporations. Some concerning Lehman Brothers were (cautiously) optimistic but in the main they did not paint a happy picture. In short, in the main, they painted a picture of the viability of Lehman Brothers coming under increasing stress. A brief illustration is as follows :

a. On 17 March 2008, *This Is Money* wrote : "Lehman Brothers was on the rack today as rumours swept the market that it could be the next bank to collapse following the crisis at Bear Stearns. Lehman shares fell 31% to US$27.01 in pre-market trading. Analysts said every bank including some of Britain's biggest - was now at risk".

b. On 10 April 2008, the *New York Times* wrote : "Ever since the collapse of Bear Stearns, questions about Lehman's liquidity have been swirling around Wall Street – some have even suggested that there was a deliberate effort by some investors to bring it down".

c. On 9 June 2008, *CNN Money* wrote : "Lehman Brothers confirmed Monday much of the speculation that has

swirled around the Wall Street firm in recent days, booking a US$2.8 billion loss and announcing plans to raise US$6 billion in fresh capital by selling stocks".

d. On 17 June 2008, *Reuters* wrote : "Lehman shares fell US$2.06 to close at US$25.14 on Tuesday, and have fallen about 60% this year. The stock trades at less than 0.8% of its book value, implying that investors see more write-downs ahead for the bank, even after the US$3.7 billion of write-downs it recorded on Monday".

v. *Governance decisions inside HSBCPB.* The evidence reveals that the bank's Investment Advisory Group ('IAG') became concerned in respect of the collapse of the share price and from January 2008 stopped recommending Lehman Brothers as the underlying stock for three-month equity-linked notes. It also began recommending to its clients that they reduce their shareholdings in the company. In an internal monthly publication of market developments and trends, published in March 2008, the IAG said the following :

> "Market rumours regarding exposures in Variable Interest Entities ('VIEs') from Goldman Sachs, Lehman Brothers and Citigroup might trigger another round of shock to financial market. Together with the lingering fear of deepening credit crisis and a bearish economic outlook, Corporate Credit Default Swap (CDS) widened significantly in the past month".

vi. *Review of credit exposure.* On 31 July 2008, as a preventive measure, the bank's head office in Geneva gave a directive that

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there should be a review of credit exposure to Lehman Brothers. In the result, on 12 August 2008, the bank reduced its broking limits for Lehman Brothers in relation to bonds, callable daily accrual notes and equity-linked notes from US$2 million to US$1 million. As it was put by Mr. Ho, for the SFC : "In other words, HSBCPB took steps to limit its exposure to a risk of failure by Lehman Brothers whilst continuing to sell LB-Notes in which its customers were exposed to the same risk".

vii. *The Daily commentaries.* It was also emphasised by the SFC that the negative news coming out of the market in respect of Lehman Brothers was passed to the bank's relationship managers by means of 'Daily Commentaries'. They, too, therefore, would have been made aware of the increasing existential threat. Again, purely by way of illustration, the following comments are cited :

a. On 18 March 2008, relationship managers were told that the "share price of Lehman Brothers dropped 20% overnight as investors were buying puts on Lehman on the view that problems that Bear Stearns had will be seen within Lehman". In March, therefore, six months prior to Lehman Brothers declaring bankruptcy, relationship managers at the bank were made aware of concerns in the market that Lehman Brothers may reflect the fate of Bear Stearns, Bear Stearns itself, of course, having been rescued from collapse in a government-assisted buy out.

b. On 11 June 2008, relationship managers were told that "Lehman announced a US$6 billion capital raise and larger than expected second quarter loss on Monday. Oppenheimer analyst slashed its estimates for Lehman after the announcement and Lehman shares pared 6.72%."

viii. *The actions of other banking institutions.* Evidence was placed before the Tribunal indicating that in late 2007 and 2008 a number of Hong Kong banking institutions, having conducted their own due diligence, came to the decision that they should no longer market LB-Notes. The evidence was contained in a report of a subcommittee of the Legislative Council published in June 2012[26], the subcommittee having been tasked to look into public discontent as to the manner in which Lehman Brothers' minibonds and structured financial products had been marketed in Hong Kong. In the report, the following was evidenced. In or about September 2007, DBS Bank (Hong Kong) Limited had made the decision, after conducting due diligence and in consideration of the sub-prime mortgage crisis in the United States, to stop selling Lehman Brothers structured products. In late May 2008, the Royal Bank of Scotland NV, after conducting counterparty due diligence, stopped distribution of Lehman Brothers products. In early June 2008, Standard Chartered Bank (Hong Kong) Limited, in view of the credit rating downgrade by Standard & Poor's and the prevailing market uncertainty, made the same decision. A few

[26] *The Report of the Legislative Council Subcommittee to Study Issues Arising from Lehman Brothers-related Minibonds and Structured Financial Products.*

days later, Citibank (Hong Kong) Limited made the same decision. The Bank of China (Hong Kong) Limited declined to participate in the distribution of a Lehman Brothers minibond series – series 36 – between June and September 2008.

193. On behalf of HSBCPB, while it was accepted that the purchasers of the LB-Notes in July and August 2008 had not been informed of the identity of the issuer, it was said that invariably potential purchasers of ELNs were more interested in the underlying equities and the price; those were the matters that concerned them when discussing purchase with the relationship managers. Rarely, if ever, was a client interested in the identity of the issuer. Arising from this, it was said, while a principal risk in the purchase of the Notes may strictly be defined as issuer risk, it was accepted across the industry that the true principal risk was the equity risk.

194. As a general statement, the Tribunal accepts that this may have been the case in ordinary times. In the view of the Tribunal, however, the period of just over six weeks (which is the centre of consideration) could not, on any reasonable and objective assessment, have been termed 'ordinary'. On the evidence, the Tribunal is satisfied that during that limited period of time professional market watchers would have been well aware of the existential threat to Lehman Brothers and indeed a number of other established Wall Street institutions. Whether at that time Lehman Brothers was doomed to fail was not the issue. The issue was whether its credit worthiness was so threatened that an obligation was thereby placed on HSBCPB to give some form of appropriate warning to clients who were considering purchasing LB-Notes. Or, put another way, had such a warning, in all the circumstances, become relevant and material? In the judgment of the Tribunal, such a warning had clearly become both relevant and material.

195. On behalf of HSBCPB of course it was never suggested that it gave less than appropriate weight to the question of issuer risk. It was said that the bank at all times had a firm policy of only distributing structured financial instruments issued by investment grade issuers. This policy, it was said, strongly mitigated any risk. In this regard, it was emphasised that the credit rating of Lehman Brothers at all material times had remained an investment grade rating notwithstanding the downgrades in June and July 2008 when Standard & Poor's downgraded Lehman Brothers' from A+ to A, when Fitch Ratings downgraded its rating from AA- to A+ and Moody's downgraded its rating from A1 to A2.

196. That was, of course, a prudent policy. In the view of the Tribunal, however, it could not reasonably stand as the *sole* protective policy in respect of issuer risk at all times and in all circumstances. On a consideration of all the evidence, it is apparent to the Tribunal that, by the summer of 2008, the financial crisis was increasing alarmingly. Lehman Brothers has been identified as being vulnerable. Events were outstripping the ability of rating agencies to give anything like contemporaneous assessments. There was bound to be a time lag, perhaps a critical one.

197. The Code of Conduct, being principles-based, has always required registered institutions such as the bank to be aware of changes in the market and, in order to meet their professional obligations to their clients, to be ready to meet the demands of changing circumstances. The requirement, in the Code to act with due skill, care and diligence is a fluid requirement, one that requires a relatively nimble managerial approach. Equally, the requirement to make adequate disclosure of relevant information when dealing with clients is a fluid requirement.

198. By way of a *reductio ad absurdam*, the Tribunal doubts that anybody could reasonably reject as directly material to 'issuer risk' the parlous financial position of Lehman Brothers on the 10 and 11 September 2008, less than a week before its collapse, when, for example, the *New York Times* wrote that waves of selling had wiped out nearly half of Lehman Brothers' value in the stock market, leaving the firm in an "all-out fight for survival"[27]. But what of the position two weeks before that or two months before? It is a question of fact. It is a question that can only be determined by having regard to all relevant surrounding circumstances.

199. On behalf of HSBCPB, it was submitted that, even if clients did not know the identity of the issuer of an ELN at the time of sale, they would learn the identity once the transaction had been executed and the final term sheet had been issued. Should a client have concerns as to the identity of the issuer, it would then have been possible to inform his relationship manager in order to unwind the transaction. It was further submitted that there was nothing to prevent a client requesting the identity of an issuer prior to the purchase. In addition, if a client requested, relationship managers would ask dealers not to select a particular issuer.

200. In the view of the Tribunal, however, the provisions of the Code of Conduct impose a positive duty on registered institutions, one that cannot be avoided by seeking to pass the responsibility to individual clients. The Tribunal is satisfied that the Code placed a regulatory burden on the bank to make adequate disclosure of relevant and material information to its clients in respect of derivative products and to ensure that its clients had an

[27] See the *New York Times* of 10 September 2008.

understanding of the nature and risks of such products *before* purchase. The Tribunal has had no difficulty in concluding that disclosure of identity (and no more) after execution was not sufficient to comply with the Code, more especially as it was in no way certain that in turbulent times the issuer would be willing or able to unwind.

201. For the avoidance of any ambiguity, the Tribunal reiterates that, as it has found, any contractual relationship entered into by the bank and a client at the time of account opening, was not able to displace the regulatory obligations placed on the bank pursuant to the Code.

202. One of the matters raised on behalf of the bank related to what was at the time an industry-wide custom not to disclose the identity of the issuer of notes during the sales process. It appears to the Tribunal that there were essentially two reasons for this. One of the reasons arose out of inter-bank competition, that is, the very real possibility that, once a client knew the identity of an issuer, he might then shop around in order to secure a better price. The second reason was apparently focused on the fact that, because of highly competitive pricing by different issuers, the practice had arisen - in the interests of potential purchasers - of negotiating with various issuers to obtain the best deal before making a final recommendation to the client.

203. The Tribunal does not dispute the fact that such a custom may have existed. Nor does it contest the underlying reasons. But the fact remains that it was a custom and no more, one that had to bow to the requirements of the Code of Conduct. Again, in the opinion of the Tribunal, it is a matter of considering issues in context, that is, by having regard to the growing turbulence in the market in the summer of 2008 and what, at that

time, the circumstances demanded in the exercise of due diligence to protect the best interests of clients.

204. Finally, mention should be made of the submission that, even though there had been an alarming decline in the value of Lehman Brothers shares, no fault could be attributed to HSBCPB in failing to anticipate that Lehman Brothers would collapse into bankruptcy. Allied to this, it was said, almost all banking institutions were under pressure at that time and there was no particular reason to single out Lehman Brothers. The professional decision was made – so it appeared to be implied – that Lehman Brothers was under no greater risk than other venerable Wall Street institutions. There was at the time, a very real and credible belief that Lehman Brothers would either be sold or that the necessary steps would be taken, as it had with other institutions, to shore up its vulnerability, thereby protecting the interests of the holders of LB-Notes.

205. As the Tribunal has already noted, it was never part of the SFC case that the bank was culpable because it failed to anticipate the collapse of Lehman Brothers. The issue has been whether, in light of all the prevailing circumstances at the relevant time, there was a burden placed on the bank in terms of the Code of Conduct, if it was to continue selling LB-Notes to clients, to make adequate disclosure of relevant and material information concerning Lehman Brothers, the issuer of the Notes; in short, some appropriate form of warning as to its credit risk. Thereafter, it was matter for the client whether or not to take the risk.

206. The Tribunal has had little difficulty in concluding that, in light of all the prevailing circumstances, one of those circumstances being the fact that the bank itself had materially reduced its exposure to Lehman

Brothers, if the bank was to act diligently in the best interests of its clients in selling LB-Notes, it had an obligation in the period in question to give some form of appropriately worded warning. It failed to do so. Even though the bank was acting to reduce its own exposure to Lehman Brothers, the relationship managers were given no instructions, when selling the LB-Notes, to inform potential purchasers even of the identity of the issuer. In short, the only way clients were able to protect themselves at that time was by demanding to know the identity of the issuer before sale and undertaking their own independent research in respect of that issuer, a contractual obligation that was placed firmly on their shoulders but a regulatory obligation that was not.

207. Finally, as to any suggestion that there was no reason to single out Lehman Brothers from amongst its peers as being particularly vulnerable, the Tribunal notes that the SFC case was never based on any exercise of comparisons between registered institutions as such. If issuers on Wall Street were all at that time – as a class – considered to be a real credit risk, then logically warnings should have been given in respect of them all.

208. For the reasons given, the Tribunal is satisfied that, in respect of this issue, the bank clearly fell well below the professional standards required of it under the Code of Conduct and ancillary guidance. In respect of each of the 15 complaints, the Tribunal is satisfied that they have been substantiated.

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II. The second LB-Notes issue - failing to ensure suitability of product for bank clients

209. As initially summarised in paragraph 20 of this judgment, it was the findings of the SFC that, between January 2006 and September 2008, while marketing Lehman Brothers derivatives – in particular, LB-CDAs to which the bank gave its highest risk rating of level 5, the bank had failed to take appropriate measures to protect the interests of clients in accordance with the Code of Conduct and other relevant guiding instruments. More particularly, it was the SFC findings that these failings fell into three categories. They were to be found, first, in the fundamentally important process of exercising the due diligence essential to understanding the parameters of each client's risk profile (the 'know-your-client' process); second, in the process of due diligence essential to ensuring that the particular product at the particular time constituted a suitable purchase by the client and, third, in the process of supervising and monitoring the sales process in order to avoid unjustified risk mismatch.

210. Before considering these findings in detail, an issue of considerable importance to the bank should be considered, namely, its philosophy of bespoke wealth management. Pursuant to this philosophy, said Mr. Neoh, assessing the suitability of a financial product for a client had to be flexible, adaptive and responsive to each client's needs. Risk tolerance levels, he said, could not therefore be seen as rigid classifications from which there was no deviation. While, as a rule of thumb, a client's risk tolerance level should be in line with a product's risk rating, when the portfolio of a client was considered to be capable of assuming additional risk in order to maximise yield, it was often advantageous to follow that path. In this regard, Mr. Neoh sought support from the evidence of Mr. Wynd who

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said that, on a portfolio basis, it was the weighted average product risk rating which should be in line with the client's risk tolerance level, rather than on a one-to-one match in respect of each transaction. Mr. Neoh emphasised that relationship managers were not expected to adhere to some form of rigid formula, they were expected to assess suitability based on all relevant factors, risk tolerance level being just one of them. The bank did not impose mandatory requirements as to risk matching on the cogent basis that it was not considered the sole determining factor in an analysis of suitability.

211. In response, Mr. Ho, on behalf of the SFC, said that the adoption of a holistic, portfolio-based approach by the bank did not mean that the need for internal checks and balances fell away. These internal checks and balances, while not intended to undermine appropriate use of discretion, were put in place for the protection of clients and the bank itself. Importantly too, if discretionary decisions were to be made - as the Code indicated - it was important that the rationale for such decisions should be recorded. This again was for the protection of clients and the bank itself. As Mr. Ho submitted, it was accepted that the bank had in place a general rule that a client's risk tolerance level should be in line with a product's risk rating. That being the case, if there was to be a deviation from that rule, he said, it had to be subject to due supervision : its rationale recorded along with the fact that the client had been informed of relevant factors going to the making of the decision, for example, the fact that, on its face, a particular purchase represented a risk mismatch.

212. As it was, said Mr. Ho, it appeared that the Code of Conduct and the bank's own guidelines had been more honoured in the breach than the observance, especially in the sale of LB-CDAs that carried the maximum risk level of '5'. Mr. Ho said that, according to the bank's own

records, out of a total of 672 outstanding transactions, 549, had involved the sale of LB-CDAs to clients whose risk profiles made it suitable for them to assume only a 'low' or 'medium' level of risk tolerance and not the highest risk level of '5'. In respect of outstanding LB-CDA transactions, 81.7% demonstrated – on their face – a risk mismatch.

213. The Tribunal accepts that, in the bespoke management of a client's wealth, the bank was not expected to strip itself of discretion. The Tribunal further accepts that, as a general principle, it was properly the weighted average product risk rating which should be in line with a client's risk tolerance level rather than a one-to-one match in respect of each and every transaction. But that said, the need for structure would have been fundamental. During the time under review, it would have been imperative for both the client and the client's relationship manager to fully understand the client's risk profile. Only on that basis could discretionary investment decisions be made in light of a mutually recognised risk profile. In the opinion of the Tribunal, when investment decisions appeared on their face to constitute a departure from a client's risk profile – a risk mismatch – it would have been equally fundamental to record that fact. Such records explain the investing history of an account, they reveal an *informed* mutuality of decision-making. Regrettably, on the evidence before the Tribunal there appears in the relevant period to have been a paucity of such contemporaneous records. That absence leaves the bank open to accusations that at the time, in an bull market, with clients seeking maximum returns and prepared to purchase derivatives, even if they were not fully aware of the downside risks, the relationship managers simply acted on instructions, processing orders rather than fulfilling the role that the Code of Conduct required.

214. Having considered these matters of approach, the Tribunal turns now to consider the three categories of asserted culpability that, according to the SFC, coloured the bank's marketing of LB-CDAs in the period between January 2006 and September 2008 : in particular, those notes, to which the bank gave its highest risk rating level of '5'.

(A) Deficiencies in the bank's systems for identifying the risk profile of clients : the 'know-your-client' process

215. It was essentially the SFC case that the deficiencies in identifying the risk profile of clients in the relevant period arose out of the bank's use of a computer programme called eCRM : the Electronic Client Relationship Management System. At the outset therefore something must be said of the workings of the programme.

216. In order to obtain a client's risk profile, data would be fed into the programme, a process commenced when a client's account was first opened. According to the bank, the data collected would be subject to review in order to keep it current, reviews apparently taking place annually or whenever relationship managers became aware of some change that might have an impact on a client's investment profile. The data fed into the programme by the relationship managers - doing so on their own and not in conjunction with the clients - would result in each client's profile being categorised in four obligatory respects; namely –

i. *Investment philosophy*, this philosophy falling into three categories : 'conservative', 'balanced' and 'aggressive'.

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ii. *Risk tolerance level*, there being three such levels : 'low', 'medium' and 'high'.

iii. *Portfolio strategy/investment objective*, there being six categories of portfolio strategy : 'loan account', 'cash and bond', 'conservative', 'balance', 'growth' and 'aggressive'.

iv. *Investment horizon*, there being five different durations of time, the shortest being one to three months, the longest being over three years.

a. Asserted deficiencies in the 'investment philosophy' categorisation

217. In its Notice of Proposed Disciplinary Action, the SFC identified what it considered to be two material deficiencies in the process of making this categorisation for each client; first, in the truncated incorporation of a computer assessment tool known as PASS and, second, in the fact that, instead of asking a client to answer the questions or to confirm the answers, the questions thrown up in the eCRM program were answered by relationship managers themselves independently based on their understanding of what the client would answer.

