

HSBC Private Bank (Suisse) SA fined HK\$400 million for systemic failures in selling structured products

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HSBC Private Bank (Suisse) SA, the Hong Kong branch of the Switzerland-based private banking business of HSBC Group, has been fined a record sum of HK\$400 million after the Securities and Futures Appeals Tribunal (SFAT) upheld the SFC's disciplinary action against the bank for material systemic failures in relation to the sale of derivative products – namely, Lehman Brothers-related Notes (LB-Notes) and Leveraged Forward Accumulators (FAs) – in the run-up to the global financial crisis in 2008 (Notes 1 to 4).

HSBC Private Bank (Suisse) SA's registration for Type 4 regulated activity (advising on securities) has been suspended for a period of one year and its registration for Type 1 regulated activity (dealing in securities) has also been partially suspended under the Securities and Futures Ordinance (SFO) for a period of one year (Note 5).

The SFAT said in its determination that the SFC was correct in its findings and concluded that the bank was culpable of material systemic failings in its marketing and sale of derivative products by falling short of the standards set out in the SFC Code of Conduct and ancillary guidelines. The bank's culpability was "extensive, putting many clients at unnecessary risk of loss and indeed resulting in substantial losses for many," it added (Notes 6 & 7).

Between January 2003 and December 2008, HSBC Private Bank (Suisse) SA's internal processes were found to be materially flawed in:

- understanding each client's true risk profile;
- ensuring the suitability of products for each client; and
- supervising and monitoring sales processes in order to detect and avoid risk mismatch.

The SFAT is of the view that a fine of HK\$400 million is appropriate and 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'," the SFAT added.

Mr Ashley Alder, the SFC's Chief Executive Officer, said: "HSBC Private Bank (Suisse) SA's systems and controls for selling structured products fell significantly short of the standards expected of them. In combination with flawed practices and intrinsically high risk products, the bank's failures magnified the risk and occurrence of significant losses for customers. Accordingly, we have decided very substantial sanctions are required."

"The message should be clear: our standards are designed to protect all investors including clients of retail or private banks. When breaches of these standards occur, the SFC will take action to enforce them and strive to achieve outcomes that are in the interest of the investing public," he added.

Lehman Brothers-related Notes

By the summer of 2008, the financial crisis was increasingly alarming. HSBC Private Bank (Suisse) SA was aware of the deteriorating financial condition and credit quality of Lehman Brothers and had itself materially reduced its exposure to Lehman Brothers (Note 8). Nevertheless, HSBC Private Bank (Suisse) SA continued to sell the LB-Notes to its clients until 3 September 2008, i.e. two weeks before the collapse of Lehman Brothers, and did not disclose to its clients that the LB-Notes were issued by Lehman Brothers nor warned its clients about the increasing credit risk of the LB-Notes during the sales process (Notes 9, 10 & 11).

It was also found that in over 80 per cent of the outstanding LB-Notes transactions, there was a mismatch between the client's risk tolerance level and the risk rating assigned by HSBC Private Bank (Suisse) SA to the relevant LB-Notes, with clients who were categorised with "low" or "medium" risk

tolerance levels purchasing LB-Notes rated the riskiest by HSBC Private Bank (Suisse) SA. HSBC Private Bank (Suisse) SA did not keep adequate or proper records of justification for these risk-mismatch transactions (Notes 12, 13 & 14).

Leveraged Forward Accumulators

In distributing FAs to clients between January 2003 and December 2008, the SFC found that HSBC Private Bank (Suisse) SA failed to implement adequate systems and controls to prevent clients from being overly exposed to FAs and to ensure that clients had sufficient financial resources to assume the risks of trading in FAs even though FAs were at the time assigned internally the highest risk rating.

Under HSBC Private Bank (Suisse) SA's own in-house policy during the relevant period, a client should not be advised to invest more than 10 per cent of his/her portfolio held with the bank in any single structured product, or more than 5 per cent of the portfolio if the investment was considered to be high risk. However, the SFC's investigation revealed that HSBC Private Bank (Suisse) SA had dis-applied this policy in the sale of FAs despite being considered as a high risk product by the bank. HSBC Private Bank (Suisse) SA did not substitute this in-house policy with any other suitable policy to prevent clients from being overly exposed to FAs and to ensure that clients had sufficient financial resources to bear the potential losses of trading in FAs at the time of entering into the trade.

