PROFESSIONAL ETHICS AND COMPLIANCE

香港銀行學會
The Hong Kong Institute of Bankers

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Module Intended Learning Outcome

1. **Understand and apply the principles of ethics and codes of ethics relating to the day-to-day work in the banking industry**
2. **Identify and exercise the requirements of professional ethics in various roles during job execution**
3. **Perform compliance monitoring and the practical application of legal and regulatory requirements in their daily work**

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Module Outline

Chapter 1: Ethics and the Individual

Chapter 2: Ethics and the Corporation

Chapter 3: Regulatory Framework and Regulatory Requirements

Chapter 4: Corporate Governance and Internal Control

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Chapter 1

ETHICS AND THE INDIVIDUAL

Learning outcomes:

Upon completion of this chapter, learners will be able to:

- Demonstrate an understanding of different perspectives on ethics.
- Describe what a profession is.
- Distinguish and apply the professional ethics and code of conduct adopted by banking professionals in Hong Kong.
- Identify integrity and list relevant anti-bribery laws and regulations.
- Manage conflicts of interest and list relevant regulatory guidelines in banking.
- Be aware of potential ethical dilemmas in their daily job execution.
- Exercise methods of dealing with ethical dilemmas and conflicts of interest.

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1. Introduction

Chapter 1 Glossary

AI	Authorised Institution
AMLO	Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance
APR	Annualised Percentage Rate
CBP	Code of Banking Practice
CIMA	Chartered Institute of Management Accountants
CPA	Certified Public Accountant
DTC Association	The Hong Kong Association of Restricted Licence Banks and Deposit-taking Companies
EOC	Equal Opportunities Commission, Hong Kong
HKAB	Hong Kong Association of Banks
HKEx	Stock Exchange of Hong Kong Limited
HKMA	Hong Kong Monetary Authority
ICAC	Independent Commission Against Corruption
PDPO	Personal Data (Privacy) Ordinance
POBO	Prevention of Bribery Ordinance
SEC	Securities & Exchange Commission
SFC	Securities & Futures Commission
SFO	Securities and Futures Ordinance

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1.1 Historical background

Before understanding the fundamental principles of ethics that influence current Banking Practices, the context within which these ethics have developed needs to be understood. While a complete and detailed history of the development is outside the scope of this training, in material, the following a few stories will be used to illustrate the considerations to bear in mind when understanding the normative ethics relevant to Banking Practices.

The Barrister and the Bag

An anecdote shared amongst English legal students and practitioners is the story of the "Barrister Purse", a tubed appendage which extends behind the left shoulder of a Junior Barristers gown:

"The gown of an English [junior] barrista fold traditionally a fold in the back, [said to be] in memory of the original pocket into which his fees were dropped. The counsel was not supposed to be able to see it. He could not sue for his fee in an English court, as it was an honorarium for his services and was usually placed into his gown pocket before he undertook the pleading. If the barrister chose to retain the fee, but not carry out his obligation, no power could bring him to book for such an offence"1.

Along with powdered wigs, these features of the uniform are a link to the history and development of the legal profession within England and subsequently countries which have adopted the practices of Common Law.

While the truth of the story is still up for debate, the story serves to illustrate a few considerations around the relationship between a professional and his client. There is an implied duty that is placed on the professional to the client once the job is accepted. On the other hand, there is also an allowance for the professional to refuse the client's services. A professional's service is held in high esteem and of value beyond just the material compensation provided. The takeaways from this story are the following: whether the professional's duty is to be towards servicing the client or towards the professional's benefit and how these responsibilities affect how services are rendered.

1 Hay: Book of Legal Anecdotes (1989) p.255

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Lehman Brothers and the Customers

The 2008 financial crisis revealed many instances of loopholes in the banking business, with most of the world's largest banks, and even many smaller ones, carrying massive liabilities in respect of derivative securities linked to US subprime mortgage valuation. Lehman Brothers was forced to close down, and a few international banks nearly collapsed and had to be bailed out by massive injections of government funds. US citizens were also outraged by the fact that many financial institutions still paid huge bonuses to their senior executives.

The Lehman minibond incident resulted in lawsuits and prolonged demonstrations against those banks in Hong Kong, which not only affected the banking industry but also dealt a blow to social order. The government was requested to put pressure on the banks to compensate those investors who claimed that they were not aware of the inherent risks and exposure of the minibonds. In Hong Kong, the Lehman Brothers incident highlighted that some banks had focused on the pursuit of targets and growth of profits and had employed improper selling practices.