218. As indicated earlier, a client's investment philosophy (which identified his or her approach to investment) fell into three categories : 'conservative', 'balanced' and 'aggressive'. In order to determine which of these three categories should apply to a client, relationship managers were required through the eCRM system to answer seven pre-set questions. Because they were acting independently, they would answer those questions

not in conjunction with the client but on the basis of their understanding of earlier discussions with the client. The seven questions were :

i. Earning a high long-term total return that will allow his/her capital to grow faster than the inflation rate is one of his/her most important investment objectives.

ii. Client would like an investment that provides him/her with an opportunity to defer taxation of capital gains and/or interest to future years.

iii. Client does not require a high level of current income from his/her investment.

iv. The client's major investment goals are relatively long-term.

v. Client is willing to tolerate sharp up/down swings in the return on his/her investment in order to seek a potentially higher return than would normally be expected from more stable investments.

vi. Client is willing to risk a short term fluctuation in return for a potentially higher long-term rate of return.

vii. Client is financially able to accept a low level of liquidity in his/her investment portfolio.

219. There were five possible answers to each question, each possible answer carrying a different score, namely : 1 point for 'strongly

disagree'; 2 points for 'disagree'; 3 points for 'neutral'; 4 points for 'agree' and 5 points for 'strongly agree'. The total score would determine the clients, investment philosophy in the following manner :

i. If the total score was below 10 points, this would constitute a 'conservative' investment philosophy, meaning that the client "desires safety of principal with willingness to accept limited portfolio volatility for higher returns. Ready to study new investment ideas".

ii. If the total score fell between 10 to 29 points (inclusive), this would constitute a 'balanced' investment philosophy, meaning that the client "seeks growth in investments, has willingness and capacity to accept portfolio volatilities over time. Open to new investment ideas".

iii. If the total score was 30 points or above, this would constitute an 'aggressive' investment philosophy, meaning that the client "seeks aggressive growth in investments, has willingness and capacity to assume a high level of risk to principal. Always open to investment ideas. Enjoys some speculation".

220. As indicated earlier in this judgment, the appropriate investment philosophy for a client was identified by using a software system called PASS. It was a system originally developed at Georgetown University and, on the evidence, had been a well-respected assessment tool for a number of years. The creator (and copyright holder) of the PASS system is Professor William George Droms, who, in his statement of 25 April 2016, said :

"PASS is developed as a model asset allocation 'scoring system' for investment decision-making and portfolio asset allocation based on an individual investor's risk tolerance and return objectives. PASS is typically presented in the form of a questionnaire, which requires an investor to score himself on seven important return and risk objectives. The first four items on PASS deal with return objectives, and the last three items on PASS measure risk tolerance. All seven objectives are scored on a one-to-five scale.

PASS attempts to capture in a simple and straightforward manner two central lessons of the modern portfolio theory, i.e. that : (a) a risk/return trade-off does in fact exist, and (b) investors should diversify to reduce risk. Whilst risk is commonly measured quantitatively in terms of standard deviation of the mean total annual return, individual investors have a more complicated approach to risk in that their risk concerns may not be captured by the standard deviation. An example is liquidity risk and the risk of incurring a loss within a particular investment holding period.

In summary, I designed PASS with the intention, on my part, that it measure the risk concerns of an individual investor and balance them against their return objectives. As a numerical goal-and-attitude scoring system, I did not envisage that PASS could in itself provide a definitive answer to an investment and asset allocation plan for an individual investor. *It was nonetheless intended to be a starting point in understanding an individual investor's risk tolerance.*

The total scores would then be used to determine a client's portfolio risk management and diversification guidelines, which would comprise different investment classes, such as money market, fixed income and equities." [emphasis added]

221. Professor Droms went on to say in his statement that the PASS system had been modified on a number of occasions since the creation of the original system in 1987.

222. The PASS system – as an entire system - was not the subject of criticism by the SFC. It was rather the fact that its use appeared (on occasions at least) to give out scores which were questionable. In this regard, the SFC said that a client would be classified as having a 'balanced' philosophy under the scoring system (i.e. that he or she sought growth in investments, had willingness and capacity to accept portfolio volatilities over time and were open to investment ideas) even though the client strongly disagreed that he or she would be willing to tolerate sharp up or down swings in the return on his or her investment and strongly disagreed that he or she was willing to take a short-term fluctuation in return for a potentially higher long-term rate of return. This dislocation of concepts could not have assisted relationship managers in accurately identifying a client's investment philosophy.

223. While the SFC in its two written notices may have placed some emphasis on the assertion that the PASS system had thrown up at least one anomaly, during the course of argument before the Tribunal the matter appeared to be put more strongly.

224. In his closing submissions, Mr. Ho, for the SFC, said that it was apparent from Professor Drom's descriptions of each version of PASS that it consisted of two integrated parts, first, a scoring system and, second, certain asset allocation guidelines, the two working together to enable the person using the system to first arrive at a score and then obtain certain guidelines as to an appropriate allocation in the light of that score. However, what the

bank had done, said Mr. Ho, was effectively to arbitrarily truncate the PASS system and only adopt one part of it, namely, the questions within the scoring system. The other parts of the system, namely, the bands of scores and the corresponding asset allocation guidelines, he said, had been disregarded.

225. Although the questions used for scoring under the 'investment philosophy' categorisations were taken from the PASS system, said Mr. Ho, the bank came up with its own scoring system of three bands with three corresponding investment philosophy categories. This fundamentally departed from the PASS model, particularly as the questions used for scoring simply did not result in any asset allocation guidelines whatsoever. As Mr. Ho expressed it, the system adopted by the bank did not reflect the fundamental scheme embodied in the PASS model. As such, the usefulness of the bank's investment philosophy categorisations – three loosely defined categories with no indication as to how an investment portfolio should be designed based on those categories – was 'highly questionable'.

226. As to why the bank should not have integrated the full PASS model into its eCRM system, Mr. Wynd explained in the course of his testimony that the bank was never going to adopt the PASS model in its entirety because the asset class allocation portion of the model was tailored essentially for the United States domestic market. In the result, he said, the bank had extracted part of the system only - the questionnaire - and had devised its own three-band scoring system in respect of that questionnaire. The purpose was a limited one. While the full model was designed to assist in assessing a client's risk tolerance and investment objectives, the bank used the system for the first purpose only, that is, to get a better understanding of the client's general approach to investing: his or her

investment philosophy. As he put it : " … we used the system to assist in the profiling of customers and then it was down to the judgment of the relationship manager or the investment counsellor and the client to determine the most appropriate asset class allocation".

227. It was never accepted by the bank that the integration of this partial system had been found to be problematic. Further, as Mr. Wynd emphasised, the three categories of investment philosophy that were identified by using this partial system were never intended to be definitive, that is, entirely self-contained.[28] Once a client's investment profile had been broadly defined, the emphasis being on risk tolerance, it was then for the relationship manager or investment counsellor and the client to come together to agree asset class allocation or, put another way, to agree an appropriate portfolio strategy.

228. Professor Drom's statement was restricted to matters of fact. It is to be noted, however, that nothing was put before the Tribunal to the effect that his PASS model (in whichever version) had to be employed as an integrated whole or not at all.

229. In this regard, the Tribunal is, of course, aware that there were discussions between the parties as to the agreed content of Professor Drom's statement. But the fact remains, the burden of proof lying on the SFC, that there was no evidence of an expert nature stating that the PASS model had

[28] In the response to the SFC's Notice of Proposed Disciplinary Action, it was said, on behalf of the bank that the partial use of the PASS model was "designed as a starting point to understand the client and was not intended as a definitive labelling of the client's investment philosophy." It was said that it "allowed the relationship managers to better understand the client and determine where he/she may fall within the bank's client base in terms of risk tolerance."

to be employed as an integrated whole failing which it would be problematic.

230. In the result, the Tribunal is unable to find that there was during the relevant period any failure on the part of the bank in adopting the partial PASS model. The SFC itself (wisely) did not say that the system was unfit for purpose. Based on one apparent anomaly only, the SFC went no further than to say that the usefulness of the system was 'questionable' or 'highly questionable'.

231. In the opinion of the Tribunal, even if there were occasional 'glitches' in the use of the truncated PASS system, there is no evidence of any substance that the use of the truncated system was simply not fit for purpose. There is little, if any, basis for criticising the bank for its use of the PASS system.

232. The Tribunal accepts that the identification of the three categories of investment philosophy was never intended in each case to be absolute. It was intended as a starting point only, a broad basis and apparently one open to correction, upon which the relationship manager and the client would be able to then discuss an appropriate asset allocation.

233. While the Tribunal has not been able to find any material fault by the bank in its truncated use of the PASS system, regrettably the same cannot be said of the second issue raised by Mr. Ho on behalf of the SFC, namely, the fact that the questionnaire completed by each relationship manager in order to identify the investment philosophy of each client was not required to be completed in conjunction with the client nor even required to be confirmed with the client. In the view of the Tribunal, this process in

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terms of which relationship managers were able for all practical purposes to work independently of their clients coming to their own independent determinations, whether right or wrong, constituted an obvious but nevertheless fundamental flaw. In this regard, the Tribunal would agree with the findings of the SFC set out in paragraphs 34 and 35 of its Decision Notice :

> "Although HSBCPB claims that the majority of the relationship managers knew their clients' preference, the fact that the questionnaire was not required to be completed by or confirmed with the clients means that the risk that the answers were wrong or inaccurate was high - there might have been miscommunication between the relationship manager and the client, misinterpretation by the relationship manager of the discussion with the clients or the relationship manager choosing biased answers that would allow for the sale of more products. There was simply no way to check or ensure that the relationship managers knew their clients' preference as claimed by HSBCPB.
>
> Indeed, there is no way HSBCPB can assert with any confidence that the majority of relationship managers knew their clients' preferences given the system relied on by HSBCPB did not require clients to answer the questions themselves or agree with any of the proposed answers. It was not even a mandatory requirement for the relationship managers to communicate or provide a copy of the results to the clients. HSBCPB had no means to ensure that the client was aware of the result, and understood what the result meant."

b. Asserted deficiencies in the 'risk tolerance' categorisation

234. Manifestly, it was of real importance that relationship managers should have an accurate understanding of each client's risk tolerance. Prior to April 2008 when improvements were made to the eCRM

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system, there were three defined risk tolerance levels : 'low', 'medium' and 'high'.

235. Risk tolerance levels were not generated by means of some formulaic process through the eCRM system, they were instead compiled by the relationship managers, doing so - again, not contemporaneously with the client - but on their understanding of a client's circumstances and wishes.

236. The problem, said Mr. Ho, for the SFC, was that the generality of the description of the three risk tolerance levels was given no clarity by any form of definition. More than that, relationship managers were not provided with any form of guidance as to how they should go about determining an appropriate level of risk tolerance for their clients. The bank did not provide any guidelines. It was left to each individual relationship manager's discretion. As Mr. Ho put it, this was clearly problematic. Different relationship managers would almost certainly interpret the risk levels differently. In such circumstances, he submitted, there was no way for the bank to ensure consistency and reliability of approach.

237. This, it was argued, was compounded by the fact that relationship managers appeared to be under no obligation to give reasons (however brief) explaining their assessment of a client's risk tolerance level. In the result, it may be said that, whether relationship managers were experienced or inexperienced, whether they were by character inclined to adopt a more aggressive attitude towards investments or a more prudent attitude, their determination of a client's risk tolerance level was left entirely to their discretion without need to give reasons. If relationship managers had been required to sit with each client when making their assessment, discussing relevant issues with that client, far greater accuracy would have

been assured, said Mr. Ho, and through that a greater consistency of approach.

238. Mr. Ho pointed to what he said were the dangers of working in this manner by reference to one example, namely, the evidence of one relationship manager (with a track record of brokering LB-Notes) who accepted that, in respect of one corporate client, when she was answering the seven questions that determined the client's risk profile, she had filled in 'neutral' in respect of two questions because she could not recall what, if anything, the client had indicated, during earlier discussions.

239. In respect of this particular incident, Mr. Neoh, for the bank, said that this was another indication of the SFC's misunderstanding of the bank's operations. If a relationship manager, through a dialogue with the client, could not determine that the client had a particular preference in respect of a particular question, the natural and only answer to be chosen in the circumstances would be the one that was recorded: 'neutral'.

240. With respect, in the view of the Tribunal, this does not really answer the point. The point made by Mr. Ho was that the relationship manager had recorded 'neutral' not because she was unable to determine any preference but because she had simply forgotten whether the client in fact had a preference and, if so, what it was. As Mr. Ho said – and as the bank itself put into practice in April 2008 – if the relationship manager had worked with the client there would have been no need for default answers entered on the basis of forgetfulness.

241. The Tribunal accepts that the questionnaire and scoring system was designed in such a manner that if there was a misinterpretation of a

client's preference in answer to a single question, that (by itself) would not necessarily distort the end categorisation. The point made by the SFC, however, one which the Tribunal accepts as being valid, is that structured safeguards would have avoided any risk of distortion.

242. Mr. Neoh's riposte, of course, was far broader than an answer to this one isolated incident. He rejected all suggestions of a deficient process. All relationship managers, he emphasised, received formal training. More importantly, however, experience was acquired through on-the-job training. In this regard, an inexperienced relationship manager would have the opportunity to work alongside more senior relationship managers and marketing team heads and in this role would meet clients and conduct initial or on-going client due diligence.

243. Again, it was emphasised on behalf of the bank that their private banking relationships were premised on a bespoke and individualised assessment of a client's risk appetite and investment objectives, that assessment being based on knowledge of each client's personal circumstances. In such circumstances, the bank did not consider it necessary at that time to have a written policy or to provide guidelines concerning the selection of risk tolerance levels. As it was explained :

> "The risk tolerance levels of 'low', 'medium' and 'high' are not special terms of art, and are terms that are commonly used (and readily understood) to describe the degree of investment risk or risk of capital loss that a client is willing to bear (or that is associated with an investment product). When assessing the appropriate risk tolerance level of each account/client, relationship managers would therefore do so based on their knowledge of the account/client, their experience and professional judgment …"

244. The Tribunal has earlier acknowledged the importance of the relationship fostered between relationship managers and clients, it has further acknowledged that a bespoke service must incorporate the ability to exercise discretion. But that said, as also indicated earlier, there must be structure. What has concerned the Tribunal is that, before April 2008 when there were improvements to the system, it appears that relationship managers were under no obligation to work with, or even report to, their clients when going about the fundamentally important business of identifying those clients' investment philosophies and, more importantly, when seeking to define their level of risk tolerance. This ability to work (for all practical purposes) entirely independently without the need even to report back could not have been conducive to the encouragement of accuracy; indeed, the opposite would have been the case. This is not in any way to suggest that diligent relationship managers would not as a matter of practice have checked back with clients if they were unsure as to required information. But this ability to work independently must have bred a culture of independence which itself would have created a gap between relationship managers and their clients, a gap all too easily filled with the detritus of misunderstandings and misinterpretations.

c. Failing to inform clients of their risk assessments

245. Directly complementary to this, it was the SFC case that a compounding defect in the bank's 'know-your-client' process was the fact that, up until April 2008, it did not require relationship managers even to inform clients of the results of their risk assessments and/or to obtain their written agreement to such assessments. In this regard, as Mr. Wynd accepted during his testimony, there was no policy in place at the relevant

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time in terms of which relationship managers were obliged to inform clients of their risk assessments. As he put it, a client "may or may not have been aware".[29]

246. In his submissions on behalf of the SFC, Mr. Ho said that, in the absence of a requirement imposed on relationship managers to inform clients of the results of their risk assessment and have those results verified, there were two material consequences undermining the entire process. First, it was impossible for the bank to be assured that the risk profile allocated to a client in fact matched that client's true risk appetite. Second, it meant that the client was denied the knowledge of how his risk tolerance had been assessed and, going forward, was therefore denied a complete understanding of the basis upon which recommendations concerning investments would be made to him.

247. As such, said Mr. Ho, this lack of any requirement to communicate to the client the results of that client's risk assessment was a quite obvious defect in the bank's systems, one that could not be justified, and was indeed later rectified.

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[29] A fuller extract from Mr. Wynd's testimony reads :

Q. … would the client know what risk level has been assigned to his or her portfolio?

A. [In] the relevant period, there was no policy to advise the client. He may or may not have been aware.

Q. Nor would he be advised as to, for example, like what risk level, risk tolerance level he is, and therefore how should he focus on the spread of asset allocation; there would be no such –

A. He may or may not have been. That would depend on the nature of the conversation with the relationship manager.

Q. But there is no policy to actually advise him on that basis, no such policy?

A. At the relevant period, no policy.

248. On behalf of the bank, Mr. Neoh disputed the fact that clients remained uninformed. While there was no written requirement to inform clients, he said, there was such a requirement in practice. As he put it, if clients were not immediately informed, it was nevertheless a common practice for relationship managers to discuss each client's risk profile information during annual reviews. The Tribunal does not dispute the fact that in practice diligent relationship managers may have informed clients of their risk assessments. The point, however, is that relationship managers were under no duty to do so and, as Mr. Wynd accepted, it meant that clients may or may not have been aware of the contents of their own risk assessments. They may therefore at all material times have been unaware of the information critical to enable them to work to best advantage with their relationship managers.

249. Mr. Neoh accepted that in a circular dated 3 March 2006, the HKMA had reminded banks to document the approval by clients of their risk profile assessments, including assigned risk tolerance levels. This did not mean, however, he submitted, that banks needed to obtain written acknowledgement of risk assessment results. More than that, the circular was in relation to retail wealth management clients only and not, therefore, applicable to the bank.

250. Mr. Neoh further submitted that it was not suggested by the SFC that the bank's practice at the time was out of line with the practice of other private banks in Hong Kong[30].

[30] The Tribunal received only oblique evidence of contemporaneous practices in other private banks at the relevant time. But, that said, the issue before the Tribunal was not whether there was a common failure at the time. The issue was entirely focused on the internal processes of the bank.

251. In the judgment of the Tribunal, this failure to impose on each relationship manager an obligation to inform each client of that client's risk assessment results did constitute a material failing in the system. The risk assessment may have been, as Mr. Neoh emphasised, a 'first step' in the process of building a relationship but it was nevertheless a fundamentally important step. If, as the bank has emphasised, the core aim was to build a working relationship between each relationship manager and his or her client, that relationship had to be built on some initial common understanding of the client's investment philosophy and risk tolerance levels. Those fundamental matters had to be agreed at the outset. Otherwise, there was a real risk of a portfolio strategy being devised, and (at least) initial investments being made, that did not reflect the true wishes and desires of the client.

252. In the opinion of the Tribunal, without a verification requirement the risk of investments being entered into on the basis of a fundamental misunderstanding had to be present. It is a trite acknowledgement of human nature that not every client, whatever their level of wealth, is fully articulate as to their wishes and concerns in the field of investment; many may, initially at least, be uncertain. In such circumstances, early conversations with their relationship manager may have been capable of being fundamentally misunderstood. If, upon the risk assessment being completed, such clients were informed of the details of that assessment and asked to verify them, it would give them an opportunity to clarify earlier doubts or uncertainties and for the risk profile to be amended accordingly. At the very least, it would protect the bank and go a long way to avoiding future assertions that a client had been persuaded to

make an investment that was simply not in accord with his or her investment philosophy.