This case was referred to the SFC by the Hong Kong Monetary Authority (HKMA) following its investigation into issues arising from numerous complaints. The SFC acknowledges the investigatory work and assistance provided by the HKMA.

End

Notes:

1. HSBC Private Bank (Suisse) SA is a registered institution under the SFO to carry on business in Type 1 (dealing in securities) and Type 4 (advising on securities) regulated activities.
2. The LB-Notes, including callable daily accrual notes (CDAs) and equity-linked notes (ELNs), were issued by Lehman Brothers Treasury Co. B.V. and guaranteed by Lehman Brothers Holdings Inc., and were sold by HSBC Private Bank (Suisse) SA to its customers on a private placement basis.
3. Between January 2006 and September 2008, HSBC Private Bank (Suisse) SA distributed a total of 480 series of LB-Notes (427 series of CDAs and 53 series of ELNs), involving 3,961 transactions and a total nominal value of HK\$12.1 billion. The gross revenue earned by HSBC Private Bank (Suisse) SA from these transactions was about HK\$94.6 million.
4. Between January 2003 and December 2008, HSBC Private Bank (Suisse) SA distributed a total of 17,034 series of FAs to its clients, involving 55,564 transactions. The gross revenue generated from these transactions was about HK\$2.19 billion.
5. In relation to the partial suspension of HSBC Private Bank (Suisse) SA's registration for Type 1 regulated activity (dealing in securities) under the SFO, HSBC Private Bank (Suisse) SA is allowed only to handle trading in listed securities for clients and to provide advice to clients incidental to such trading.
6. In the SFC's decision, it was decided that (i) HSBC Private Bank (Suisse) SA's registration for Type 4 regulated activity (advising on securities) be revoked and 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 to provide advice to clients incidental to such trading; and (ii) HSBC Private Bank (Suisse) SA be fined HK\$605 million. Taking into account, among other things, that HSBC Private Bank (Suisse) SA's failings were not shown to be dishonest, intentional or reckless and that steps were taken by HSBC Private Bank (Suisse) SA from time to time to improve its systems, the SFAT determined that an appropriate period of suspension, in lieu of a revocation of HSBC Private Bank (Suisse) SA's registration, would have a better effect. In respect of the level of fine, the SFAT has treated the four areas of misconduct in relation to the sale of FAs as alleged by the SFC as one single category of "failure to ensure suitability of product" and reduced the fine to HK\$400 million
7. Please refer to the SFAT's Reasons for Determination, which is available on its website at www.sfat.gov.hk
8. On 31 July 2008, as a preventive measure, HSBC Private Bank (Suisse) SA's head office in Geneva gave a directive that there should be a review of credit exposure to Lehman Brothers. As a result, on 12 August 2008, HSBC Private Bank (Suisse) SA reduced its broking limits for Lehman Brothers in relation to bonds, CDAs and ELNs from US\$2 million to US\$1 million
9. A total of 672 LB-Note transactions were outstanding as at 15 September 2008. The outstanding LB-Notes are held by over 540 customers and involve a total nominal value of approximately HK\$2.33 billion
10. Based on the records provided by HSBC Private Bank (Suisse) SA, 59 transactions in LB-Notes, involving a total nominal amount of HK\$338.3 million, were executed after 1 January 2008. Of these transactions, 42 were executed after 1 June 2008
11. From a review of the tape recordings provided by HSBC Private Bank (Suisse) SA in relation to 16 transactions executed between July and August 2008, the SFC found that the sales staff did not disclose to the clients that the LB-Notes were issued by Lehman Brothers or alert the clients to the increasing credit risk associated with the LB-Notes during the sales process.

12. At the relevant time, HSBC Private Bank (Suisse) SA adopted a 5-level classification of product risk rating (1-minimal, 2-low, 3-moderate, 4-medium, 5-high). CDAs and ELNs issued by Lehman Brothers were assigned the highest risk rating of "5" and the second highest risk rating of "4" respectively by HSBC Private Bank (Suisse) SA
13. Before April 2008, HSBC Private Bank (Suisse) SA divided its client's risk tolerance into three levels, i.e. "low", "medium" and "high".
14. A risk-mismatch in this case refers to a client of "low" or "medium" risk tolerance level purchasing a product with the highest risk rating of "5".