Keeping in mind the takeaways from the "Barrister and the Bag", what is the relationship between a legal story and the devastating impact of the meltdown of Lehman Brothers? Lehman Brothers and its role in the financial crisis of 2008 has served as a learning lesson of the extreme consequences where professional have prioritized profit in their relationship with their clients.

In the next section an overview of the guiding ethical concepts will be discussed. The goal of this discussion will be to gain a better understanding of the guidelines in place for professional to identify the most appropriate balance between prioritizing client needs and profit.

1.2 Ethical concepts around Banking

Duty theories

Duty theories link ethics to a society's specific fundamental principles of obligation. For

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instance, parents may be regarded as having an obligation to take care of their children. These theories are sometimes called 'deontological theories', as 'deon' means duty.

A number of philosophers in the 17th century created three major categories of duty:

- duties to God
- duties to oneself
- duties to others.

An inverted type of duty theory is the 'rights theory'. A rights theory may state, for instance, that citizens have specific rights in a society and that those rights should be protected.

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Duty of Care

Duty of care refers to the effort made by an ordinarily prudent or reasonable party to avoid harm to another, taking the circumstances into account. It refers to the level of judgment, care, prudence, determination, and activity that a person would reasonably be expected to do under particular circumstances. This standard is applied in a vast variety of contexts, whether the duty may be driving on the road or performing a background check. The precise definition is usually made on a case-by-case basis, judged upon the law and circumstances in each case.

Fiduciary Duties

A fiduciary relationship arises under common law where A and B agree that A will act on behalf of or for the benefit of B in circumstances which give rise to a relationship of trust and confidence. A has some discretion or power which affects B's interests. B in turn relies on A for information or advice.

In determining whether a relationship is fiduciary, the substance of the relationship must be examined in light of its commercial context and the entirety of the obligations undertaken (and not just the label given to the relationship). Fiduciary duties are owed by:

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- Partners (to their fellow partners)
- Solicitors and other professional advisers (to their clients).
- Trustees (to beneficiaries).
- Agents (to principals).

The four key fiduciary duties

A fiduciary has an obligation to act in the interests and for the benefit of his beneficiaries. There are four key fiduciary duties (where A is the adviser acting on B's behalf and B is his client):

1. No conflict: "A" must not place himself in a position where his own interests' conflict with those of "B" or where there is a real possibility that this will happen. This is also known as conflict of duty or conflict of interest. For example a compromised bank staff accepts advantages for expediting loan applications[2].

2. No-profit: "A" must not profit from his position at the expense of "B." This is also known as misuse of property held in a fiduciary capacity. This duty has been interpreted strictly. For example if a financial firm makes excessive trades from a client bank accounts.

3. Undivided loyalty: "A" fiduciary owes undivided loyalty to his beneficiary. Rather confusingly, this is sometimes called conflict of duty. "A" must not place himself in a position where his duty to another customer conflicts with his duty to "B." A consequence of the duty of undivided loyalty is that a fiduciary must make available to a customer all the information that is relevant to the customer. An example of this may be where an investment firm must disclose if they are also managing the investment of a competitor, wherein it will affect the overall investment strategy of the immediate client.

[2] ICAC: https://hkbedc.icac.hk/en/sector_industry/banking_and_finance/22

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4. Confidentiality: “A” must use or disclose information obtained in confidence from “B” for the benefit only of “B.” An example of this is where a trader should not use confidential information secured from its client to profit.

    i) Note that a fiduciary relationship subsists between a professional adviser and client, but it comes to an end with termination of the retainer. Thereafter, the adviser has no obligation to defend and advance the interests of the former client. The only duty to the former client which survives termination of the client relationship is a continuing duty to preserve the confidentiality of information imparted during its subsistence.

    ii) In professional relationships such as accountants, solicitors and bankers, it is implied that the client's affairs will be kept secret and not disclosed to anyone without just cause (Parry-Jones v Law Society (1969) 1 Ch). The limits on the duty of secrecy will depend on the circumstances peculiar to each occupation. The continuing nature of the duty of confidentiality means that, if a professional wishes to act against a former client or for an opponent of a former client, he should only do so if he can avoid disclosing confidential information given to him by the former client. The former client can relieve the fiduciary from his duty of confidence by giving his real consent.