253. Looking to the interest of clients, as Mr. Ho put it in the course of his submissions, a requirement for the risk assessment results to be communicated to and verified by each client would have had the obvious benefit of enabling each client to know how he or she had been classified in terms of levels of risk tolerance and hence the fundamental premise on which he or she would be treated by the bank in terms of the recommendations and solicitations that the bank would make to them.

d. The introduction of enhanced processes in April 2008

254. Commencing in April 2008, the bank enhanced its due diligence process by introducing a paper-based Client Investment Profiling ('CIP') form which was required to be completed as part of the account opening process. The CIP form contained a series of questions which each client would be invited to answer, the overall purpose of the answers being to reveal that client's desired portfolio strategy[31].

255. The form provided a summary of each client's investment profile (with information such as age, investment experience, investment philosophy and the like). In addition, the existing three levels of risk tolerance were expanded to five levels, each level being given a more detailed description. By way of illustration –

i. Conservative (risk averse) carried the description : 'You would like to consider products that carry no investment risk and you

[31] In this regard, the form contained a new 'portfolio strategy/investment objective' classification.

A A

B B

C C

D D

E E

F F

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H H

I I

J J

K K

L L

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N N

O O

P P

Q Q

R R

S S

T T

U U

V V

are prepared to accept lower returns in order to preserve your capital. In particular, you would be interested in products that have no price volatility and are 100% capital protected upon maturity.'

ii. Assertive (high risk tolerance) carried the description : 'You would like to consider products which have the potential to achieve higher returns for capital growth. You are prepared to accept higher volatility and moderate risks with the aim to accumulate assets over medium to long term. The values of your capital can fluctuate and may fall substantially below your original investment. You expect that the fluctuation will be high.'

256. A copy of the CIP form (and later revisions of it) would be sent to the client who would be asked to inform the bank if he or she was in disagreement with any of the results shown in the form.

257. Mr. Ho, for the SFC, accepted that the introduction of the CIP form constituted a marked improvement on what had gone before, particularly as each client played a direct role in compiling his or her own risk assessment and was, in addition, sent a full print-out of all relevant details. He pointed to the fact, however, that each client was not positively required to sign to acknowledge the assessment results. A requirement for a positive endorsement, he said, would have avoided any dispute as to whether the client had in fact endorsed the risk assessment results and thereby taken responsibility for them.

258. In the opinion of the Tribunal, however, there is little force in this point. The fact is that each client was now given a full print-out of the assessment results which he or she could check immediately to ensure that the bank's classifications were in line with their wishes and could also be used as a future point of reference.

259. A point of greater force is that the use of the new CIP form only had minimal effect in the period under review, that is, between January 2006 and September 2008. The form was only introduced in April 2008. It was to be noted, said Mr. Ho, that relationship managers were only required to use the new form when opening a new account for a client, when conducting the annual review or when an *ad hoc* review was deemed necessary. In the result, said Mr. Ho, only three clients completed the new CIP form before purchasing outstanding LB-Notes.

(B) Deficiencies in the bank's systems for ensuring suitability of LB-Notes

260. It is self-evident of course that, in the circumstances of bespoke banking, investment instruments should be suitable for the needs of each client. If a client's risk profile is low, if that client's investment aim is essentially the preservation of capital, it speaks for itself that caution must be exercised before that client either convinces a relationship manager to sell high risk derivative products to him or is convinced by the relationship manager that it is in his interests to make such a purchase. Mr. Neoh, for the bank, emphasised the importance always of ensuring suitability of product. There was, he said, a directive issued by the bank to this effect. By way of illustration, the bank's own Compliance Manual (section 9) stated that : "marketing staff must not make any recommendation to a customer unless

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the recommendation or transaction, as appropriate, is suitable for the customer concerned having regard to the customer's investment objectives, the degree of risk he/she is prepared to accept and any restrictions imposed by the customer and any other relevant facts known about the customer."

261. To meet this end, throughout the relevant period the bank adopted a five level classification of risk in respect of its investment products. This five-level classification was as follows :

Risk Level		*Principal Risk*
'1'	Minimal	No interest rate risk
'2'	Low	Only interest rate risk
'3'	Moderate	Less than 5%
'4'	Medium	Less than 25%
'5'	High	More than 25%

262. Equity linked notes generally were rated '4' or '5' depending on the nature of the underlying stocks. The risk rating would be '4' if the underlying stocks were blue chips and '5' if they were not.

263. As to the approach that it had at all times adopted, the bank emphasised what may be termed the importance of the 'holistic' approach, the close working relationship between each client and his or her relationship manager. The importance of such a relationship in determining suitable investments is, of course, fully accepted. It was further emphasised that investments were chosen based on portfolio weightings rather than on a

strict one-on-one comparison between the risk profile of a client and the risk classification of each investment product[32]. That also, subject to the circumstances of each case, is accepted as a rational approach. In the bank's final submissions, however, a *caveat* was spelt out, one which emphasised the importance of the contractual relationship between the bank and its private banking clients. In this regard, Mr. Neoh, in his written submissions, said the following :

> "But, regardless, it is essential that the client understands the product in which he will be investing. By virtue of the contractual provisions in the Account Opening Booklet, each client has undertaken to actively try to understand the risks of any product. The responsibility of the bank under the Code [of Conduct] is therefore to provide all necessary information so as to enable the client to assess his risks."

264. This, said Mr. Neoh, had clearly been done; first, in the creation of the product risk rating classification and, second, in the explanatory documents provided to clients.

265. In so far as these submissions are intended - by bringing in the issue of contract - to compromise the regulatory obligations imposed on the bank, they are not accepted by the Tribunal. The obligation of the bank, as the Tribunal understands it, in terms of the Code of Conduct goes further than simply providing information so as to enable a client to assess his or her own risk. In this regard, as earlier set out in paragraph 47 of this judgment, "a registered person providing services to a client in derivative products … *should assure itself that the client understands the nature and risks of the*

[32] In this regard, emphasis was laid on the statement by Mr. Wynd during cross-examination (day 5) to the effect that "on a portfolio basis, the weighted average product risk rating should be aligned with the client's risk tolerance level, rather than we do a one-to-one match on a transactional level".

products and has sufficient net worth to be able to assume the risks and bear the potential losses of trading in the products." [emphasis added]

266. Accordingly, in the opinion of the Tribunal, it was not sufficient for the bank to provide to a client considering the purchase of a derivative investment a product risk rating table accompanied by explanatory documents. What was required in all times was adherence to a structured system, one protecting the interests of the client but also the interests of the bank itself, that ensured the giving of prudent advice and, importantly, ensured (certainly when there was to be an apparent risk mismatch), setting out by way of a record a clear history of the rationale of investment decisions made.

267. As the Tribunal understands it, it was essentially in this regard that the SFC's criticisms were mounted; namely, in the failure to establish effective systems which – particularly in the event of an apparent risk mismatch – governed and recorded that LB-Notes were suitable instruments for purchase. In his opening submissions, Mr. Ho, for the SFC, summarised the grounds upon which the SFC had come to its findings :

i. An indication of the material shortcomings in the system, said Mr. Ho, was to be found in the fact that there was no on-going review of the risk rating of LB-ELNs to ensure on a continuing basis that any material changes in the risk level of the product were accurately reflected in the risk rating classification. Risk ratings, of course, are not immutable; they must be adjusted according to the vagaries of the market. A turn in the market may mean that a 'moderate' risk product given a rating of '3' should be given a higher risk rating, one of '4' or even '5'.

ii. The bank, said Mr. Ho, did not have any systematic and rational 'risk mapping' system in place during the period under review. Nor did the bank have proper guidelines in place to assist relationship managers to determine whether a client's risk profile was in line with the product risk rating. As it was, said Mr. Ho, instances of apparent risk mismatch were noted in over 80% of the outstanding LB-Note transactions, there being no (or virtually no) recorded justifications for such apparent mismatches.

iii. No special approval was required for the sale of LB-CDAs - which at all times carried the very highest risk rating of '5' - to clients who had been assessed as having a 'low' or 'medium' risk tolerance level.

iv. Although the bank did make available a Product Suitability Checklist (a 'PSC') to assist relationship managers in conducting suitability assessments, Mr. Ho submitted that it was limited in scope and poorly designed and was not, therefore, capable of operating as an effective tool in making such assessments.

268. As to the need for an on-going review of risk ratings, Mr. Ho said that in the early part of 2008 there had been clear signs that the credit risk of Lehman Brothers itself had been significantly increasing, that is, the risk of the issuer itself being unable to meet its obligations under the derivative contracts. Despite this, said Mr. Ho, the risk rating of LB-ELNs had remained at '4' (medium risk) throughout the offering period of April to September 2008. It was submitted that, on balance, this revealed that the

bank had been prepared to 'sit' on the fact that Lehman Brothers was an investment grade issuer despite the prevailing turbulence.

269. As Mr. Neoh, for the bank, noted, it does not appear that the SFC was criticising the bank for any lack of ongoing review of risk ratings in general. The criticism related to an asserted failure to look to an increase in the risk rating of LB-ELNs only. As earlier indicated in this judgment, at the relevant time the bank did have a mechanism for review in place; it was limited, however, to the following: if an issuer of derivative instruments remained 'investment grade' that was sufficient and there would be no trigger pulled for a review. As submitted by Mr. Neoh, market volatility or share price and earnings fluctuations of an issuer cannot reasonably be used to drive the determination of product risk rating. If that was the case, there was the risk that product ratings would follow a roller coaster ride tied in with day-to-day market news and sentiment.

270. The Tribunal accepts that, when there is little or no turbulence in the market, relying on the investment grade of the issuer of a derivative product may well be sufficient. But, as earlier stated in this judgment, in times of very heightened turbulence – as was the case in mid-2008 – it may not be sufficient. There is nothing notable in the observation that banking institutions marketing investment products are required, in the interests of their clients, to have an understanding of the market, to be possessed of a certain nimbleness that enables them to give timeous advice. Yes, of course, what occurred in 2008 was in many respects unprecedented. But its seriousness was manifest, increasingly so, and that, on any reasonable assessment, must have alerted the financial professionals tasked with ensuring the integrity of the bank.

271. As set out above, it was further Mr. Ho's submission that the bank did not have in place a systematic and rational 'risk mapping' system. In this regard, reference was made to section 9 of the bank's Compliance Manual which provided that marketing staff should not make any recommendation to a client unless the recommendation was suitable for the client concerned having regard to that client's investment objectives, the degree of risk he or she was prepared to accept and other relevant factors. The compliance manual, however, said Mr. Ho did not provide guidance to relationship managers on how they should go about the business of accurately assessing suitability.

272. Mr. Ho submitted further that, even though, according to the bank, its general rule was that a client's risk tolerance level should be 'in line' with the risk rating of the product under consideration, that general rule was not set out in any written communication given to relationship managers. The degree to which it would have been adhered to by relationship managers would therefore have been entirely problematical, especially in a bull market with clients seeking maximum returns 'while the sun shone' : that is, of course, being particularly the time when relationship managers would have been under an obligation to give sober and prudent advice.

273. In this regard, Mr. Neoh, for the bank, accepted that that there was a general rule (or guide) that a client's risk tolerance level should be "in line" with the risk rating of the product in which the client was investing. This, he submitted, would likely have been told to relationship managers during their on-the-job training. Mr. Neoh acknowledged, however, that the bank had not produced any written communication to its relationship managers explicitly setting out the general rule (or guide).

274. It was Mr. Ho's submission that the term 'in line' was worryingly uncertain as to its true meaning; the phrase was capable of being interpreted in a very elastic manner. This uncertainty would have been compounded by the fact that during the relevant period the bank adopted a 3-level system to classify the risk profile of clients but presented relationship managers with a 5-level classification of product risk rating.

275. Mr. Neoh did not accept that relationship managers would have been left in a position of uncertainty. Whether a client's risk tolerance level was "in line" with a product's risk rating, he said, was a matter which relationship managers would have been able to assess, doing so on the basis of their professional knowledge, their professional judgment and general expertise. He said that there could be no hard definition or strict guidelines to determine the issue. Relationship managers sought to enhance the wealth of each client by having regard to that client's full portfolio and seeking the required balance within that portfolio. As such, "a rigid characterisation from which they should not be any deviation or leeway" was not feasible.

276. Mr. Neoh submitted that the bank did make use of a 'risk mapping' system. It was, however, a "fluid tool". While each relationship manager was required to determine suitability at a basic level by comparing a client's risk tolerance level with the risk rating of an investment product, that is, whether a client's risk tolerance level and the risk classification given to a product were "in line" with each other, that did not end the matter. More specific issues of suitability then arose. As Mr. Neoh put it, the results of risk mapping were not fully determinative. A client may wish to undertake a much higher risk in respect of a particular product or in respect of a particular part of their portfolio. In this event, the relationship manager

would have to exercise professional judgment to consider all the surrounding circumstances to determine whether the investment was appropriate.

277. It was emphasised by Mr. Neoh that the private banking model administered by the bank at the relevant time could not be looked at in the same light as retail banking models : in private banking clients demanded the 'holistic' approach. What had to be borne in mind at all times, he said, was that the general aim of investment management was to spread the risks of investment and balance the risks against return, private banking clients generally being interested in a wide range of products aimed at maintaining a diversified portfolio. As such, there would generally be a mixture of products with varied risk ratings. In this regard, Mr. Neoh made mention of the evidence of Mr. Herbert who, in the course of his testimony on behalf of the bank, said that, as a starting point, the suggested ratio of equities to bonds would be 70-30 in aggressive portfolios, 50-50 in balanced portfolios and 30-70 in conservative portfolios. But this of necessity constituted guidance only and could not be taken as some form of concrete parameter. In summary, said Mr. Neoh, there could be no "one-size-fits-all" approach adopted by relationship managers.

278. Mr. Ho accepted that in private banking the exercise of discretion was of importance, certainly in assessing the suitability of an investment product for a client. But that, he said, did not do away with the very real need for a systematic and rational risk mapping system, one that would give clear guidance to relationship managers in their determination of whether a client's risk profile allowed for the purchase of specific investments. This was particularly the case, he said, when clients with a conservative risk profile was seeking to purchase investment products with

a high risk rating or when, as happened, relationship managers were recommending high risk products to those clients. As it was, he said, the probabilities revealed that a lack of clear guidance which could be exercised with rational discretion gave far too great a freedom to individual relationship managers, each of whom would have different approaches to investments, many no doubt (especially in a bull market) willing to give more aggressive and persuasive advice.

279. At this juncture, the Tribunal pauses to note that General Principle 2 of the Code of Conduct (paragraph 3.4) directs that, when providing advice to a client, a registered person shall act diligently and carefully in providing the advice and shall ensure that its advice and recommendations are based on thorough analysis and take into account available alternatives : a directive, therefore, requiring adherence to a fairly vigorous process.

280. In light of this, Mr. Ho said that, despite the bank's counsel having made repeated reference to the need for a 'holistic' approach, the bank had not been able to give any substance to the rhetoric by pointing to any rational system, rational guidelines or controls, which would have enabled the bank to effectively supervise relationship managers by ensuring that they properly assessed the suitability of investment products for their clients. There was simply no framework, said Mr. Ho, to indicate how different factors ought to have been taken into account. Nor - and this was a matter of concern - was there any convincing evidence as to whether such matters had in fact been taken into account.

281. Considering the relevant evidence, the Tribunal accepts that, on a balance of probabilities, an effective system of the kind described in the

paragraph above was regrettably lacking at the material time and, as such, the bank fell below the standards required of it in the Code of Conduct.

282. In coming to this conclusion, the Tribunal has taken into account that the bank did have in place a document of limited use required to be completed by relationship managers; namely, the 'Product Suitability Checklist', a document which the Tribunal will consider shortly.

283. Central to Mr. Ho's submissions was the assertion that, if clear guidelines had been given, those guidelines would have resulted in a stricter adherence to due process in determining suitability, one that would have reduced the risk of clients with essentially conservative risk profiles taking on investment products that, having regard to their investment aspirations, carried an unwarranted risk rating. As the Tribunal understood it, it was Mr. Ho's submission that a worrying statistic – one that suggested deficiencies in the risk mapping process – was to be found in the fact that in over 80% of the bank's outstanding LB-Note transactions, there was an apparent mismatch between a client's risk tolerance level and the rating of the derivative product. It was the SFC case that, out of a total of 672 outstanding LB-Note transactions, the client's recorded risk tolerance level was 'low' in 63 transactions (all being LB-CDA transactions); it was 'medium' in 517 transactions (486 in LB-CDA and 31 in LB-ELN transactions) and was 'high' in 91 transactions (81 in LB-CDA and 10 in LB-ELN transactions). No information was available in respect of just one transaction. As it was put: "in other words, in at least 81.7% (549) of the outstanding transactions, HSBCPB had sold LB-CDAs (with the highest product risk rating of '5') to clients who [by reason of their risk profiles] could assume a low or medium level of risk only".

284. On behalf of the SFC, it was submitted that, in addition to evidencing apparent risk mismatches between the risk tolerance levels of clients and the risk rating of products sold to them, a consideration of the outstanding LB-Notes transactions revealed the following in respect of client portfolios :

i. As a percentage of their portfolios (designed to meet the investment philosophy of every client), the total LB-CDAs held by some clients exceeded the recommended maximum, the rationale for this being unexplained.

ii. Although the bank's own manuals said that relationship managers should not advise clients to have more than 5% of their portfolios in a single high risk product, in respect of some clients this limitation had not been adhered to, the rationale for this being unexplained.

a. Considering the bank's Structured Products Recommended List in respect of both LB-Notes and FAs

285. In addition, in respect of LB-CDAs – and FAs – it appeared that clients had been sold high-risk products marked 'no' on the bank's 'Structured Products Recommended List'. This list, which was compiled by an internal equity research team, was updated weekly and represented the bank's view on stocks and structured products appearing in the list. The list served as a guiding reference for relationship managers in recommending equities and structured products to clients. While items marked 'no' on the list were not stricken from consideration, it was the bank's own evidence that relationship managers should not discuss these products with clients

unless the clients themselves requested information on them. The evidence of Mr. Herbert, for the bank, indicated the following, namely, that relationship managers were obliged to consult the list before recommending any product and, if the product was given the negative marking of 'no', they were not to recommend it and were only to enter into discussions concerning it at the client's behest. As to trading in non-recommended items –

i. Concerning the sale of CDAs, in respect of 55 mismatch cases (and 9 other complaint cases), 33 cases – involving 38 transactions – involved the purchase of CDAs with underlying equities that were not recommended in the list or covered in the list. In only 5 of those transactions did the records reveal that it had been the clients who had initiated the transaction.

ii. Concerning the sale of FAs – the issue of FAs generally being looked at in greater detail later in this judgment – in ten of the 13 complaint cases clients had traded in FAs with underlying equities identified as not being recommended in the list or not being covered in the recommended list. In only three of the transactions did the records reveal that it had been the clients who had initiated the transaction.

286. As the Tribunal has understood it, it was never the SFC case that the bank had breached its regulatory obligations in allowing clients to invest in shares or structured products that were marked 'no' in the list or were not covered in the recommended list. It was rather the SFC case that the fault lay in the fact that the bank did not have systems in place to ensure that relationship managers referred to and followed the recommended list and, if the list was not followed, that the reasons were recorded. As it was

put by Mr. Ho, as relationship managers were not required to keep a record for not following the recommended list, the bank could not ensure that structured products (such CDAs and FAs) had only been sold to clients after the exercise of due diligence. In this respect, by way of example, Mr. Ho referred to a complaint lodged by Mr. RVJ who on 10 October 2007, on the recommendation of his relationship manager, purchased an FA linked to Merrill Lynch stock which at the time was marked 'not recommended' in the list. An investigation conducted by the bank itself reported that : "Internal Control was unable to ascertain on what basis the relationship manager recommended the related FA contract to Mr. RVJ as there was no voice log or other documentary evidence to support his recommendation."

287. The broad point made by the SFC was that, in respect of clients purchasing high risk structured products that exceeded recommended limitations in their portfolios or were not recommended in the bank's Structured Products Recommended List, the absence of any records to show the relationship managers had followed due process in the great majority of cases gave rise to a compelling inference that, in truth, in the absence of any clear processes, relationship managers have failed to engage in proper forms of assessment of product suitability, relying haphazardly on their own discretion.

288. It was Mr. Ho's submission that if, in accordance with clear guidelines given, relationship managers had made prudent assessments, discussing those assessments with the clients, there would surely be records of how in each case the process had been played out. There was, however, a stark lack of records. As Mr. Ho expressed it, even if there could in principle have been occasions on which a product would be suitable for a client despite a mismatch between that client's risk tolerance level and the

product risk rating, the bank had not provided any material evidence to show that there was in fact at the time a systematic and diligent consideration of relevant matters by the relationship managers. It did not appear that the bank had any system which required relationship managers to document and record the rationale and justification for why they considered that LB-Notes bearing the highest risk rating of '5' were suitable for clients who, according to the assessments of the relationship managers themselves, were only willing and able to assume a low or medium level of risk.

289. Mr. Ho emphasised that there were clear requirements for registered persons to document and record the rationale for providing recommendations to clients and to give a copy to the clients concerned.[33] The bank, however, had failed to comply with the requirements, a matter that took on extra gravity in respect of apparent mismatch cases. In these latter cases, said Mr. Ho, a mismatch clearly called for proper and systematic consideration as to whether the product was suitable for the client and, in the light of the decision made, for the issues under consideration to be recorded.

290. The SFC accepted that there might have been occasions when an apparent mismatch between a client's risk tolerance level and a product risk rating would be justified in light of the specific circumstances. The point made by the SFC was that the bank, when there was an apparent mismatch, was under a duty to demonstrate that it had ensured suitability of the product for the client at the relevant time. This, however, it had conspicuously failed to do.

[33] As set out in paragraph 51(iii) of this judgment, in a document dated 7 May 2007 issued by the SFC concerning the standard of documentation it was said that investment advisers should document – and provide a copy to each client – of the rationale underlying investment recommendations.

291. On behalf of the bank, Mr. Neoh said that, bearing in mind that the burden of proof would at all times remain on the SFC, the fact that no contemporaneous records could be produced did not mean that at the relevant time a record had not been kept. Nor did it mean that there had been no discussion as to suitability.

292. While, of course, the Tribunal accepts that the burden of proof – the civil burden - has at all times rested on the SFC, bearing in mind that the bank did produce numerous documents and gave extensive evidence through two of its senior officers as to the workings of relationship managers with their clients, it is puzzling that, if in fact there were contemporaneous records made by relationship managers (and shared with the clients) of the many decisions made to invest clients in apparent risk mismatch products, no such records should have been forthcoming. Yes, the events took place a considerable time ago but, when viewed in historical context, many signs would have presented themselves to the bank fairly early on to suggest that, if the records did exist, it would have been entirely prudent to make sure that they remained safely archived.

293. The Tribunal accepts that among the many 'apparent mismatch' cases there may in fact have been many that were not in fact mismatches. No attempt was made by the SFC to prove to the required standard that each and every case constituted an actual mismatch. As the Tribunal understands it, the submission made by the SFC was focused on the effectiveness of the bank's internal systems intended to govern services provided to clients by the bank in the sale of derivative products. Those services, it was argued, if they had been subject to clear and rational process following set guidelines in terms of which relationship managers were obliged to ensure that

derivative products purchased by clients had been the subject of reasonable advice and recommendation would surely – on balance at least – in most cases have resulted in some record setting out the rationale for the decision. The fact, however, that no such records are available must give rise to a real doubt as to the effectiveness of the systems that were in place at the time in binding relationship managers to set process. In the opinion of the Tribunal, it is a submission of some strength.

b. Considering the bank's Product Suitability Checklist form

294. This is not to say that the bank had no form of documented rationale related to the suitability of derivative products for clients. As stated earlier in this judgment, as part of its suitability assessment process the bank required all relationship managers to complete a Product Suitability Checklist form ('PSC form') for clients who were - for the first time - considering the purchase of structured notes either immediately or at some later stage. The PSC form would be completed by relationship managers in respect of *both* LB-Notes and FAs. In completing the form, relationship managers were required to select the type of products that had been introduced to the client and then answer a series of some seven questions.[34]

[34] As to a client's knowledge of structured instruments, a number of questions were contained in the form, the answers by the relationship managers being essentially (but not entirely) 'yes' or 'no' answers. By way of example, one question asked : have the features of each product selected above been explained to the client, either by phone or at a meeting with the client? Other questions asked whether the client understood how the product worked, whether the client understood the risks involved, the transaction size contemplated and matters of margin coverage. A final question asked : are you satisfied that the product proposed is suitable for the client in accordance with the risk tolerance level of the client profile? If no, please give reasons.

295. It was the bank's position that the PSC form (one of some age), while obviously it was improved in April 2008, was prior to that date nevertheless effective in ensuring product suitability.

296. In the view of the Tribunal, however, the form was of limited use and value in respect of the issues under consideration. It appears that it was only required to be completed when a client was contemplating the acquisition of one or more structured instruments for the first time. As Mr. Neoh himself put it, the form constituted "an indication of interest" by a client who may or may not trade. It was not, therefore, a document designed to record the rationale for each and every decision to acquire a structured instrument even though, on its face, that acquisition appeared to constitute a risk mismatch. In this regard, it is to be remembered that the bank's own 'holistic' approach to the giving of advice to clients was based on the assertion that portfolio weightings were not rigid; to the contrary, they were changing and essentially dynamic. In seeking an appropriate weighting for an investment portfolio, apparent risk mismatches may therefore have thrown themselves up, not simply when an expression of possible interest was being shown but at later stages too.

297. Aside from the fact that the PSC form was not designed to meet the obligation to record the rationale behind all sales of derivative instruments where, by reason of an apparent mismatch, an explanation was necessary, the SFC considered the use of the form to be materially defective. A number of reasons were given which may be summarised as follows :

i. It appears that the forms were completed by relationship managers who had no obligation to obtain confirmation from the client concerned as to the correctness of what was asserted.

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As the Tribunal would observe, whether therefore, by way of example, a client would have agreed that he or she understood how a derivative instrument – such as an FA (an accumulator) worked, as opposed to believing them to be profitable instruments, was far from certain.

ii. There was no limit to the number of products that could be covered in one form. It was often the case, even though the form was not designed for it, that more than 10 products would be selected in a single form, each product not only being different in kind but carrying various degrees of risk and, of course, 'working' differently. It was suggested by Mr. Neoh, for the bank, that, practically speaking, it should not make a real difference whether suitability of a dozen investment products was being recorded or one. The Tribunal does not accept that contention. The derivative instruments issued by Lehman Brothers which are the subject of this judgment each had their own distinctive internal workings and risk structures; there can be no suggestion that each client would have considered each instrument equally suitable.

iii. The relationship managers were not required to give *affirmative* reasons why they considered that any particular product detailed in the form was suitable for the client, not even if it was apparent that the client's risk tolerance level was not in line with the risk rating of the product (or products) detailed in the form and therefore, on initial consideration perhaps, not suitable. They were only required to give reasons if they believed that any product was not suitable.

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iv. The classification of a client's risk tolerance level in the form was given as 'low', 'balanced' or 'high'. Although, in the judgment of the Tribunal, this was not a major issue, it was a fact that these descriptions were different from the risk tolerance level classifications contained in the eCRM, namely, 'low', 'medium' and 'high'. It was the case of the SFC that the different description of the middle classifications ran the risk of creating confusion as to whether the risk tolerance levels were the same or were in some way different from each other.

v. It would appear that the bank did not have procedures in place to check the information in the form against the eCRM records. This, it was said by the SFC, would explain why it was that in some cases the client's risk tolerance level was stated as being 'balanced' in the form while in the eCRM records it was stated as 'low' : the two classifications, in terms of risk profile and investment aspiration, being of real difference.

vi. There were no procedures in place to review and approve the completed forms. The forms were submitted direct to the operations team, that team being responsible for setting up the relevant trading privileges.

298. However, as the SFC acknowledged, the form was revised in April 2008. The revised form allowed for one product only to be detailed and relationship managers were required to provide reasons why the product was or was not suitable for the client. In addition, it was necessary to record the fact that relevant product documentation had been provided to the client.

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As an additional safeguard, the approval of the relationship managers' team head was required when the client was regarded as being a 'vulnerable customer'[35] or if the risk rating of the product was '4' or '5'. While the Tribunal acknowledges that these improvements to the form were of importance when a client initially expressed an interest in acquiring structured instruments, for the reasons already given, it has remained of the view that the form itself was of very limited value in ensuring – on an on-going basis – effective systems governing risk suitability of complex derivative products for clients.

299. It was further emphasised by Mr. Neoh, on behalf of the bank, that the SFC appeared to have failed to give any recognition to the bank's continued efforts, both during and after the relevant period, to enhance its existing client and product suitability controls. Put simply, at all times, the bank itself was looking to improve its internal control structures and was not simply 'sitting on its hands'. In the opinion of the Tribunal, while a point of importance, it is one that goes more to the issue of appropriate sanction.

(C) Inadequate monitoring mechanisms at the point-of-sale to ensure product suitability

300. In its statement of proposed disciplinary action dated 23 March 2015, the SFC came to the provisional finding (later confirmed) that the bank had failed to put in place effective monitoring mechanisms at the point-of-sale or thereafter - a form of final safety gateway - to ensure that relationship managers had met their obligations to ensure, in respect of each and every client, suitability of product. The SFC commented that it

[35] A 'vulnerable customer' included a client aged 75 years or above, unsophisticated clients or those who may not be able to make independent investment decisions on complex investment products and had to rely solely on the bank for advice.

appeared from the evidence that the bank had simply relied on the relationship managers to ensure suitability, this despite the fact that :

i. The relationship managers had been permitted to sell LB-Notes to clients even though those clients' risk profiles - their risk tolerance levels - were not consistent with the product risk rating.

ii. It appeared that relationship managers had not been under any actively pursued obligation to document the reasons why, despite an apparent risk mismatch, they had recommended LB-Notes as being suitable.

iii. No internal approval by the bank's management had been required before a client with a 'low' or 'medium' risk tolerance level was able to trade in derivative products carrying the highest risk rating of '5'.

iv. Although there was supervision of relationship managers by team heads, this was mainly by way of post-transaction review and heavily dependent on individual judgment.

301. These assertions were not accepted by the bank, certainly not the assertion that apparent risk mismatches should be assessed on a one-to-one basis. As it was put by Mr. Wynd during the course of his testimony, risk mismatches should be assessed on a portfolio basis. There

would not be a risk mismatch in his opinion "if the value of the investment is proportionate relative to the overall distribution of the portfolio"[36].

302. Mr. Neoh supported this approach, submitting that the SFC appeared to be under a misconception as to the bank's overall approach in relation to suitability assessment. It was important to stress, he said, as Mr. Wynd had done, that specific risk matching – one-on-one – was *not* a determinative factor in suitability assessment. Suitability assessments involved a consideration of all relevant factors – the 'holistic' approach – including a client's investment philosophy, investment objective, his or her portfolio composition and tolerance for risk.

303. It was not the bank's approach, therefore, to work on the entirely mechanical basis that if there was an apparent mismatch between a client's risk tolerance level and the risk classification of a particular product, that fact alone somehow demanded a review. Private banking required a more sophisticated, nuanced approach.

304. It was an interesting fact, said Mr. Neoh, that clients only complained after the bankruptcy of Lehman Brothers and not, while they were receiving the coupon payments on their derivative notes. Very few complained of risk mismatch. The complaints, he said, were largely why Lehman Brothers counterparty risk had not been explained to them or why no action (or more vigorous action) had been taken to recover the amounts due to them in the bankruptcy proceedings.

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[36] Mr. Wynd explained his position by stating : "if you have 10% of your portfolio in high risk products, in products rated 5; 10% in products rated 1; 80% in products rated 3, obviously, the weighted average risk is 3 of the product risk. If the value of the high risk product doubles then your weighted average product risk rating moves above 3 and you might consider re-balancing."

305. Of course, whether suitability of product was to be assessed on a one-on-one basis or on a portfolio basis, the SFC's assertion that the bank had failed to put in place effective monitoring mechanisms at the point-of-sale did not lose its strength. In this regard, it is notable that in 2008, an internal audit considering the bank's investment suitability controls commented that there was no systematic monitoring at the point-of-sale to ensure that products sold to clients were consistent with their investment profiles.

306. Nor can it be said that the bank staff worked only on investment portfolio weightings as opposed to consideration of the purchase of individual, high risk products. In this regard, in the SFC's Notice of Proposed Disciplinary Action, an email from a member of the bank's ORIC monitoring team to a relationship manager was cited, this email very clearly referring to a single product although, not having had the opportunity to review all surrounding documents, the Tribunal accepts that it may have been within the context of a general portfolio weighting. The email read :

> "As the product purchased by the client is with internal risk rating of 4 to 5, which is classified as high risk product. As noted from eCRM, the client's risk tolerance is low and is very prudent in making investment decision, which is not consistent with this investment. Please assess client's suitability and review the client's profile and update it necessary in order to better reflect the client's investment appetite."

307. These factors appear to have been accepted by Mr. Neoh who submitted that in any event the bank had at all relevant times had comprehensive monitoring systems in place.

308. What first had to be recognised, said Mr. Neoh, was that the bank had in place a governing management structure which enabled it to comply with applicable regulatory requirements, a fact which the SFC appeared to have ignored. By way of example, the Executive Committee, the highest level of governance, considered all aspects of the private banking business including compliance with regulations while the Risk Management Committee had responsibility for ensuring that the private banking business operated within the appropriate risk parameters: operational, legal and regulatory.

309. At the banking level itself, there were comprehensive manuals and guidelines to be referred to by bank staff which gave guidance as to compliance with the principles set out in the Code of Conduct. These publications, it was said, were reviewed and updated periodically. They included the Private Banking and Trustee Functional Instruction Manual; the Private Banking Operations Manuals and the Guideline on Suitability Obligations.

310. As to the day-to-day supervision of bank staff, it was emphasised that all relationship managers were required to be licensed in respect of the activities they undertook. They were fully trained in respect of the appropriate compliance systems; there were not ignorant of them. Relationship managers worked under the supervision of team heads who were themselves accountable for the activities of their teams (each containing 6 to 8 relationship managers). The team heads would exercise this supervisory authority on a day-to-day basis by way of oversight, this including review of ‘system generated exception reports’ and attending meetings with clients to discuss (together with the relationship managers) appropriate investment strategies.

311. Concerning the system of supervision by team heads, two principal criticisms were levied by the SFC. First, this second line system was an unsatisfactory system because inevitably transactions were only reviewed after execution and, second, in the absence of clear and cogent guiding controls, it was heavily reliant on individual judgment.

312. As to the first criticism, it appeared to be accepted that invariably, unless a team head was at the actual meeting when a client was considering the acquisition of a high risk product, the transaction would be concluded by the relationship manager. There appeared to be no system in terms of which risk mismatch cases (however judged), having been agreed between the relationship manager and client, were not first put before the team head for endorsement : that being (on its face at least) a relatively straightforward system for ensuring at the point-of-sale the suitability of product. The following short exchange between the Chairman of the Tribunal and Mr. Herbert illustrates the point :

> "Chairman : All right. So what the second line could do then was to say "we need to mitigate any future possible loss by perhaps reformatting the portfolio a little". But the deal would have been done.
>
> Mr. Herbert : Yes, the deal would have been done, and if that was picked up by the team head or the second line, then obviously a discussion would happen around the portfolio in terms of engaging the client."

313. As to the second criticism, namely, the overdue reliance on individual judgment, the issue is somewhat more difficult. As continually emphasised on behalf of the bank, private banking demanded a close working relationship between relationship manager and client and, to a

lesser degree, between client and team head. The driving force in this 'holistic system' was judgment. But, as the Tribunal has said earlier, without clear guidelines (albeit guidelines that permit discretion), there is no structure. Clear guidance protects both the client and the bank.

314. As to the existence of specific systems designed to ensure suitability of product when the point-of-sale was reached or thereafter – this appearing to be the essential focus of the SFC complaint – it was the bank evidence that internal checks were conducted by the Operation Risk and Internal Control team ('ORIC') and essentially consisted of the following :

i. From March 2007, there was a sample review of taped conversations, these conversations being randomly selected to ensure that handling procedures had been properly performed.

ii. On a quarterly basis in 2006 and on a monthly basis in 2007 and 2008, the ORIC team had operated by randomly reviewing 20 samples across all high risk securities, the purpose being to ensure that clients' investments were in line with their risk profiles, their investment experience and their investment objectives. In April 2008, the scope of this review had been broadened to include checking taped conversations in order to ensure that relationship managers had clearly communicated details of the nature of high risk securities and had spelt out the risks associated with their purchase.

315. It was the SFC case, however, that these suitability reviews were not effective and would not have enabled the bank to discharge its

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'suitability' obligations in respect of the sale of high risk investments. In this regard, the SFC was of the view that the basis for choosing the samples for suitability checks was too narrow. This was based on an interview with a member of the ORIC team[37] who said that she only selected transactions involving high risk products for review.

316. In carrying out the reviews, the ORIC team relied on information (including a client's risk tolerance level and portfolio strategy) as those details appeared in the eCRM, that information not being subject to any independent verification. This was despite the fact that the information had been put into the eCRM system by the relationship managers "without the client's knowledge and written acknowledgement".

317. In determining whether a client's risk profile was inconsistent with a particular investment, it appears that the ORIC team would only find it to be so if there had been a purchase of a high risk product by a client whose portfolio strategy (as recorded in the eCRM) was 'conservative' or whose risk tolerance level (as recorded in the eCRM) was recorded as 'low'. However, the purchase of high risk products by clients with a recorded 'medium' risk tolerance level, or a 'balance' portfolio strategy would not be considered exceptional despite the apparent mismatch and the lack of any written justification.

318. Where the member of the ORIC team considered that a product purchased was not in line with the client's risk tolerance level, the relevant relationship manager would be asked to review the client's risk profile and to update it if necessary. It appears that no independent investigation into

[37] The member of the ORIC team being a Ms. Jofi Chan.

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such cases was conducted to determine whether there had been any mis-selling activities and/or non-compliance with relevant internal policies or regulatory requirements.

319. As for the 'sample' tests carried out by the ORIC team, it was the SFC case that, having regard to all the circumstances, these tests were simply inadequate. Put another way, they were not comprehensive or rigorous enough to make up for the inadequacies already integrated in the bank's internal monitoring and control systems.