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2. Ethics and the Individual

2.1 Introduction

We are aware of the importance of ethics for the sustainability of a corporation. The senior management may well uphold the principles of corporate social responsibility but employees may not necessarily follow. Without ethical employees, it is hard to have an ethical corporation.

The banking sector particularly emphasises ethical behaviour since customers put their trust in banks to deal with their assets/money, and bank employees handle financial transactions every day. It may be tempting for bank employees to take personal advantages when carrying out those transactions, which could affect the welfare of customers and damage the reputation of the bank resulting in lawsuits, loss of customers, loss of business and investor confidence, financial losses, and even an unstable banking system.

Professionals working in banks provide financial services on behalf of their employers, advise clients on financial matters and provide solutions to investment, funding and risk management issues. In many cases, they also serve as intermediaries between the banks and their clients and among their clients. Therefore, conflicts of interest and ethical dilemmas can arise.

Professions and ethics

A profession normally has the following characteristics:

- high ethical standards
- specialist knowledge and skills
- a recognised and organised body of knowledge
- knowledge and skills exercised in the interest of others.

Lawyers, doctors, accountants, engineers and so on are generally categorised as 'professionals', because they have obtained licences to perform duties in their specialised

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areas. Most professions have a professional association, professional standards and codes of ethics.

As the banking industry is regulated, the banks themselves must have licences and observe the regulations and rules issued by bank supervisory and industry bodies respectively. These regulations include detailed guidelines on the minimum standards of behaviour expected of bank employees. Banks are required to adopt these standards of behaviour in the form of internal codes of conduct. In Chapter 2, we shall discuss in more details about the banking professionals.

Code of Conduct and Code of Banking Practice

All employees of a bank must observe the strict ethical standards required by bank regulators and there are two ethical codes currently applicable to banking professionals in Hong Kong:

- the first is the Code of Conduct developed by each bank for its employees, as prescribed by the HKMA;
- the second is the Code of Banking Practice issued by The Hong Kong Association of Banks and the DTC Association.

Module CG-6 """Competence & Ethical 'Behaviour" of the HKMA Supervisory Policy Manual3 illustrates the importance of the competence and ethical behaviour of staff at all levels within an AI's organisational structure and provides guidance on measures AIs are expected to adopt in monitoring and maintaining the competence levels and ethical behaviour of their staff. This Module CG-6 also states the following:

"Good ethical behaviour should be required of all levels of staff within an AI. Staff members of an AI should act with integrity, due skill, care and diligence in carrying out their role and responsibilities."

"AIs should ensure that integrity and professional ethics are integrated into their corporate values and standards."

[3] "**Code of Banking Practice**", The Hong Kong Association of Banks and The DTC Association, February 2015 at https://www.hkma.gov.hk/media/eng/doc/code_eng.pdf

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"AIs are expected to establish and implement policies and procedures for monitoring, developing and maintaining the competence levels and ethical behavior of their staff with due regard to the principles set out in this module. In so doing, AIs may adopt a proportionate approach, such that their policies and procedures are appropriate for and commensurate with the size, scope, nature and complexity of their business."

2.2 Code of Conduct

Every bank is required to put in place an internal code of conduct which sets out the expected standards of behaviour of its staff. The HKMA requires all banking institutions in Hong Kong to develop and issue their own in-house code of conduct to fit with each bank's own structure, size and business operations. The code is to cover all legal, regulatory and ethical issues with separate codes or policy statements for different topics including integrity & bribery, making lending decisions, borrowing by bank employees, conflicts of interest, use of confidential information, outside employment, making personal investments and obtaining personal benefits, and employees' reporting obligation.

2.2.1 Bank on Integrity

Minimum standards

Under Module CG-3 "Code of Conduct" of the HKMA Supervisory Policy Manual[4], the HKMA has provided the minimum standards for the Code of Conduct developed by each AI and they are summarised as below:

1. The AI, i.e. bank, should appoint an Officer or a committee to oversee the implementation of and adherence to the Code of Conduct and handle queries from staff regarding the contents of the Code.
2. The Code should contain a set of ethical standards and values for staff to follow when conducting business, and would normally include the areas of honesty, integrity, diligence, fairness, responsible citizenship and accountability.
3. All staff should avoid situations that may lead to a conflict of interest.