320. In 2008, the bank's Group Financial Services and European Audit carried out an internal audit, covering a thematic review of the bank's investment suitability controls and monitoring systems. The audit identified a number of weaknesses including –

i. Clients were not informed of the content of their investment profile, in particular the risk grading assigned to them by their relationship manager.

ii. There was no systematic monitoring at the point-of-sale to ensure that products sold to clients were consistent with their investment profiles.

iii. The review and oversight of the daily report detailing all transactions in high-risk products by the Platform Manager was not formally evidenced. In addition, the review of this document by the Platform Management was not included as a requirement in the local procedures.

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iv. There were no system-generated exception reports to facilitate the monitoring of any mismatch between a client's investment risk profile and the current composition of their investment portfolio.

v. The record held confirming that the relevant product literature had been provided to the client did not require the relationship manager to record the details of all product literature that had been provided and the date on which that literature had been given to the client.

vi. Client statements did not highlight where there was a mismatch between the client risk grade and the risk grading of investments in the portfolio. In addition, they did not remind clients of their stated portfolio strategy and risk tolerance level.

321. It was the SFC's assertion that these audit findings were consistent with its own findings, the effect being that the bank had not implemented adequate and effective monitoring and control mechanisms to ensure that LB-Notes were sold in accordance with regulatory requirements.

322. On a consideration of all the evidence, the Tribunal is satisfied that in the period under review, in its marketing and sale of LB-Notes, the bank's internal processes designed to ensure the interests of clients were materially flawed. They were flawed, first, in the fundamentally important process of understanding each client's true risk profile; second, in the process of ensuring suitability of product for each client and, third, in the process of supervising and monitoring sales process in order to detect and

avoid risk mismatch. The Tribunal is further satisfied that this systemic failure put each client unjustifiably at risk.

III. The FAs issue - again, failing to ensure suitability of product for bank clients

323. In several ways, the scope of the matters raised under this heading may be described as a sub-set of the second LB-Notes issue. It was emphasised by Mr. Ho, in the course of his submissions for the SFC, that the clients of the bank who purchased FAs - forward accumulators - were dealt with under the same general internal procedures as clients who purchased LB-Notes. Indeed, as the Tribunal understands it, there were clients who purchased both LB-Notes and FAs. Accordingly, said Mr. Ho, the systemic failings earlier identified, for example, the failings to identify the risk profile of clients, applied equally to those clients who purchased FAs.

324. As stated earlier in this judgment, following an investigation by the HKMA 13 complaint cases related to the purchase of FAs were referred to the SFC. According to Mr. Ho, an examination of these 13 complaint cases by the SFC revealed further failings, these being specific to the marketing and sale of FAs. As Mr. Ho expressed it, that was why the FA matters had been dealt with separately.

325. The systemic failings specific to the marketing and sale of FAs may be summarised as follows. First, a failure in the 'know-your-client' process, specifically, a failure to reliably estimate the net worth of clients seeking to purchase FAs; second, a failure to ensure that clients had sufficient net worth to assume the risks of purchase of these particular products and were not overly exposed; third, a failure to ensure suitability of

product for the clients and, fourth, that the relationship managers explained the key features of FAs and, importantly, made clear the inherent risks embedded in them.

(A) A failure to reliably estimate net worth

326. In the view of the Tribunal, having an accurate understanding - or at the least an *agreed* understanding - of a client's net worth would have been fundamental to the proper discharge of the bank's obligations when marketing forward accumulators to that client. FAs have many working parts but it is only necessary to briefly mention three which, in a declining market, can be the cause of very considerable losses to an investor, losses that can reach out and destroy that clients' broader financial worth. First, the investor is obliged to continue accumulating the underlying stock at the agreed strike price even if the prevailing market price is trading below the strike price and the investor is therefore purchasing every share at a loss. Second, while the issuer is able to terminate the contract if the underlying stock rises to an agreed level (the knockout price), the investor is obliged to hold the contract until maturity which may be many months ahead[38]. Third, potentially the most damaging feature of all is that the investor is obliged to continue purchasing at a loss on a leveraged basis : by way of illustration, to purchase double the amount of stock in each period when the contract requires the underlying stock to be acquired.

327. On this basis, assuming (for illustration only) that, in a sharp decline in the market, the underlying equities in an FA were reduced in value by half, it would mean that the investor, obliged to pay the strike price, would be purchasing those equities in every period at double the market

[38] Contracts can be unwound but it is never guaranteed and the cost factors can be very high.

price. In addition, he would be obliged to purchase on a leveraged basis, say, double the amount of stock in each period. Nor could the investor simply cancel and walk away. As stated earlier, unwinding, while possible, was never guaranteed and was a very expensive business. Assuming no recovery of the market or, worse, a further decline, unless able to unwind, the investor would be faced with growing losses each month through until the end of the contract. Without the broader net worth to meet those growing losses, the investor could find himself or herself in the gravest difficulty. Hence the critical need for a clear and rational understanding of the net worth of the investor.

328. How was the net worth of a client assessed? As indicated earlier in this judgment, this was essentially the job of the relationship managers. They would estimate a client's net worth by evaluating the information that was given to them or which, by some collateral method, came into their possession. Estimation of net worth was not an exact science. For a start, clients were not always prepared to provide a balance sheet of their total net worth - for example, the nature and extent of any debts they may have - and their privacy had to be respected. Often clients were multi-banked and invariably there would be different classes of assets held, for example, property both in Hong Kong and outside of Hong Kong. There was no guarantee that estimates of their value, if given, would be accurate.

329. As Mr. Neoh put it, private banking clients, with sizeable net worth, would not, on any given day be expected to know or be able to provide a concrete figure of what they were worth. In the result, it is clear that net worth estimation – as part of the bank's 'know-your-client' process

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– had to be built on often partial information provided by the clients amplified by other relevant information as and when it became known.

330. In building up a profile of net worth, it was said that relationship managers had to use their judgment, looking to such matters as a client's trading behaviour or the amount of funds coming into an investment portfolio on a regular basis.

331. However – and here, in the view of the SFC, lay a fundamental failing – it was not mandatory for relationship managers to discuss and agree their estimated net worth with the client, nor even indeed to inform the client of their estimation.

332. It was the SFC case that this failure to confirm net worth was contrary to the provisions laid down by the SFC in a document issued in April 2003 titled : 'Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the SFC'. In section VII of the document under the heading 'Operational Controls', it was said that effective policies and operational procedures and controls were to be established, ensuring, among other matters, the maintenance of proper records and the reliability of the information contained in those records. More particularly, the first control guideline provided that :

> 'Management establishes and maintains processes to obtain and *confirm* information regarding every client in relation to establishing the true identity of the client, the beneficial owner(s) and person(s) authorised to give instructions; and the client's financial position, and investment experience and objectives prior to the establishment of an account." [emphasis added]

333. The bank, which accepted that relationship managers were under no obligation to confirm their estimation of net worth with the client, submitted that the guideline left the 'modality of confirmation' to the bank itself. It would be unduly burdensome, it was said, if the bank was expected to "audit and verify" the net worth of each client. As it was, the role of the bank in the 'know-your-client' process lay in 'capturing the information' and ascertaining that the information was correct. This amounted to a form of 'confirmation'.

334. The Tribunal accepts that confirmation of information may, depending on the circumstances, take different forms. But the Guidelines nevertheless make clear that there must be some form of confirmation and in the present case it would seem to beg the question : how, having 'captured' information as to estimated net worth, were relationship managers to ascertain that it was in fact correct unless (invariably) they were to return to the source of the information, that is, the client, to confirm that the individual valuations and the overall estimation were correct. Confirmation was not to be found in simple self-belief of accuracy. As the Tribunal understood it, it was never the SFC case that relationship managers were under an obligation to conduct some sort of 'audit' of a client's net worth. The obligation was less stringent but no less important. It was the SFC case that what had been required was a structured process, one that relationship managers were obliged to follow, in terms of which, having made their assessment of net worth, they would contact the client, advise him or her of the estimation, discuss matters (for example, as to whether there had been omissions or miscalculations) and then agree the figure of net worth. Whatever the management 'custom' may have been at the time, in the view of the Tribunal, when considering the acquisition of an accumulator, a structured process to this effect was essential. Agreed estimates, whether

objectively they were entirely accurate or not, would at least have been settled estimates, the result of a meeting of minds of the client and the relationship manager.

335. In the course of his submissions, Mr. Ho emphasised that, on the basis of extensive interview evidence, it appeared that, not only were relationship managers under no obligation to confirm their findings with their clients, they were not even provided with guidelines, objective criteria or specific training for the purposes of carrying out their unilateral exercise. Determining net worth therefore was based on the experience of each individual manager who would, of course, liaise with team heads and other superiors.

336. A stark example of the potential for fundamental misunderstandings in the absence of a confirmation process was raised by the SFC in its Notice of Proposed Disciplinary Action, that being the complaint of Ms. SK. In estimating Ms. SK's net worth to be US$12 million, her relationship manager incorporated a number of purely subjective assessments, more particularly, first, that she should have inherited from her deceased father a sum equal to that received by her sister who was also a client of the relationship manager and, second, that, as she was married to a member of a very rich and influential family in Hong Kong, the husband must surely have given her considerable sums of money. The relationship manager did not confirm either of these matters with the client. According to the SFC, had confirmation been sought, the relationship manager would have discovered that Ms. SK had separated from her husband, who in any event, was not a member of the family identified by the relationship manager. According to Ms. SK, she had no knowledge of her relationship manager seeking to identify her net worth. As it was, she said, her total net

worth at the time had been approximately US$8.97 million, US$3 million less than the estimate of the relationship manager.

337. Mr. Ho submitted that, in addition to the matter of Ms. SK, there were other examples to be found in the details of the 13 complaints in which there was a material divergence between the true net worth of a client and the net worth assessed by the bank. By way of example, in his interview with the HKMA, Mr. ALC, who had been educated up to primary school level in the Mainland and was 83 years of age when he opened his account with the bank, said that at the time of opening his account his total net worth had been approximately US$2.8 million. His bank records, however, estimated his net worth at US$6 million (with US$4.5 million being liquid net worth). Between 2003 and 2007, Mr. ALC had entered into a total of 54 FA and 48 CDA contracts.

338. In his submissions on behalf of the bank, Mr. Neoh said that the misunderstandings in respect of Ms. SK had constituted an isolated example. In respect of other examples, he disputed their accuracy. The Tribunal accepts that disappointed clients lodging complaints several years after they had opened their accounts or had acquired FAs would be labouring under the frailties of memory and would perhaps be tempted to embellish the nature and extent of their complaints.

339. In the view of the Tribunal, however, it is not necessary to determine the accuracy of each and every example of a misunderstanding as to total net worth put forward by the SFC. That there should have been conflicts as to the bank's assessment of net worth is of itself a persuasive indicator that the system employed by the bank lacked effectiveness,

particularly in failing to obtain confirmation of each client's net worth assessments after they had been computed.

(B) A failure to ensure clients had sufficient net worth to assume risks of purchase and were not left over exposed

340. Paragraph 5.3 of the Code directs that a registered institution providing services to clients in derivative products must ensure not only that the clients understand the nature and risks of those products but that they have sufficient net worth to be able to *assume* those risks and to bear the potential losses.

341. The word 'assume' means to 'adopt' or 'to take up' and, as such, in the context of paragraph 5.3 of the Code, suggests that, in the present case, the bank had an obligation to assure itself that clients not only understood the nature of FAs and their inherent risks but that they had sufficient net worth to be able to take up, that is, to purchase, these derivative instruments and, in the event of a decline in the value of the underlying equities, to bear the (accumulating and leveraged) losses.

342. The bank's relationship managers would (or should) have been aware of the very particular risks inherent in the acquisition of forward accumulators and the need therefore to ensure that, in accordance with paragraph 5.3 of the Code, clients considering assuming the risks inherent in forward accumulators had sufficient net worth to bear the losses that would arise if the value of the underlying stock fell very significantly, such losses being capable of reaching out and enveloping the client's other assets.

343. For reasons set out more fully later in this judgment, it was the bank's evidence that, because of the particular nature of forward accumulators, it did not have in place at the relevant time any precise measure or set of parameters in order to estimate the potential exposure of clients contemplating acquisition. Instead the bank relied on the relationship managers to exercise their professional judgment, adopting a holistic approach. As it was put by Mr. Herbert on behalf of the bank when asked about the issue of concentration of potential risk :

> " … a prudent relationship manager, in my experience, would look at that as part of the overall portfolio. I admit you wouldn't know the exact deliverable [under an FA contract] but the fact there's an underlying would bear some reference in the conversation. You know, they weren't expected to do that with policy but I think in good practice certainly the best relationship managers would do that in terms of the advice they give to clients."

344. In short, as the Tribunal understands it, there was no policy in place at the time in terms of which relationship managers were required to give to clients considering acquiring forward accumulators a quantitative assessment of potential risk.

345. As pointed out by Mr. Ho, for the SFC, however, this approach was problematic. If it was the bank's obligation to ensure that clients had sufficient financial resources to bear any potential loss before they entered into a transaction to acquire one or more forward accumulators, surely some clear quantitative methodology should have been employed. It was the responsibility of the bank to ensure that clients understood the level of potential risk that they were assuming.

346. In presenting its case, the SFC itself used as a primary metric of measurement the concept of 'maximum notional exposure' : MNE. This was on the basis that the maximum notional exposure under a forward accumulator was determinable at the time the client was ready to enter into an acquisition. Mr. Herbert described this as being a worst-case scenario calculation, a calculation that assumed that the contract was held to maturity and that the underlying equities had dropped in value to zero.[39] It was therefore an artificial calculation, especially when the underlying equities in a contemplative forward accumulator were blue-chip. It was simply never likely to happen.

347. Perhaps not. But, as Mr. Ho emphasised, MNE, being determinable immediately before a client entered into an acquisition, could be used as a quantitative measuring device for what the bank considered to be the maximum potential exposure. As the Tribunal understands it, it was never the case that the bank should have employed the concept of maximum national exposure to the exclusion of all other quantitative methodologies.

348. That said, it appears that the concept of maximum notional exposure was used at or about the time under consideration by the bank's Credit Department in approving a client's credit proposal. It also appears that since 2010 the bank itself has adopted the concept of maximum notional exposure to impose a limit on the maximum amount which clients can invest in forward accumulators.[40]

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[39] Maximum notional exposure is calculated in the following manner. It equals (strike price) x (number of shares per day) x (leverage ratio) x (number of remaining days).

[40] In this regard, during the early investigations, the bank informed the SFC that "in response to changing market conditions, the Bank issued credit policy in 2010 which has stipulated that the maximum amount that a client can invest in forward accumulators should not exceed 100% of the client's AUM maintained with the bank.

349. During the course of submissions, it was submitted on behalf of the bank that a more accurate barometer of potential loss was to employ marked-to-market – MTM – values. The utility of this metric of measure will be considered a little later. At this juncture, it suffices to say that, as accepted by Mr. Herbert for the bank, an MTM loss can only be incurred *after* a client has entered into a forward accumulator transaction. It is therefore essentially a post-transaction metric of measure.

350. In the circumstances, in considering the broader (and more general) issues of asserted systemic failures, the Tribunal considered that the use of MNE as a measuring device was of value.

351. The SFC came to the view that the MNE of the forward accumulators that had been acquired by each of the 13 complainants, when compared with the total value of assets held by each of them with the bank, that is, when compared with each client's assets under management ('AUM'), put each of the complainants in a position of being potentially very materially over exposed. In this regard, the SFC produced the following table to show, in respect of each of the 13 complainants, the degree to which the maximum notional exposure in the FAs purchased by them exceeded their assets under management. The table, it was said, showed that the maximum notional exposure in respect of each of the 13 complainants exceeded their assets under management by 135% to over 400% –

Outstanding MNE/AUM (%)	*Number of cases*
300% - 430%	3
200% - 299%	7
100% - 199%	3

352. In challenging the assertion that the 13 complainants had been put into a position of being potentially very materially over exposed, Mr. Neoh, for the bank, challenged the concept of the need at the time for any form of precise and formulaic calculation to be employed by relationship managers. Bearing in mind the nature of private banking, he said, determining suitability, demanded not a bare mathematical approach that would present the client invariably with a stark and entirely artificial spectre of exposure, but a more realistic approach, one encompassing a number of interlinked processes and one that took into account all relevant factors; in short, what had always been required had been professional assessment.

353. The bank's policies, said Mr. Neoh, required relationship managers to advise clients to maintain diversified investment portfolios and to avoid concentrating on particular financial products. However, with respect to each client, the level of diversification and exposure to particular products depended on a number of factors, each of which had to be put into the balance. These included a client's risk tolerance, investment objectives and other personal circumstances. In accordance with the guidance given by the bank, marketing team heads and relationship managers were expected to exercise their professional judgment and to adopt a holistic approach.

354. This was not to suggest, said Mr. Neoh, that the bank had no systems in place. Every client, who wished to trade in FAs had to obtain a credit line, each line being approved and monitored by the bank's Credit Department. Assets in the client's investment portfolio with the bank had to be pledged to the bank as collateral for the credit extended to the client. The client's credit line and the nature and value of the investment portfolio were kept under constant monitoring by the Credit Department as an investment trading line (an ITL).

355. The amount of credit available to a client at any one time to purchase an FA would be a fraction of the marked-to-market value of the client's investment portfolio with the bank. By way of example, said Mr. Neoh, a blue chip stock may have an advanced ratio of 70%, the collateral value being given to that stock being 70% of its market value. In addition, an asset concentration 'haircut' would be applied if the collateral for one security represented more than 25% of the total portfolio.

356. Mr. Neoh accepted, it would seem, that a key consideration – but not the only one - in determining the value of any credit line advanced was the estimated net worth of the client. This was, however, and was always acknowledged to be, an estimate only. The Credit Department had on a number of occasions challenged the reasonableness of estimated net worth figures and had revised down the value of the ITL sought by the client. In addition, said Mr. Neoh, the Credit Department would take the initiative once a year to review the ITLs of every client and, if considered appropriate, would propose a reduction in their value.

357. By way of further protection, said Mr. Neoh, a smaller ITL was always granted initially and would only be revised upwards once the Credit

Department had gained a better understanding of the nature and extent of the client's assets and trading history.

358. In addition to the need to obtain an ITL, any client who wished to trade in FAs had to pledge all the assets in his or her investment portfolio with the bank and, when the transaction took place, an initial margin requirement was put in place. The amount of the initial margin - a pre-assessment by the bank of the potential loss in value of the underlying equities[41] - depended on the nature of the underlying stock. For each FA contract with blue-chip underlying equities, 15% would be required; for mid-cap stocks 30%. This initial margining requirement, submitted Mr. Neoh, placed a cap on how much a client was able to invest in an FA and was itself, therefore, a form of control.

359. Once an FA had been purchased, the contract would be valued daily on a marked-to-market (MTM) basis. If, during the currency of the FA, the market price of the underlying stock closed below the strike price, the client would have to provide additional margin to cover the MTM loss.[42] That being the case, the collateral value in the client's account would have to be maintained at a level sufficient to cover the initial margin and, in the event of MTM losses, those losses also.

360. It was the SFC case, however, that these measures had proved to be ineffective. In the course of his submissions, Mr. Ho summarised the grounds upon which the SFC had identified culpability on the part of the bank :

[41] As to this description, see Mr. Neoh's closing submissions : paragraph 476.

[42] As to the formula for calculating the MTM loss, see the footnote 14 to paragraph 122.

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i. The bank had determined not to apply the standard limits which it used to review its clients' concentration risks on the basis that they were not appropriate when dealing with FA transactions. However, the bank had failed to put in place any suitable alternative structured measures (not necessarily a single precise formula) to ensure that relationship managers would have due regard to the financial capabilities of clients and the risk of over exposure when marketing and selling FAs to them.

ii. The bank's contention that its credit system and margin policies prevented clients from being over exposed was flawed.

iii. The bank's argument that the marked-to-market value of FAs should be used as a relevant barometer rather than a test of maximum notional exposure was also materially flawed.

iv. Reviews of the portfolios of the 13 complainant's gave clear indications that all of them were over exposed and did not have sufficient net worth to bear the risks inherent in trading in FAs.

361. The bank's Operations Manual[43] set out guidelines to assist relationship managers (and other bank staff) when reviewing clients' concentration risks. These guidelines included the following :

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[43] In force at the relevant time.

i. A client should not be advised to have more than 10% of his portfolio in any single stock, bond, fund or structured product.

ii. Exposure should be limited to no more than 5% of the portfolio. If the investment was considered to be high risk.

iii. If the purchase did result in a concentration above these percentages, relationship managers should advise the client of that fact : overexposure to one single investment carrying the risk that a market downturn may cause a significant decrease in the client's total assets under management.

iv. If the client did choose to invest more than 10% of his or her portfolio in any single stock, bond, fund or structured product, the relationship manager should then prepare a report in the eCRM documenting the fact that the client had been advised of the risks but had nevertheless made the decision to purchase.

362. However, according to the bank, these guidelines did not (during the period under review) apply to the marketing and sale of FAs. This was because, in the view of the bank, it was not possible before the commencement of a forward accumulator contract to determine the quantity of the underlying equities that would be delivered to the client's account in terms of the contract. By reason of the observations set out earlier in this judgment concerning the inherent risks in FAs, outcomes were inherently contingent. In the result, concentration levels could not be calculated until the underlying stock had actually been delivered.

363. While obviously, in respect of any individual forward accumulator contract, it was not possible to determine the quantity of underlying equities that would be delivered to the investor's account during the currency of the contract, the requirement of paragraph 5.3 of the Code directed the bank to assure itself that the investor had sufficient net worth to assume, that is, to take on, the contract. The bank was required to make the assessment, therefore, prior to the transaction taking place. Once the transaction had been concluded, then, whether the client had sufficient net worth or not, he or she was already committed and subject to the risks of the transaction.

364. Mr. Herbert, for the bank, said that the relevant bank manual[44] had directed that no client should be advised to have more than 10% of his total portfolio in any single stock, bond, fund or any single structured product. In respect of a structured product (such as an FA), the value at risk of the product - that is the marked-to-market value of the product at any one time - should not exceed 10% of a client's portfolio. Mr. Herbert accepted, however, that there was nothing contained in the relevant manual to the effect that, prior to the sale of an FA, relationship managers should have regard to concentration of risk assessed according to some system incorporating marked-to-market values. Marked-to-market values, as he accepted, could only come into play after the forward accumulator contract itself was in play.

365. In light of this, it was Mr. Ho's submission that over the relevant period the bank, as a matter of policy, had not adopted any measure

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[44] The Private Banking and Trustee Functional Instruction Manual

to assess the exposure of clients to the risks inherent in FA transactions *before* such transactions were concluded.

366. As to the safeguards provided by requiring all clients who wished to trade in FAs to first obtain an investment trading line – an ITL – and agree to pledge their full investment portfolio held with the bank as collateral, Mr. Ho submitted that this process was fatally undermined by the fact that there was no effective system in place to ensure that the key consideration in determining whether to grant an ITL, namely, the estimated net worth of the client, was reliable. The fact that the estimations of net worth compiled by relationship managers were never, as a matter of policy, confirmed by the clients gave rise to the real risk that the clients' net worth may be overestimated. As it was, said Mr. Ho, the evidence showed that there had been material over estimations in a number of cases.

367. In the opinion of the Tribunal, even if the individual cases cited by the SFC are open to question, when considering the integrity of the systems in place, there had to be at least a real danger of over estimations. That in turn created a real danger of allowing clients a much larger line of credit that, in truth, they should have been granted, that itself constituting at least a potential for over exposure.

368. That the Credit Department had to rely on the estimations made by the relationship managers and had no means of independently corroborating those estimations was accepted by the bank. As Mr. Wynd put it, members of the Credit Department would question the estimation of a relationship manager if they had concerns but had no means of independent verification. Again, therefore, so much depended on the professionalism of the individual relationship managers.

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369. In respect of the bank's assertion that the ITL acted as a measure of control to protect clients from over exposure, Mr. Ho advanced the collateral argument that, apart from the uncertainty of the reliability of the estimations of net worth, it was unclear how exactly the bank determined the amount of a client's ITL with reference to that client's estimated total net worth. There did not appear to be any quantitative formula in place, he said.

370. In order to support his contention that the granting of ITLs was a defective control mechanism, Mr. Ho said that, in respect of the 13 complainants, the records revealed that the ITLs approved by the bank's Credit Department permitted those complainants to invest in FAs with a potential maximum exposure which greatly exceeded their assets under management. As he put it : "in 10 out of 13 cases, the ITL granted to the client would allow the client to enter into FAs with a potential maximum exposure representing 100% or above of the client's estimated liquid net worth[45]. In two of the FA cases, the ITL granted to the client would allow the client to enter into FA trades with a potential maximum exposure exceeding 100% of the client's estimated total net worth[46]."

371. Those startling figures, said Mr. Ho, were not in keeping with the bank's contention that its credit system and policy of margins enabled it to ensure that its clients had sufficient net worth to bear the risks of trading in FAs and would not be over exposed.

[45] Liquid net worth would only include liquid assets and not, for example, bricks and mortar.

[46] This would include bricks and mortar.

372. As to the bank's margin policy, as set out earlier in this judgment, once granted an ITL, clients were required to maintain sufficient cash and/or other forms of collateral in their accounts with the bank as an initial margin. The amount of the initial margin would be determined by the bank based on the perceived risk level of the underlying stocks in the FA instrument (or instruments) purchased. In respect of 'tier 1' equities, the initial margin was 20%, being reduced to 15% from August 2006. In respect of 'tier 2' equities, the initial margin was 30%.[47] Most, if not all, of the FAs purchased by the complainants, said Mr. Ho, were linked to 'tier 1' or 'tier 2' equities. In the result, it ensured that each client had sufficient collateral value in his or her account to cover up to a maximum of only 30% of the maximum notional exposure inherent in each contract at the time of entering into the transaction.

373. As to any further margin that would have to be provided, this arose when the marked-to-market value of the contract showed a loss : in short, it only arose *after* the FA had been purchased and was in play.[48] The bank had certain 'cut loss margin levels' – M1, M2 or M3 levels – which, when reached, required the client to provide extra margin cover.[49]

374. In the opinion of the Tribunal, it is difficult to see how the requirement for the provision of an MTM margin would have constituted a protection for clients, a protection, that is, that ensured they had sufficient net worth to enter into these derivative instruments in the first place and that, before committing themselves, a rational assessment had been made that,

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[47] In respect of new IPIO equities with six months trading history, the initial margin was 35%; all other equities – from August 2006 - required an initial margin of 50%.

[48] As to the formula for calculating the MTM loss, see the footnote 14 to paragraph 122.

[49] These margin levels were for the bank's purpose only and not communicated to clients.

even if there was a sharp decline in the market, they would not be left over exposed. With respect, it seems to the Tribunal that MTM margins protected the bank rather than the individual client, who, by that time was already fully committed. And, of course, once committed, stood at risk of losing not only his or her initial margin but a material percentage of, or indeed all of, the assets under management.

(C) A failure to ensure suitability of product

375. In respect of the sale of forward accumulators, it was the SFC case that a mismatch between a client's risk tolerance level and the product risk rating of FAs (set at the bank's highest rating level of '5') had been observed in ten of the 13 complaint cases. In addition, mismatches had been observed in respect of clients' investment philosophies, portfolio strategies and recommended maximum of high risk investments in their portfolios. In this regard, the following table was set out in the SFC's Notice of Proposed Disciplinary Action (paragraph 150) –

	Clients' risk profiles recorded in eCRM				**FA exposure**
No. of case	**Risk Tolerance** (High / Medium / low)	**Investment Philosophy** (Aggressive / Balanced / Conservative)	**Portfolio Strategy** (Loan account / Cash & bond / Conservative / Balance / Growth / Aggressive)	**Max % Portfolio of High Risk Investment**	**Outstanding MNE / AUM**
10	Medium	Balanced	Balance	20% - 50%	135% - 424%
2	High	Balanced	Balance	30% - 40%	200% - 315%
1	High	Aggressive	Aggressive	30%	273%

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376. In respect of the table, the SFC pointed out that in ten of the complaint cases the client's risk tolerance was classified as 'medium', while the investment philosophies and portfolio strategies were set at 'balanced' and 'balance' respectively. The (non-mandatory) classifications of the recommended maximum of high risk investments for the ten complaint cases would have been between 20% and 50%. It was submitted that, on the face of these classifications, the level of high-risk forward accumulators held by the complainants was materially in excess of what should have been held. The outstanding MNE – maximum notional exposure – of the forward accumulators held by the ten complainants represented between 135% and 424% of their assets under management.

377. In two of the complaint cases, the risk tolerance level was set at 'high' – suggesting a greater tolerance for loss – but, that said, the relevant portfolio strategies were set at 'balance' while the recommended maximum of high-risk investments would have been between 30% and 40%. By contrast, the outstanding MNE of the forward accumulators held by the two complainants represented between 200% and 315% of their assets under management.

378. These figures, said the SFC, were strong indicators that the bank had failed to put into place adequate and effective systems to ensure that forward accumulator transactions were suitable for those 12 complainants to whom they were sold. In short, they were evidence that, in respect of those complainants, there had been systemic failures in ensuring a transparent and structured process to protect the interests of clients in respect of the accumulation of forward accumulators.

379. When determining this issue, the Tribunal has taken into account the fundamental objection made by the bank that it was the job of the relationship managers, before finding a high risk product was suitable for a client, to consider the matter on a portfolio basis and to take into account all relevant matters. But whether this was in fact done, in the light of the absence of quantitative guidelines, was very much the issue.

380. The Tribunal has also taken into account that, no doubt, the risk appetite of some clients would have changed as they became more experienced : it was said on behalf of the bank that some clients became quite aggressive in their trading patterns. But such a change would not of itself have made the products suitable and, in the event of any such shift, the Tribunal would have expected there to be records showing that, working in conjunction with the client, there would have been a re-assessment of that client's overall philosophy and portfolio strategy. Regrettably, however, there was all too often an absence of relevant records and, in one instance concerning one of the 13 FA complainants, the preponderance of the evidence showed that a relationship manager had unilaterally changed a client's profile not as a result of an objective re-assessment of suitability but as a device to enable the client to trade in more high risk instruments. In *Kwok Wai Hing Selina v HSBCPB,* a first instance decision referred to earlier in this judgment,[50] Reyes J came to a finding of fact that the relationship manager had not consulted the client about changing her profile from 'balanced' to 'aggressive' and that the relationship manager's own reasons for thinking that she could do so had been "difficult to accept".[51]

[50] See paragraph 98 of this judgment.

[51] Reyes J (in paragraph 76) had made the following finding : "It seems that Ms. Chau [the relationship manager] simply updated the Client Profile in order to enable Ms. Kwok's account to obtain a higher credit limit. Under HSBC's internal guidelines a client with a 'medium' appetite is only allowed credit of up to 50% of net worth. In contrast, a client with an 'aggressive' appetite is allowed credit of up to

381. In looking to systemic issues, what has troubled the Tribunal has been the very substantial (indeed, almost total) lack of contemporaneous records to prove that, despite what appears on the face of things, relationship mangers had worked in conjunction with clients to attain agreed rational ends or that, if the client insisted on proceeding in the face of advice to the contrary, that had been placed into the records. It was said on behalf of the bank that the absence of a record did not mean that there had been no relevant discussion between the relationship manager and the clients; it was further said that the absence of a record did not mean that there had been an actual risk mismatch. That may (perhaps) be true in some instances. But the issue is one of systems and the focus must therefore be, on two things; first, the nature of the processes in place and, second, whether those processes had as a matter of regular practice been followed. As Mr. Ho, for the SFC, expressed it : the failure to keep contemporaneous records (in itself a breach of regulatory obligation) must be a factor which counts against the bank's case that it has properly assessed product suitability. The Tribunal would agree with that submission.

382. In the result, the Tribunal is satisfied that, in respect of at least ten of the FA complainants, the apparent suitability mismatches set out in the table may be given due weight, not necessarily as proving as a matter of fact that in each instance there had been clear mismatches but, when taken with the other evidence, that the systems in place at the time to ensure suitability had been materially lacking.

100% of net worth. By unilaterally raising Ms. Kwok's appetite level to 'aggressive', Ms. Chau was facilitating Ms. Kwok's ability to trade in a large number of FAs and similar structured products."

(D) A failure to explain to clients the key features of FAs and their inherent risks

383. In the course of his evidence for the bank, Mr. Wynd accepted that relationship managers had at all times borne an important responsibility to ensure that clients had a full understanding of their features and inherent risks. If a client who had acquired a forward accumulator had not been made aware of these matters prior to making the acquisition, Mr. Wynd accepted that it would have constituted a material default. Mr. Herbert was of the same view.

384. This acceptance on the part of Mr. Wynd and Mr. Herbert complemented the SFC's principled advice[52] in which it was said that it was not enough for an investment adviser to hand over documents to a client saying 'read these, they explain the product and its risk.' Nor was it sufficient to focus on the good points only : a balanced view had to be given, drawing to the attention of the client not only the advantages but the disadvantages and risks. More than that, relationship managers would have understood that, in order to demonstrate compliance with the Code of Conduct, they were required to document and record contemporaneously the information given to each client and the rationale for any recommendations made : self-evidently, in the opinion of the Tribunal, that would have been good practice.

385. It was, however, the SFC case that a review of the records concerning the 13 complaints had revealed what the Tribunal can best describe as a haphazard approach on the part of relationship managers to these clear and unequivocal obligations.

[52] In this regard, see paragraph 51 of this judgment and its sub-paragraphs.

386. In paragraph 166 of its Notice of Proposed Disciplinary Action, the SFC identified what it considered to be the failure of relationship managers, in the process of selling forward accumulators to the 13 complainants, to explain to them all salient features and associated risks. The detailed position was set out in an appendix to Mr. Ho's opening submissions on behalf of the SFC[53]. Stated in general terms, the failures were summarised as follows -

i. The essentially important leverage effect, that is, the client having to receive double the amount of shares if the stock dropped below the strike price, was not mentioned in many of the FA transactions.

ii. The maximum exposure of the contract should the leverage effect occur was not calculated for the benefit of the client in 12 of the complaint cases.

iii. In only one complaint case did the relationship manager explain the margin requirements and the workings of the MTM feature to the client.

iv. In a number of cases the key product features such as strike price, knock-out price, the number of shares accrued daily and the identity of the underlying equities was not mentioned to the client.

[53] See Appendix 9.

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387. In its Notice of Proposed Disciplinary Action, in support of its contentions, the SFC put forward five summaries chosen from the 13 complaint cases. For illustrative purposes, the Tribunal refers to two of those summaries.

Ms. GS

i. Ms. GS, a housewife, had come from the Philippines as a domestic helper and, some 13 years prior to opening her account with the bank, had married a Hong Kong resident, a retired man. When the account was opened in June 2006, the husband was apparently in bad health. Ms. GS therefore managed his wealth. The eCRM records of Ms. GS reveal that her portfolio strategy was 'balance', her risk tolerance level described as 'medium'. The maximum toleration percentage of her portfolio for high-risk investments was 30%. As at the end of October 2007, her total net worth was estimated to be US$10.5 million, her liquid net worth being estimated at US$7 million.

ii. Ms. GS also held investment accounts with three other banking institutions and it appears that she had made capital gains in her investments in equities and foreign exchange.

iii. Ms. GS first entered into a non-leveraged FA contract in July 2006, just a month after opening her account. In the relevant telephone recording, the bank's relationship manager highlighted the profits to be made but did not mention the

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downside risks inherent in the contract. Nor was any mention made of margin requirements or calculation of MTM losses.

iv. After the first contract had been executed, Ms. GS was persuaded by her relationship manager to transfer cash valued at some US$180,000 and bonds valued at some US$700,000 into her account. She was not told, however, that these assets would be pledged as collateral for the FA contract.

v. Whatever may have happened later, clearly, in the view of the Tribunal, Ms. GS, in purchasing her first forward accumulator, was not given the sort of comprehensive advice that the bank, as part of its case, said would always be given to first-time buyers.

vi. Thereafter, through until October 2007, Ms. GS entered into a total of 37 forward accumulator transactions. According to the SFC, a review of the various telephone conversations relating to these acquisitions revealed that most of the transactions were initiated by the relationship manager[54], that the requirement for margin provisions was never mentioned nor the MTM loss features. On occasions, the relationship manager had calculated the bi-weekly exposure under the contracts but without taking into account the leverage effect. On no occasion,

[54] In this regard, of course, the Tribunal accepts that the intended launch of products such as FAs would very unlikely be known to retail clients and would therefore invariably be brought to the attention of the client by the relationship manager. The real issue, in the view of the Tribunal, goes to the circumstances in which they would be raised by the relationship manager, whether essentially to persuade the client to enter into more transactions – the role of a sales agent – or whether to enter into a balanced, prudent discussion as to whether they would or would not enhance the client's portfolio at that moment in time: the role of a relationship manager.

however, had Ms. GS been informed of the maximum contract exposure should the leverage effect be triggered. In this regard, the bank's own investigation report recorded : " … it was observed that in general the relationship manager only mentioned the economic terms but the key features and the downside risks (i.e. leverage effect and maximum exposure under the one-year contract, margin requirements and MTM loss) were not explained to the client each time."

vii. In or about October 2007, the maximum notional exposure of Ms. GS's outstanding FA contracts amounted to US$8 million and represented 327% of her assets under management with the bank; 114% of her estimated liquid net worth and 76% of her estimated total net worth. Such levels were not consistent with her 'balance' portfolio strategy and 'medium' risk tolerance level nor did it accord with her percentage of high risk investments.

viii. In November 2007, when clearly the forward accumulator contracts were not profitable for Ms. GS, she was asked by her relationship manager to inject additional funds to cover a collateral shortfall. The relationship manager said that the money would be placed in a fixed deposit for two weeks and that, when the market improved and the bank did not require the additional funds, she could take back the money. Of importance, the relationship manager did not explain that the funds would be pledged to the bank as collateral for the FA contracts then in place and in the event that the market

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continued to decline all the funds held with the bank would be in jeopardy.

ix. In January 2008, the bank demanded that Ms. GS pay a further shortfall. It would seem that she was unable to do so and the bank exercised its right to unwind the existing FA transactions at a cost of some HK$10.74 million, liquidating the charged assets in her account to settle the amounts due to it.