[4] "Supervisory Policy Manual, CG-3 Code of Conduct, v.1 – 21.06.02", Hong Kong Monetary Authority. Retrieved on 5 August 2017 at http://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/supervisory-policy-manual/CG-3.pdf

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4. The Credit Policy should include clear lending authority and specified limits for staff granting credit. No member of staff or their relatives should borrow or receive credit from third parties on a favoured basis.
5. No staff member should offer any bribe or consideration so as to obtain business for the bank.
6. No staff member should use his/her own authority or influence other staff to obtain personal benefit or an indirect benefit, and all staff should observe the statutory provisions of section 9 of the Prevention of Bribery Ordinance and section 124 of the Banking Ordinance. Staff members may be permitted to accept and retain a personal benefit within the acceptance criteria of the bank set out in the Code of Conduct provided that it complies with relevant legal requirements and there is no likelihood of improper influence or prejudice on the proper performance of duties conducted by the staff member. The bank should maintain proper records of personal benefits received by staff within the bank's acceptance criteria so as to protect both the bank and its staff against subsequent adverse allegations. We shall further discuss anti-bribery laws under the later section of Integrity Management.
7. All staff should handle customer information carefully in compliance with relevant statutory requirements, e.g. the Personal Data (Privacy) Ordinance ("PDPO") and common law principles on customer confidentiality. The PDPO will be further discussed in this chapter.
8. Staff should not deal in the shares of any listed company when possessing privileged or price-sensitive information. Insider trading/dealing refers to the buying or selling of securities while in possession of price-sensitive, non-public information about the entity, and is a form of market misconduct and a criminal offence under the Securities and Futures Ordinance ("SFO"). If a staff member is not sure whether a deal would constitute insider dealing, he/she should consult the appropriate officer.
9. Staff should not take up any directorship, employment or part-time commercial duties without prior written consent as required by the Code of Conduct.
10. All staff should contribute to the good reputation of the bank and be alert to any matter that could give rise to fraud, deception, theft, forgery, corruption or other illegal activities. Staff should report any suspected illegal matters according to the bank's procedures. Failure to report such activity immediately may result in internal disciplinary action. It is also a statutory obligation to report suspected money

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laundering and terrorist financing and failure to report any knowledge or suspicion of property being crime proceeds or terrorist property is a criminal offence.

11. Any breach of the Code of Conduct will give rise to disciplinary action and, where applicable, to criminal prosecution.

For the full list, you may refer to Appendix 1 of this Chapter 1 or access the Supervisory Policy Manual on the HKMA website.

To raise the awareness of the high ethical and integrity standards required in the banking business, the ICAC has published Bank on Integrity - A Practical Guide for Bank Managers[5] ("Bank on Integrity Guide") to provide guidance on actual and potential risks of corruption. This will be discussed in the later section under Integrity Management.

The ICAC also offers advice for private companies, including banks, on codes of conduct with regard to corruption prevention and a sample Code of Conduct is provided in Attachment 1 of the "Bank on Integrity Guide" which is accessible on the ICAC website.

Enforcing the Code of Conduct

The HKMA carries out periodic on-site examinations to ensure that banks have sufficient systems in place to enforce their codes of conduct. Such systems are an essential part of ethics and integrity management.

A good system for enforcing a code of conduct should contain the following elements:

- involvement of senior management and the board;
- comprehensive communication to bank employees regarding the code;
- segregation of conflicting responsibilities;
- appropriate channels for reporting and obtaining approvals;
- appropriate procedures for mitigating misconduct;
- maintenance of proper written records on any relevant activities; and
- regular reviews and audits on the enforcement of the code.

[5] Bank on Integrity – A Practical Guide for Bank Managers, jointly developed by the ICAC, HKMA, HKAB, The DTC Association and The Hong Kong Institute of Bankers at https://hkbedc.icac.hk/Upload/guides/4/pdf/8cc4d22f0765467c9be44151a50d44f8.pdf

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Appendix 2 describes the expectations of the HKMA regarding how a code of conduct should be enforced.

Integrity management

All banking staff should act with honesty and integrity and observe the ethical standards set out in their employer bank's code of conduct.

The "Bank on Integrity Guide"[6] illustrates in detail the actual and potential risks of corruption and provides advice and tips on how bank employees may help their banks to prevent corruption. The following section is an extract of the anti-bribery laws and related legal requirements in Hong Kong.

Anti-bribery laws and relevant legal requirements

- Prevention of Bribery Ordinance (Cap. 201) ("POBO") - Section 9

Bribery in the private sector is governed under this provision. All staff members of a bank should have an adequate understanding of the provision, so as to avoid and help avoid potential breaches of the law by themselves or other staff members.

Section 9 – Corrupt Transactions with Agents (note a)

- Section 9(1) – It is an offence for an agent to, without reasonable excuse, solicit or accept an advantage (note c) as an inducement to, or reward for, his doing or forbearing to do any act, or showing or forbearing to show favour or disfavour to any person, in relation to his principal's (note b) affairs, except with his principal's permission (note d).
- Section 9(2) – Any person who offers an advantage to an agent for the above purpose also commits an offence.
- Section 9(3) – Any agent who, with an intent to deceive his principal, uses any receipt, account or other document which contains any statement which is misleading, false or deceptive in any material particular and in respect of which the principal is interested, is guilty of an offence.

[6] The Guide is jointly developed by the ICAC, HKMA, HKAB, The DTC Association and The Hong Kong Institute of Bankers.

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A person convicted of an offence under this provision is subject to a maximum penalty of seven years' imprisonment and a fine of HKD500,000.

(note a) Agent – an agent is a person acting for the principal. A bank's director or employee is an agent of the bank (the principal) in carrying out the bank's business.

(note b) Principal – the principal is the employer or any authorised persons of the employer. For a bank employee or director and in relation to the bank's business affairs, the bank is the principal.

(note c) Advantage – includes money, gifts, discounts, commission, loans, offers of employment/service, etc. Please note entertainment, defined as the provision of food or drink (e.g. a free business meal) provided for consumption on the occasion and any other entertainment connected with, or provided at the same time as, such provision (e.g. a show or performance provided at the venue where the meal is provided), is not an advantage under the POBO.

In practice, banks should have in place a strict policy and proper procedures on the acceptance of entertainment (defined as aforementioned), with explicit amounts and occasions, and with proper record-keeping and audit trails.

(note d) Principal's Permission – if the advantage is accepted with the principal's permission, then neither the agent nor the offeror commits an offence. The permission must be given before the advantage is offered or accepted. In any case where an advantage has been offered or accepted without prior permission, the agent must apply for his principal's permission as soon as reasonably possible.

Furthermore, it is not a defence to claim that an advantage accepted or offered is customary in any profession, trade, vocation or calling.

A person convicted of an offence under this provision is subject to a maximum penalty of seven years' imprisonment and a fine of HKD500,000.

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Staff of a bank are subject to more stringent requirements under the Banking Ordinance (Cap. 155) in relation to the acceptance of an advantage. For example, under the Banking Ordinance, there may be no defence of the bank having agreed to the acceptance of the advantage for showing favour to any person when approving loans or credit facilities from the bank.

In practice, banks should have in place a strict policy and proper procedures for staff to obtain prior approval from relevant parties (e.g. approval authority given to senior management) before acceptance of any advantages.

As the principal is the bank, permission for staff to accept advantages can normally be given by the Board of Directors, or persons with appropriate authority to make such decisions (e.g. the CEO), or persons explicitly delegated with authority to make such decisions (e.g. in exceptional cases the Human Resources Director).

- Prevention of Bribery Ordinance (Cap. 201) – Section 4 and Section 8

In addition to dealing with customers or business partners, staff of a bank may have to deal with public servants. They should therefore be aware that the provisions prohibit the offering of advantages to public servants in relation to business dealings.

Section 4 – It is an offence to offer an advantage for a public servant's performing or abstaining from performing any act in his official capacity, assisting, favouring, hindering, or delaying any person in the transaction of any business with a public body. Examples of public servants include staff of the HKMA, SFC, Stock Exchange of Hong Kong Ltd., etc.
Section 8 – It is an offence to, while having dealings with a government department or public body, offer any advantage to an officer of the government department or a public servant employed by the public body.

A person convicted of an offence under these provisions is subject to a maximum penalty of seven years' imprisonment and a fine of HKD500,000.

Please refer to Appendix 3 for the full version of Sections 4, 8, 9 and 11 of the Prevention of Bribery Ordinance (Cap. 201).

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- Banking Ordinance (Cap 155) – Section 123 and Section 124

Section 123 – Bank employees are prohibited from committing deliberate deception by making a false entry in any documentation relating to the bank's business.

A person convicted of an offence under this provision is subject to a maximum penalty of five years' imprisonment and a fine of HKD1,000,000.