Mr. RVJ

i. Mr. RVJ opened his account with the bank in November 2006. He first acquired a forward accumulator in May 2007 and thereafter required a further 15 contracts through until October 2007.

ii. According to the SFC, a review of the taped telephone conversations in respect of six of these transactions revealed the following. All six were initiated and recommended by the relationship manager. In none of the six transactions were the product features (including the knock-out price, leverage, margin requirement and maximum exposure under the contract) mentioned. In respect of two of the contracts no mention was made of the number of shares to be accrued at regular intervals and in respect of another two no mention was made of the strike price. In one of the transactions no mention was even made of the underlying equity, the relationship manager saying only that it was a Hong Kong stock.

iii. In a taped conversation in late May 2007, the relationship manager told Mr. RVJ that, in respect of any recommendation to purchase, she would first send an email to him so that the matter could first be discussed. However, no record of the emails could be found. It appears they were not archived; in short, no contemporaneous record was kept.

388. While Mr. Neoh, for the bank, appeared to concede that individual relationship managers may from time to time have fallen below the standards expected of them, he did not accept that, on balance, this was evidence of any systemic failure. As he put it, the systems in place during the period under review could not be described as being defective "for the times they operated in".

389. It was said that the Risk Disclosure Statement which was provided to clients at about the time when they opened their accounts provided an explanation of the bank's investment products, setting out features and explaining inherent risks.

390. This document, of course, referred to investment products in a generic sense. The Tribunal also accepts the force of Mr. Ho's submission that, in terms of the Code, the bank's duty to ensure that each client understands the risks and features of a specific transaction cannot be discharged simply by giving the client, at the very start of the banking relationship, a "generic risk disclosure statement" containing a litany of different categories of products.

391. On behalf of the bank, it was said that all clients contemplating the purchase of forward accumulators (and other derivatives) were provided with product guides and fact sheets.

392. Again, however, while this may have been an intended practice, as pointed out by Mr. Ho, it does not appear to have been scrupulously followed. In this regard, by way of illustration, Mr. Ho pointed to two of the bank's own investigation reports in which relationship managers had admitted failing to send relevant literature to the client[55] : further evidence it was submitted of the bank's haphazard approach.

393. More importantly perhaps, it was emphasised that part of the bank's suitability assessment process in respect of each client involved an explanation of the nature and risks of financial products being contemplated for acquisition. In this regard, should the client consider acquiring forward accumulators, the Product Suitability Checklist form – the PSC – would record a number of essential matters : in particular, the risk tolerance level of the client, whether there had been an explanation given of the product features, whether the client had understood the nature of the products being considered and risks involved and the experience of the client in dealing in such products.

394. In respect of the PSC forms, however, it is to be remembered that prior to 2008 a single form invariably made reference not to a single product but to a number of products even though the architecture of the form was not really suitable. In this regard, the Tribunal accepts Mr. Ho's submission that it was inherently improbable that relationship managers

[55] Mr. Ho also submitted an analysis of pre-transaction documents sent to the 13 complainants from it appears that product material was not sent in each and every case.

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would have comprehensively explained the features and inherent risks in each product listed in the form or, even if that was done, that clients would have digested all relevant material in respect of each at that single meeting. The Tribunal is satisfied, therefore, that, even if there had been some general discussion when the PSC form was completed, it would still have been incumbent on relationship managers, in the event of a specific client seeking to acquire a specific forward accumulator, at that time to provide a full explanation.

395. It was the bank's position that, even if there were occasional lapses, invariably, when a forward accumulator was being considered for purchase for the first time, relationship managers would have understood full well that there was a need for a comprehensive explanation of features and inherent risks and such an explanation would have been given. The records of the 13 complaints, however, do not bear that out. On the evidence, the approach appears to have been, to employ a description used earlier: 'haphazard'.

396. Indeed, the compelling inference is that relationship managers all too often allowed themselves to slip into the role of a 'selling agent'. What mattered more than the provision of objective, prudent advice was the desire to 'move the product'.

397. It was further the bank's position that the great majority of the 13 complainants traded numerous times in forward accumulators, each time working with their relationship managers, and, in doing so, they would have come to understand the workings of the products. As it was put on behalf of the bank in the reply to the SFC's Notice of Proposed Disciplinary Action, where key features and risks had been explained to the client previously,

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there was generally no need for the same to be repeated in full each time. This was particularly the case if the only differing term from one FA to another was the underlying stock. In this regard, for example, it was emphasised that Ms. GS had entered into 37 FA contracts : surely, after a number of transactions had been completed, the failure to mention every feature and risk would have been entirely unnecessary.

398. Each case, of course, must depend on its own circumstances. If the evidence is clear that the essential features and risks in a product have been made known to the client on more than one occasion, and if it is clear that the client has understood, then arid repetition may not be necessary. The difficulty, however, is that the evidence of what was told and not told was chequered. In this regard, the Tribunal accepts Mr. Ho's submission that an analysis of the records of the early FA transactions do not show that the features and risks were explained in a clear and balanced fashion.

399. In the view of the Tribunal, it is not sufficient to say : "well, with time the client must have come to understand." Equally, in the view of the Tribunal, it is not sufficient to say that, because clients were multi-banked, they would have understood what was involved in trading in forward accumulators.

400. In the final analysis, therefore, the Tribunal has been drawn to the conclusion that, on the evidence, the systems in place at the relevant time did not ensure that the 13 complainants would from the outset of their trading have been given, in a clear and balanced fashion, the necessary information to enable them to understand the features of forward accumulators and, importantly, their inherent risks.

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A summary of the Tribunal's general findings

401. For the reasons set out in this judgment, the Tribunal has unanimously concluded that the SFC was correct in its findings that, in the periods under review, the bank fell short of the standards demanded of it in the Code of Conduct and ancillary guidelines.[56]

402. No doubt, in respect of derivative products being marketed to clients of private banks, the investment landscape at the relevant times, that is, in the years leading up to the collapse of Lehman Brothers, was different. It would appear that there was at about that time a considerable appetite among private investors for such instruments, a demand that was all too easy to meet. But the fact remains that the Code of Conduct was in place, its principles being focused very much on the need to ensure the protection of investors. Those principles required financial institutions such as the bank to ensure that clients were fully informed of the nature of derivative products being marketed to them, there being no avoidance of inherent risks. Those principles required financial institutions such as the bank to ensure suitability of product. It is not, therefore, as if the bank has been judged through the prism of hindsight. The protective limitations were at all times in place and should have been acted upon by the bank.

403. The Tribunal is satisfied that during the periods under review clients of the bank who had been asked to consider purchasing or had

[56] More particularly, as set out by the SFC these failings were in respect of General Principle 2 (Diligence); General Principle 3 (Capabilities); General Principle 5 (Information for clients); General Principle 7 (Compliance); paragraph 3.4 (Advice to clients: due skill, care and diligence); paragraph 4.2 (Staff supervision), paragraph 4.3 (Internal control, financial and operational resources); paragraph 5.1 (Know your client : in general); paragraph 5.2 (Know your client : reasonable advice); paragraph 5.3 (Know your client : derivative products) and paragraph 12.1 (Compliance : in general).

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purchased derivative instruments were not given the guidance demanded by the Code of Conduct. The failures of the bank in this regard were systemic. In the result, many of the bank's clients had suffered material losses. Yes, all of those clients must have understood that there was an investment risk in the derivative products which they purchased; many no doubt were all too eager to make the purchases. The bank could not guarantee clients against loss. In the judgment of the Tribunal, however, where the bank failed was in ensuring, by the creation of appropriate systems and rigorous implementation of those systems, that those clients understood the true nature of the investment risk they were contemplating and, before purchase, they had received adequate guidance as to the suitability of the product.

404. It is to be remembered that many of the bank's clients were not 'professional', 'sophisticated' or 'highly experienced' investors. Many, despite possessing affluence, were, in respect of derivative instruments at least, inexperienced and lacking in sophistication. Many no doubt would have become clients of the bank because they were expecting, indeed relying upon prudent investment guidance from skilled professionals.

The issue of sanctions

(A) An overview

405. In its Notice of Proposed Disciplinary Action (confirmed in its final Decision Notice), the SFC came to the determination that the disciplinary penalties to be imposed on the bank should include, first, orders of revocation and, second, pecuniary penalties.

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406. In respect of revocation, the SFC ordered that the bank's registration for Type 4 regulated activity (advising on securities) be revoked and that its registration for Type 1 regulated activity (dealing in securities) be partially revoked to the extent that the bank would only be allowed to handle trading in listed securities for clients and in that limited capacity to provide incidental advice to clients.[57]

407. In reaching this determination, the SFC rejected the submission made on behalf of the bank that the revocation ordered was wholly disproportionate in that there had at all times been systems and controls in place and that these systems and controls had been subject to review and amendment. The SFC considered that, despite limited improvements, viewed as a whole, the bank's systems and controls during the period under review had remained materially flawed and ineffective.

408. In respect of financial penalty, the SFC ordered that the bank should pay a total financial penalty of HK$605 million, this penalty (described more fully below) being made up of a penalty of $5 million in respect of six areas of misconduct multiplied by the number of complaints in respect of each such area of misconduct. In reaching this decision, the SFC rejected the submission made on behalf of the bank that the financial penalty was wrong in principle and was manifestly excessive.

[57] During the course of the hearing, it was suggested that, in order to justify the revocation of the bank's Type 4 registration, it had to be demonstrated that the bank had in fact given wrong advice. If there was a failure in this regard, the causal link between the regulated activity and the justification for the revocation related to that activity was absent. When viewed in its regulatory context, however, the Tribunal had no difficulty (on a consideration of all the evidence) finding that such advice was given by the bank's relationship managers to clients in respect of derivative instruments as a matter of routine. For the reasons given in this judgment, the Tribunal is satisfied that the fact that account opening contractual documents stated that clients agreed not to engage the bank in respect of advisory services, while effective no doubt as between each client and the bank in terms of private law, was not determinative in the public law regulatory context.

409. In its Notice of Proposed Disciplinary Action (not in any way amended in its final notice) the SFC said that, even taking into account that the bank had a clear disciplinary record, the penalties imposed were appropriate after taking into account all the circumstances of the case, including the following :

i. The concerns set out in detail in the SFC notices had during the period under review revealed systemic weaknesses in the management systems and internal controls governing the bank's overall marketing and sale of derivative products.

ii. The bank's failings had been serious and likely to have caused clients to suffer substantial losses. In this regard, by way of illustration, in its Decision Notice of 9 July 2015 (paragraph 409), the SFC noted that "in relation to the LB-Notes case, the loss suffered by clients are approximately HK$302 million (HK$40 million for the 15 non-disclosure of issuer cases and HK$262 million for the 55 mismatch cases)".

iii. The duration of this misconduct had been extended, running for a period of at least six years from January 2003 to December 2008.

iv. A strong deterrent message needed to be sent to the market that it was not acceptable for large financial service providers to disregard clients' interests, putting their own financial interests above those of clients.

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410. In respect of the last point just made, on a consideration of all the evidence, the Tribunal has not been able to draw the inference, that necessarily being a compelling inference, that the bank's failures arose out of the fact that it had intentionally or recklessly put its own financial interests above those clients. With that exception, however, the Tribunal is satisfied that the remaining three points made by the SFC are valid.

411. That said, the Tribunal has also taken into account the mitigatory factors advanced by Mr. Neoh for the bank, those factors including the following :

i. Along with the fact that the bank has a clear record, it is to be recognised that, leaving aside the period under review, its history has been one of high reputation, reliability and financial integrity. Nor has any suggestion been made that the serious and systemic failings continued much beyond the collapse of Lehman Brothers in or about October 2008.

ii. It has never been suggested that the conduct of the bank was in any way dishonest. Nor can it be said, that its actions were intentional and/or reckless. In this regard, it is to be remembered that there were comprehensive systems in place (albeit found to be materially lacking) intended to ensure the efficiency of business proceedings and, in so doing, to ensure the protection of clients. In addition, it is to be remembered that during the period under review steps were taken from time to time to improve the systems. It was never a case, therefore, of wilful neglect.

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iii. It is not disputed that the bank did take active steps to try and assist clients who had been financially prejudiced; the bank's on-going obligations to its clients was, therefore, acknowledged and given practical effect.

(B) The statutory power to impose sanctions

412. In terms of s.196(1) of the Ordinance, if a registered institution (such as HSBCPB) is found to be guilty of 'misconduct' or if the SFC is of the opinion that the registered institution is not a fit and proper institution to remain exercising the same regulated functions, the SFC may exercise certain disciplinary powers.

413. As to the nature and extent of the word 'misconduct', it is defined in s.193 of the Ordinance. The word includes an 'act' or 'omission' relating to the carrying on of any regulated activity which, in the opinion of the SFC, is, or is likely to be, prejudicial to the interests of the investing public or to the public interest.

414. As to the statutory powers that may be exercised, these include the power, exercised under s.196(1), to *revoke* the registration of a registered institution such as the bank and the power to *suspend* that registration. An order of revocation may be in relation to all or any - or any part of all or any - of the regulated activities for which the institution is registered. In respect of an order of suspension, it may be in relation to all or any - or any part of all or any - of the regulated activities to which it is registered. An order of suspension may be for a specified period or until the occurrence of a specified event.

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415. In addition to the power of revocation or suspension, the SFC is also given the power to impose pecuniary penalties. In this regard, in terms of s.196(2) of the Ordinance, if a registered institution has been found guilty of misconduct, or if the SFC has determined that it is not a fit and proper institution, the SFC, may, separately or in addition to any of the powers exercisable under s.196(1), impose a pecuniary penalty. In this regard, the SFC may order a registered institution to pay a pecuniary penalty not exceeding the amount which is the greater of HK$10 million or three times the amount of the profits gained or loss avoided by the registered institution as a result of its misconduct.

416. The statutory provisions concerning the imposition of pecuniary penalties are broadly defined. This is to enable pecuniary penalties to be determined in the light of a very broad spectrum of culpabilities.

417. In the course of his submissions, Mr. Neoh, for the bank, suggested that, if the Tribunal found that the SFC had been correct in finding six breaches of the Code of Conduct warranting separate penalty, it should look to the singularity of each breach and not whether each breach had been multiplied by reason of the finding that a number of different clients had been affected by it. On that basis, he submitted, if the Tribunal found six breaches of the Code constituting 'misconduct', the maximum penalty that could be imposed would be HK$60 million : this being HK$10 million in respect of each breach. However, since only the most egregious cases would warrant the imposition of the maximum financial penalty, the Tribunal would need to consider penalties below the maximum and would, of course, before determining on a total penalty, have to take into account the principle of totality.

418. While the Tribunal, of course, accepts that the principle of totality must be taken into account, it does not accept the submission that the provisions of the Ordinance only permit the imposition of one pecuniary penalty for each generic breach identified. The Tribunal is satisfied that, on an ordinary reading of the statute, a number of culpable acts or culpable omissions, even if they are of the same generic nature, may attract multiple penalties. In order to illustrate the point, the Tribunal is satisfied that, if a registered institution contravenes the provisions of paragraph 5.3 of the Code on three separate occasions in respect of three separate clients, it may be penalised for each of those three contraventions.

419. In the present case, the SFC, in determining an objectively rational basis for the imposition of pecuniary penalties, looked, first, to the bank's marketing and sale of LB-Notes and, second, to the bank's marketing and sale of FAs.

420. In respect of the bank's marketing and sale of LB-Notes, the SFC identified two areas of culpable conduct. First, it identified the failure of the bank between January and September 2008 to inform purchasers of LB-Notes of the increasing 'issuer risk' in those notes, namely, the increasing credit risk in Lehman Brothers. Second, it identified the failure of the bank, in marketing and selling LB-Notes, to ensure, in a number of ways viable internal processes to protect the interests of clients : namely, the 'risk mismatch' issue.

421. In respect of the matter of 'issuer risk', 15 affected complainants were identified. In respect of the matter of 'risk mismatch', 55 affected complainants were identified.

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422. In order to assess an appropriate pecuniary penalty in respect of each area of culpable conduct, the SFC determined on a penalty of HK$5 million (this being half of the maximum) and multiplied it by the number of affected complainants. Accordingly, the penalties were calculated as follows –

Nature of the misconduct	***Financial penalty***	***Affected complainants***	***Total***
Issuer risk	$5 million	15	$75 million
Risk mismatch	$5 million	55	$275 million

423. In respect of the bank's handling of FAs, the SFC identified four areas of misconduct; first, a failure to 'know-your-client' before recommending investment in FAs; second, a failure to ensure that clients had sufficient net worth to meet the risks involved in the purchase of FAs; third, a failure to ensure that investment in FAs accorded with each client's risk profile and investment preferences and, fourth, a failure to disclose or explain key features of, and key risks involved in, FAs. In respect of the first three instances of misconduct, the SFC identified 13 affected complainants, in respect of the fourth instance, it identified 12. Accordingly, the penalties were calculated as follows –

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Nature of the misconduct	*Financial penalty*	*Affected complainants*	*Total*
'know-your-client' failure	$5 million	13	$65 million
'sufficient net worth' failure	$5 million	13	$65 million
'risk profile' failure	$5 million	13	$65 million
'lack of explanation' failure	$5 million	12	$60 million

424. In the result, the total instances of 'misconduct' which the SFC identified for the purposes of levying a pecuniary penalty was six. In respect of those six, the total pecuniary penalty levied by the SFC was HK$605 million.

(C) Determining the issue of revocation

425. The sanction of revocation, whether it sits together with prohibition or not, is the most severe form of sanction that may be imposed under s.196 of the Ordinance. In plain language, in ordering revocation, the following is said : "Your misconduct has been of such a serious nature that you cannot be trusted to continue your licensed activity". The consequences of an order of revocation are profound. The direct consequence is the closing down of the licensed activity. This may lead to the closing down of the registered institution itself. Even if that is not the case, in a financial market such as Hong Kong where reputation is of such importance, even if the institution is able to continue in business, it is a grievous blow to that reputation.

426. The same may be said of the sanction of suspension. In ordering suspension, the following is said : "Your culpability is of such a serious nature that you cannot be trusted to continue your licensed activity until you have been given a sufficient period of time to put your house in order". Again, the direct consequence is the closing down of the licensed activity, albeit for a specified period of time only, but that consequence too, assuming the institution itself is able to remain in business, constitutes a serious blow to its reputation.

427. The fact that a sanction may be severe, that it may have deterrent and penal elements, does not render it a criminal sanction if these elements are incidental to the protective nature of the sanction. Plainly, the sanctions of both revocation and suspension are fashioned for the single, overriding purpose of protecting the integrity of the market as a whole.

428. When such a protective sanction is necessary must encompass a broad range of circumstances. Findings of fraud or dishonesty are obviously strong pointers to the need for revocation and/or suspension but the Tribunal is not aware of any authority to the effect that sanctions of revocation or suspension may only be applied when fraud or dishonesty are present. Yes, they are strong pointers but remain relevant considerations only.

429. During the course of submissions, it was revealed that the HSBC Group has transferred the bank's business to another entity in Hong Kong. Accordingly, it was suggested on behalf of the SFC, if revocation is ordered, while HSBCPB, as a corporation, will be shut out of the business of private banking, the Group's ability to continue will be unimpaired. In reply, Mr. Neoh, for the bank, submitted that this was a simplistic approach : the

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bank was still an operating entity, still registered in Switzerland and any order of this Tribunal would have significant regulatory consequences.