Section 124 – It is an offence for any director or employee of a bank to ask for or accept advantages for his/her own personal benefit, or for that of his/her relatives, for showing favour to any person when approving loans or credit facilities from the bank. There is no defence of the bank having agreed to the acceptance of the advantage concerned.

A person convicted of an offence under this provision is subject to a maximum penalty of five years' imprisonment and a fine of HKD200,000.

The following case scenarios based on real life corrupt practices have been extracted from the ICAC's "Bank on Integrity" Guide as below, to illustrate the application of the relevant POBO provisions and highlight the risks of corrupt practices in a banking business environment.

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Case study 1 – Bribery for Loan Extension

Scenario:

A Corporate Customer encounters a cash flow problem and approaches the Senior Bank Manager to extend the loan due date with a promise to reward the latter. The Senior Bank Manager endorses and recommends to the Bank the loan extension. The Customer presents to the Senior Bank Manager expensive gifts (including a watch) and cash.

Being an employee (agent) of the Bank and without permission of the Bank (principal), the Senior Bank Manager agreed to assist the Customer to secure an extension of the loan, an act in relation to the Bank's business, in return for advantages as rewards. The Senior Bank Manager contravened Section 9(1) of the POBO. He might have also contravened Section 124 of the Banking Ordinance.

The Customer contravened Section 9(2) of the POBO when he offered the advantages to induce the Manager to give him the favour.

Case study 2 – Bribery and Collusion with a Third Party for Favour in a Mortgage Loan Application

Scenario:

A Property Developer frequently offers a Manager of a Finance Company expensive luncheons and free golf trips to the Manager and his wife. The Property Developer asks the Manager to secure a higher loan amount for the redevelopment of village houses, promising a reward. The Manager bribes a Valuer of a property valuation agency to inflate the collateral value in the valuation report. Based on this false valuation report and the Manager's recommendation, the Finance Company approves the loan and the Property Developer pays a commission as a reward to the Manager's wife, in an attempt to conceal the corrupt deal.

The Manager (agent) was considered to have accepted the advantage as his wife received the advantage on his behalf, without permission of the Finance Company (principal), he has contravened Section 9(1) of the POBO.

The Property Developer contravened Section 9(2) of the POBO when he requested the

Manager's assistance with an offer of a reward.

The Manager also breached Section 9(2) of the POBO as he had bribed the Property Valuer to inflate the value of the collateral, while the Property Valuer contravened Section 9(1) of the POBO. They both contravened Section 9(3) by each submitting false, misleading reports to their employers.

The Manager might have also breached Section 123 and 124 of the Banking Ordinance.

Case study 3 – Bribery for the Assistance in Money Laundering

Scenario:

A Customer asks a Bank Manager to provide a bank account for him to transfer huge amounts of money around without revealing his identity, and offers to pay the Bank Manager a percentage of the funds transferred as commission. The Bank Manager asks another customer, a small trading company whose accounts are largely inactive, to allow him to perform such transactions on the company's accounts at a fee. The scam is discovered when the Bank finds suspicious transactions in the trading company's accounts where large sums are frequently deposited and then shortly transferred to various accounts, and the sums involved are not commensurate with the company's business turnover volume.

The Bank Manager (agent), without permission of the Bank (principal), accepted an advantage as a reward to assist the Customer to perform suspicious transactions. The Manager contravened Section 9(1) of the POBO while the Customer contravened Section 9(2).

The Bank Manager might have committed an offence under the Drug Trafficking (Recovery of Proceeds) Ordinance, Organised and Serious Crimes Ordinance or United Nations (Anti-Terrorism Measures) Ordinance if there was evidence to show that he knew or had reasonable grounds to believe those sums were the proceeds of drug trafficking or an indictable offence or were terrorist property, but still dealt with them, and/or he knowingly failed to disclose his knowledge or suspicion to the authorities. The Bank Manager might have also breached the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance ("AMLO") if he knowingly

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defrauded the Bank and caused the bank to contravene a specified provision in the AMLO.

The trading company owner might similarly have committed a money laundering offence notwithstanding his limited role.

Case study 4 – Misuse of Vulnerable Customers' Funds

Scenario:

A number of elderly customers entrust a Bank Manager and they sign blank instruction forms and leave them with the Bank Manager for convenience. One day, the Bank Manager wrongly executes a customer's investment instruction leading to a huge loss for this client. He covers up the mistake by transferring money from an elderly customer's account using the signed blank instruction form and he also forges a false transaction advice to deceive the elderly customer. The scam was discovered when the elderly customer enquired about his account balance while the Bank Manager was on leave.

The Bank Manager contravened Section 9(3) of the POBO by using a false document, i.e. he forged the customer's instruction to deceive the Bank.

He might also be charged with a series of other criminal offences including theft, fraud and forgery.

For more case scenarios, please access the ICAC website for the "Bank on Integrity" Guide at http://cpas.icac.hk

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2.2.2 Conflicts of interest

Section 2.4.1 of Module CG-3 ‘Code of Conduct’ of the HKMA Supervisory Policy Manual states that:
All staff should avoid situations that may lead to or involve a conflict of interest, actual or potential and, in case of doubt, should seek the advice of the Code of Conduct officer.” [7]

Professionals should provide services to their employers and customers in those parties’ best interests. However, in some cases, professionals receive unauthorised personal advantages, and the interests of either their employers and/or their customers are not protected. Conflicts of interest are likely to occur in the following circumstances:

- Direct dealing – a professional makes direct personal deals with current or potential clients of his/her employer, without soliciting approval from the employer.
- Outside employment – a professional’s engagement in outside employment may sometimes constitute a conflict of interest, especially if the two employers are competitors.
- Family interests – if a professional contracts out his/her employer’s work to a company owned by his/her family members, or hires family members as his/her subordinates.
- Gifts from clients – professionals who accept gifts or other benefits directly from current or potential clients may be inclined to make business decisions that are unreasonably favourable to those clients.

Bank managers are considered to have a conflict of interest in the following situations where they:

- process loan applications submitted by their friends or relatives.
- have outside employment that may produce a conflict of interest with their employer.
- develop an external business relationship with their clients.
- advise clients to invest in assets or companies in which they have a financial interest.
- process and evaluate tenders or quotations submitted by their friends or relatives.

The above examples illustrate conflicts of interest between the bank staff and the bank.

[7] Ibid 1.

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Besides this, the SFC's "Code of Conduct for Persons Licensed by or Registered with the SFC" includes guidelines on avoiding conflicts of interest and they include:

Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission in Hong Kong[8]

General Principle 6 – 'A registered person should try to avoid conflicts of interest, and when they cannot be avoided, should ensure that his/her clients are fairly treated.'
10.1 Disclosure & Fair Treatment – 'Where a registered person has a material interest in a transaction with or for a client or a relationship which gives rise to an actual or potential conflict of interest in relation to the transaction, he/she should neither advise, nor deal in relation to the transaction, unless he/she has disclosed that material interest or conflict to the client and has taken all reasonable steps to ensure fair treatment of the client.'

Identifying and managing conflicts of interest in a bank

Banks must have in place appropriate policies and procedures to identify and properly manage conflicts of interest in the day-to-day provision of banking services as well as investment banking activities.

Common set-up and arrangements:

- Information barriers ("Chinese Wall") between different departments/areas of the bank are in place to restrict the flow of confidential or sensitive information, e.g. segregation of corporate advisory & securities dealing/investment advisory;
- A Control Room system to report any potential conflicts of interest and usually the Compliance Department or a unit within the Compliance Department is assigned this role. Relevant staff will declare actual or potential conflicts of interest to the Control Room for comments and approval, and, where necessary, the relevant employee will abstain from participation in the relevant transactions. This is particularly relevant for regulated businesses;
- Where a conflict of interest remains and where permissible by regulations, the bank can seek disclosure of the conflicts of interest to the affected clients and obtain the clients' consent, e.g. a swap transaction with disclosures to counterparties;

[8] June 2017 Eighteenth edition

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- Procedures established for the acceptance of entertainment and hospitality, and gifts offered by clients. The acceptance limits and related handling and approval procedures should be provided in the relevant procedural manuals or guidelines.

Proper written records are to be kept and updated regularly so as to facilitate effective management, good control and audit trails.

Real-life cases on conflicts of interest

Three cases are presented to illustrate the serious impact on public interest and the consequences of contravening the related laws and regulations.