430. Certainly, in the opinion of the Tribunal, any order of revocation or any extended period of suspension would likely cause significant hurt to the reputation of the HSBC Group.

431. Of course, the fact of revocation does not prevent an institution from applying for the relevant licence at some time in the future. Revocation is not, therefore, the same as a prohibition with no temporal limitation. Nevertheless the ability – at some future point – to make a fresh application must in each instance be surrounded by uncertainties. In the result, while the possibility of a fresh application at some time in the future takes some limited sting out of the section, it remains a severe penalty.

432. During the course of submissions, a number of authorities were put before the Tribunal concerning issues to be taken into account when determining the sanction of revocation. These authorities have all been taken into account. In doing so, however, the Tribunal has borne in mind that each case depends very much on its own circumstances. One of the authorities put before the Tribunal was that of *Wong Ting Choi Joe v SFC* [58] in which a number of non-exhaustive considerations were enumerated. Among those considerations were following :

i. *Did the bank's conduct impact upon market integrity?* The history of these proceedings began with a series of complaints

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made by clients of the bank to the HKMA in the wake of the Lehman Brothers collapse. Those complaints would have become known in the market and, together with complaints of similar dealings by other financial institutions, must have had an impact upon market integrity. It would not be an overstatement to say that notoriously the fallout from the Lehman Brothers collapse brought about widespread dissatisfaction with the Hong Kong banking industry, one of the members of that industry (indeed, a leading member) being the bank.

ii. *What were the degree of losses, if any, caused to clients?* The evidence makes plain that substantial losses were sustained by clients of the bank. With the bank's assistance, part of those losses have been recovered.[59]

iii. *What was the duration of the conduct and its frequency?* It was the SFC case that the systemic failings in the bank's systems ensured from 2003 to 2008, a period of at least six years. While the Tribunal accepts that the 83 cases which have been used as the basis for this review arose essentially in a more limited period, it can be said that the failings had a material effect over a fairly extended period of time when derivative instruments of the kind considered in this judgment were very popular and were marketed by a good many financial institutions in Hong Kong. To repeat, however, there is no

[59] It was submitted on behalf of the bank that there had been no evidence of loss, especially when all of the complainants (that is, the clients of the bank) had acknowledged in their opening account contractual documentation that they would not rely on the bank for advice. That submission has been rejected by the Tribunal for reasons set out elsewhere in this judgment.

suggestion that, after the collapse of Lehman Brothers, the bank took no remedial action to try and prevent future such outcomes.

iv. *Was the conduct widespread in the industry?* It has been suggested that the SFC put forward no evidence in this regard. This is not accepted. Among the papers submitted by the SFC was a document setting out the details of resolutions reached by the SFC with a number of registered institutions concerning their marketing of Lehman Brothers structured products, including 'Minibonds' at or about the same time as the bank. The details contained in this document were not at any time challenged. The document shows that the conduct for which the bank has been held liable by the SFC was fairly widespread in Hong Kong at the time. The document lists a number of leading institutions as well as smaller institutions. That said, and accepting that each of the listed cases was resolved without the need for formal proceedings, it is noted that there were no orders for revocation and only limited orders of partial suspension. The document does, however, list a number of constructive measures agreed between the institutions and the SFC, more particularly, a requirement to conduct independent reviews of systems and processes relating to the sale of structured products to ensure that future marketing is in all respects appropriate[60].

[60] In this regard, the Standard Chartered Bank (Hong Kong) Limited resolution contained the following terms : "to engage an independent reviewer to review its systems and processes relating to the sale of unlisted structured investment products, to report to the SFC and the HKMA, and will commit to the implementation of all recommendations of the independent reviewer."

v. *Was there a breach of fiduciary duty?* It is accepted that there was no such breach by the bank.

vi. *What of the disciplinary record of the bank?* The bank has no such record.

433. Determining whether there should be an order of revocation has not been the easiest matter. Certainly, the bank's failings were serious; they were systemic in nature, extended over a relatively lengthy period of time and not only put clients at risk but caused loss to many. These are compelling factors. Against that, however, it has to be recognised that the bank's failings were not shown to be dishonest, they were not shown to be intentional or reckless. There were at all times systems in place albeit in a number of crucial respects those systems were materially inadequate. In addition, steps were taken from time to time during the period under review to improve those systems, doing so in order to protect the interests of clients. While, with the cold comfort of hindsight, it can now be shown that those systems were inadequate, it has not been demonstrated that there was at the time an institutionalised cynical disregard for the interests of clients. Nor has it been shown that, after the collapse of Lehman Brothers, those inadequacies were permitted to remain in place. Returning to what the Tribunal has observed earlier, along with the fact that the bank has a clear record, it must be recognised that, leaving aside the period under review, its history has been one of high reputation, reliability and financial integrity.

434. The Tribunal, of course, recognises that, while honesty and diligence are always essential, unless they are accompanied by the requisite level of professionalism, there will always be a risk to the integrity of the market. Yes, there were systems in place, there were manuals intended to

guide and train but, on a consideration of the evidence, it appears that, if anything, was lacking, it was the requisite level of rigorous professionalism that would, first, have enabled the systems to be better designed and, second, would have enabled front line staff responsible for implementing those systems to be trained more effectively and given more effective oversight.

435. While recognising the seriousness of these failings, more particularly the profundity of their systemic nature, it is nevertheless the opinion of the Tribunal that, in so far as such failings have not already been remedied, the integrity of the bank can be restored if, together with an independent reviewer, rigorous steps are taken to improve its internal control systems.

436. On balance, while not in any way diminishing the default of the bank in the period under review, the Tribunal has been drawn to the conclusion that an appropriate period of suspension would in all the circumstances, be to better effect. It is a measure that will protect the integrity of the market, serving also as a warning to other institution, but, with regard to the mitigating factors set out earlier, will enable the bank to rejoin the market, serving the interests of the many clients, who, before the period under review, had been able to rely fully on its integrity.

437. In all the circumstances, the Tribunal makes the following orders :

i. That HSBCPB's registration for Type 4 regulated activity (advising on securities) be suspended for a period of one year, that period commencing on 21 November 2017.

ii. That HSBCPB's registration for Type 1 regulated activity (dealing in securities) be partially suspended for a period of one year, that period commencing on 21 November 2017, to the extent that during the period of suspension HSBCPB be allowed only to handle listed securities trading for clients and to provide advice to clients incidental to such trading.

(D) Determining the issue of the pecuniary penalties

438. On behalf of the bank, Mr. Neoh submitted that the total pecuniary penalty of HK$605 million imposed by the SFC was wrong in principle. In addition, it was manifestly excessive. The correct approach to be adopted, he submitted, was either, first, to adopt what he described as the 'disgorgement of profits' approach or, second, to consider an appropriate financial penalty for each of the generic breaches of the Code of Conduct found to have been established. As a final measure, said Mr. Neoh, the totality principle had to be employed, a principle that appeared not to have guided the SFC.

439. In respect of what he termed the 'disgorgement of profits' approach, Mr. Neoh set out his calculations as follows :

i. In relation to LB-Notes, the bank had been involved in 3,961 transactions for all clients between January 2006 and September 2008. In that period, the available evidence showed that it had made an estimated profit of HK$50.6 million. In relation to FAs, the bank had been involved in 55,564 transactions for all clients between January 2003 and

December 2008 and in that period it had made an estimated profit of US$154,818,061.

ii. Given that the allegations against the bank involved 15 clients who had purchased LB-ELNs (this being 16 transactions) and 55 who had purchased LB-CDAs (this being 69 transactions), the bank's profit would have been some HK$1.1 million.

iii. Given that the allegations against the bank had also involved 13 clients who had purchased FAs (765 transactions), the bank's profit would have been some HK$16.6 million.

iv. Looking to the totality of the transactions, said Mr. Neoh, assessed on a civil basis, one that was rationally related to the alleged misconduct, the SFC should not have imposed a pecuniary penalty of more than HK$1.1 million plus HK$16.6 million : say HK$18 million.[61]

440. The Tribunal does not dispute that the 'disgorgement of profits' approach may in certain circumstances be the appropriate approach. Equally, it does not dispute the appropriateness in certain circumstances of the approach in terms of which the singularity of each generic breach of the Code of Conduct is identified and a single pecuniary penalty levied in respect of each such breach. As the Tribunal has noted, the statutory provisions concerning the imposition of pecuniary penalties are broadly defined, allowing for appropriate penalties to be determined in the light of a wide spectrum of culpabilities. The issue, however, appears to the Tribunal

[61] Mr. Neoh did provide the Tribunal with details of the exact data upon which his calculations were made; data which the Tribunal (considered in broad terms) has no reason to dispute.

to be contained in the following two questions. First, was the approach adopted by the SFC in the imposition of pecuniary penalties a permissible approach? Second, if so, does the Tribunal itself, acting as the primary decision-maker, consider it to be in all the circumstances the appropriate approach?

441. As indicated earlier, the SFC identified, first, in respect of LB-Notes and then in respect of FAs, areas of culpability, that is, acts or omissions constituting 'misconduct'. In respect of LB-Notes, it identified two areas of culpability, these being, first, the particular systemic failure to inform clients of 'issuer risk' and, second, the broader, more general and longer-lasting systemic failure of 'risk mismatch'. Concerning 'risk mismatch', when looking to its essential nature, the Tribunal in the body of this judgment has described it as constituting a 'failure to ensure suitability of product for bank clients'.

442. In respect of each of these two areas of culpability, the SFC sought to measure their seriousness and extent by the adoption of the following approach. First, on the basis that the maximum pecuniary penalty that it could impose in respect of each act or omission of culpability is HK$10 million, it assessed the level of seriousness of each at HK$5 million. Second, in looking to the extent of culpability in each instance, it chose as a 'multiplier' the number of complaints.

443. In the result, in respect of 'issuer risk', there being 15 complainants, it levied a pecuniary penalty of HK$75 million and, in respect of 'risk mismatch', there being 55 complainants, it levied a pecuniary penalty of HK$275 million.

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444. This raises the question of the permissibility of the number of complainants as a 'multiplier'. As stated earlier in this judgment, each complaint lodged was investigated and supported by a detailed dossier. That said, the individual complainants were not called to give evidence. However, crucially, much of the material in each dossier consisted of material found in the bank records, for example, the material obtained from the clients' eCRM records. Such material was not contested. Each complaint, of course, was particular to its own facts. But, in determining whether there had been a systemic failure on the part of the bank which had put these particular clients, and clients generally at risk, there was a commonality :

i. In the 15 complaints of a failure to inform clients of 'issuer risk', it did not appear to be disputed on the face of the documentation that in each instance there was a failure to inform the client purchasing the LB-ELN - either before or at the time of sale - of the identity of the issuer (Lehman Brothers) or of the intensifying issuer credit risk. Indeed, records of SFC interviews with relationship managers reveal that, as matters stood at the time, they themselves did not know who the issuer of the relevant product was until after each transaction had been completed.

ii. In the 55 complaints concerning a failure by the bank to ensure suitability of product when selling LB-CDAs to clients ('risk mismatch'), the records revealed a commonality going to the following matters. First, there were no records of consideration by each client's relationship manager as to the

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suitability of the CDAs for each client : a significant absence. Second, compounding the significance of a lack of pertinent records, on its face each complaint revealed a risk mismatch between the risk tolerance level of each client ('medium' or 'low') and the product risk rating of '5', this being the bank's highest risk rating. Third, in 42 of the complaints, the total of the CDAs and/or high risk products in that client's portfolio exceeded the maximum percentage recommended by the bank itself and recorded in its eCRM records.[62] Fourth, although the bank's own manual stated at the time, that relationship managers should not advise clients to hold more than 5% of their portfolio in single high risk products, in 47 of the complaints that limit appears to have been ignored with no recorded reasons justifying it.

445. In the 13 complaints concerning a failure by the bank to ensure suitability of product when selling FAs to clients, the records revealed a similar commonality. First, there were again no records of consideration by each client's relationship manager as to the suitability of the derivative instruments for the client. Nor were there records indicating that clients had been informed of the key features of FAs.[63] Second, each complaint, on its

[62] By way of example, in respect of the complaint by Ms. SNN, while the bank's own records said that the maximum percentage of high risk investments in the clients portfolio should not exceed 10%, Ms. SNN held a number of CDAs in addition to the one purchased in April 2007, these instruments constituting 26.96% of her account balance at the end of April 2007, this being well in excess of the recommended maximum percentage of 10%. The bank records revealed no evidence of consideration by the relationship manager as to the suitability of the instruments purchased in April 2007. In addition, one of the two underlying stocks purchased that month was on a list of stocks put out by the bank endorsed to the effect that they were not to be recommended by the bank and were only to be sold to clients who made a specific request. No records appear in any specific request.

[63] By way of example, in respect of one complainant Mr. RVJ, the SFC dossier stated the following : "According to the bank's investigation report, the client complained that the relationship manager purchased the FAs linked to Merrill Lynch in late 2007 without his written or verbal consent. The bank

face, revealed a risk mismatch. In short, there were no records indicating that the bank had ensured that the net worth of the clients who purchased FAs on margin was sufficient to cope with the risks inherent in holding such instruments. In this regard, the records of each of the 13 complainants revealed that their aggregate maximum notional exposure exceeded the client's assets under management.[64]

446. In the opinion of the Tribunal, the core purpose of the dossiers was not to prove that each and every complaint was true in each and every respect but, on a broader basis, to illustrate that the bank's own records, when read with the substance of the complaints, indicated that there had been a systemic failure in the marketing and sale of derivative instruments to protect the interests of clients in accordance with the principles set out in the Code of Conduct. The Tribunal is satisfied that, when the three sets of dossiers are read individually and/or as a whole, that they do serve this purpose.

447. As such, taken together, the Tribunal is satisfied that the complaints are capable rationally of constituting the requisite multiplier in assessing the appropriate level of pecuniary penalty.

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was unable to locate any telephone conversation for the relevant transaction. Internal Control of the bank was unable to ascertain on what basis the relationship manager recommended the FA contract to Mr. RVJ on 10 October 2007 as there was no voice log or other documentary evidence in support of the recommendation to him."

[64] By way of example, again referring to the dossier on Mr. RVJ, the SFC said the following in respect of concentration of risk : "As of 31st of August 2007, the outstanding MNE of the four FA contracts in the client's account amounted to US$5.6 million which represented over 210% of the client's assets under management. In addition to the FAs, the client was holding six CDAs at the market value of about US$694,539 which represented 26.06% of the client's assets under management. Such level of exposure to FAs and CDAs, that is, products with the highest risk rating, was clearly inconsistent with the client's 'balance' portfolio strategy and medium risk tolerance level and exceeded the maximum percentage portfolio of high risk investments set for the client's account, i.e. 20%."

448. The Tribunal, however, as the primary decision-maker, would amend the approach adopted by the SFC in assessing the appropriate FAs penalties. In respect of the FAs penalties, the SFC broke down the nature of the relevant misconduct into four discrete areas : 'know-your-client' failure, 'sufficient-net-worth' failure, 'risk profile' failure and 'lack of explanation' failure. However, as indicated in the body of this judgment, the Tribunal is of the view that, considered as a whole, these failures, for all essential purposes are, of the same generic nature and have the same effect as the failures constituting 'risk mismatch' in respect of the 55 LB-Notes complaints; namely, a failure to ensure suitability of product for clients of the bank. On this basis, in respect of the same essential *systemic* failures, in respect of LB-Notes the SFC chose to consolidate those failures into a single entity while they chose not to do so in respect of FAs. This is despite the fact that, in respect of both, the sum of the failures came to the same thing : a failure to ensure suitability of product.

449. Accordingly, The Tribunal is satisfied that, in respect of the FAs, a single systemic failure should be the multiplier rather than four failures.

450. As to the level of the pecuniary penalty, guided by its own Disciplinary Fining Guidelines[65], the SFC settled on an amount of HK$5 million in respect of each and every instance in which a pecuniary penalty was to be levied. For the reasons set out earlier in this judgment, the Tribunal is satisfied that the bank's culpability in respect of the marketing and sale of derivative was extensive, putting many clients at unnecessary risk of loss and indeed resulting in substantial losses for many. The

[65] Made under s.199(1)(a) of the Ordinance.

Tribunal is satisfied, therefore, that the assessed amount of HK$5 million is in all the circumstances appropriate.

451. In the circumstances, the Tribunal assesses the appropriate pecuniary penalty in respect of each area of culpable conduct as follows –

Nature of the misconduct	***Financial penalty***	***Affected complainants***	***Total***
LB-Notes issuer risk	$5 million	15	$75 million
LB-Notes risk mismatch	$5 million	55	$275 million
FAs risk mismatch	$5 million	13	$65 million

452. This comes to a total pecuniary penalty of HK$415 million, a total which is, of course, subject to consideration through the prism of 'totality'. In this regard, stepping back and doing the best it can to weigh the bank's disciplinary culpability in the context of what is appropriate to serve the regulatory purpose, namely, to protect the integrity of the market, the Tribunal is of the view that a total pecuniary penalty of HK$400 million is appropriate[66].

453. The Tribunal recognises that the penalty may be viewed as severe. However, in the light of all the relevant evidence - including profits made by the bank and overall losses suffered by many of its clients - it has been drawn to the conclusion that it is an appropriate penalty. The Tribunal

[66] In arriving at this total sum, the Tribunal has taken into account that, when assessing an appropriate financial penalty concerning FAs, the SFC found that there were 12 affected complainants in respect of the failure to disclose key risks as opposed to 13.

recognises that it is also exemplary in that, for the greater protection of the integrity of Hong Kong's financial markets, it provides a stern warning that principles of professional conduct must be adhered to. Put another way, that – in future – penalties imposed for convenient avoidance of the requirements of the Code of Conduct will constitute something more severe than the mere 'cost of doing business'.

Summary

454. For the reasons set out in this judgment, having found that HSBCPB was in the period under review culpable of material systemic failings in its marketing and sale of derivative products, failings that offended the Code of Conduct, the Tribunal has determined that the following orders should be made –

i. That, pursuant to s.196(1) of the Ordinance, the bank's registration for Type 4 regulated activity (advising on securities) be suspended for a period of one year, that period commencing on 21 November 2017.

ii. That the bank's registration for Type 1 regulated activity (dealing in securities) be partially suspended for a period of one year, that period commencing on 21 November 2017, to the extent that during the period of suspension, the bank be allowed only to handle listed securities trading for clients and to provide advice to clients incidental to such trading.

iii. That, pursuant to s.196(2) of the Ordinance, the bank shall pay a pecuniary penalty of HK$400 million.

iv. That there be liberty to apply.

455. In respect of costs, the Tribunal will hear submissions from the parties.

(Mr. Michael John Hartmann)
Chairman, Securities and Futures Appeals Tribunal

(Mr. Vincent Chin)
Member

(Ms. Helen Zee)
Member

Mr. Anthony Neoh, SC leading Mr. Jonathan Chang, instructed by Davis Polk & Wardwell
for the Applicant

Mr. Ambrose Ho, SC leading Ms. Janet Ho, instructed by SFC
for the Respondent