Cases 5 and 6 regarding licensed persons have been extracted from the SFC website: www.sfc.hk

Case study 5 – The SFC Suspends a Licensed Representative of a Securities Firm and a Commodities Firm for Nine Months for Conflicts of Interest and Unsound Advice (29 Mar 2005)

Scenario:
In an investigation concerning a placement deal in January 2002, the SFC found that the licensed representative had borrowed HKD4.5 million from a client and lent it to three other clients to subscribe for company shares in the placement. As a result, he became interested in the transactions. Although the conflict of interest could easily have been avoided, the licensed representative failed to avoid it because he did not want to lose a business opportunity. The loans also breached his employers' internal rules.

Furthermore, the licensed representative recommended the three clients subscribe beyond their means by borrowing substantial loans from him to finance the investment. He had, however, failed to consider whether the amount of potential loss, magnified by the leveraging effect of the loans, was appropriate for the three clients. One of the clients suffered a loss that exceeded her annual income as a result of the subscription. The bases of the licensed representative's recommendations were flawed and unreasonable and failed to take into account the

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three clients' risk tolerance and investment objectives.

One of the subscribing clients was his mother and he shared the loss of the transactions through his mother's account. By not informing his employers of the fact that he had a personal interest in those transactions, he also breached his employers' internal rules.

The SFC's then Executive Director of Enforcement said, "Licensees must handle conflicts of interest with care. Loans to and from clients clearly give rise to conflicts of interest. Licensees should avoid becoming personally interested in clients' transactions. Client interests are at risk in such situations and the SFC will penalise more heavily if there is evidence of any harm to clients."

He added, "Equally importantly, advice or recommendations given by licensees to clients must be suitable, based on thorough analysis and having taken into account alternatives. In the case of a leveraged transaction, licensees must also ensure that the client understands the nature and risks of the transaction and has sufficient net worth to be able to assume the risks and bear the potential losses of the transaction."

Case study 6 – A Dealing Director and Executive Director Surrenders her Licence to the SFC for Five Years for Serious Conflict of Interest (1 Mar 2005)

Scenario:

At the material time, Ms X was a dealing director of a securities company (Y Ltd.) and an executive director of a holding company (Z Ltd). Both Y Ltd. and Z Ltd. are under the same group.

The SFC found that Ms. X was instrumental in obtaining funds from her clients at Y Ltd. to finance Z Ltd.'s activities between 1999 and 2002, in circumstances where she was aware of the financial and regulatory difficulties facing both companies. Her clients were not told that they were lending money to a company in financial difficulties.

In the single most serious incident, a client's shares were borrowed and pledged to Z

Ltd.'s bankers and were subsequently sold by the bank without the client's consent.

Ms. X owed her clients a positive duty to act in their best interests by evaluating their appetite for risk and ensuring they understood the nature and related risks of their investment. However, Ms. X failed to:

- avoid a conflict of interest; and
- fully inform her clients of the nature of their investment and the risks they were taking.

The SFC decided that the seriousness of the misconduct in this case, coupled with Ms X having been previously disciplined by the SFC for failings also related to conflicts of interest[9], necessitated revocation of her licence.

The then SFC's Executive Director of Enforcement said, "The conflict of interest might have been addressed if Ms. X had been prepared to inform her clients clearly about the identity of the borrower, its financial situation and the risks of lending to that entity including, in particular, the risk of losing their money should the borrowing company's position deteriorate. Ms. X was obliged to tell her clients of Z Ltd.'s up-to-date financial position, and should not have expected them to rely on outdated published accounts."

He added, "I said last year that a tough stance would be taken in cases involving serious conflicts of interest. The consequences of the conflict in this case were serious. Some investors had to wait months before they could get their money back and the single largest lender will not be fully repaid until 2007. This is not acceptable."

2.3 Code of Banking Practice

All authorised institutions in Hong Kong must observe the Code of Banking Practice (CBP, latest version 2015), issued jointly by the Hong Kong Association of Banks and the DTC Association—the industry associations—and endorsed by the HKMA. The Code provides detailed guidelines for authorised institutions on how to deal with customers and protect their interests.

[9] The SFC suspended the registration of Ms X as a Dealing Director and Investment Adviser Director under the Securities Ordinance and as a Commodity Dealer's representative under the Commodities Trading Ordinance for a period of 9 months. (4 Oct 2001)

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The Code has the following objectives:

- Promote good banking practices by setting out the minimum standards which institutions should follow in their dealings with customers.
- Increase transparency in the provision of banking services so as to enhance the understanding of customers of what they can reasonably expect of the services provided by institutions.
- Promote a stronger culture of treating customers fairly which will ensure customers' interests are taken into account by institutions in their business dealings with customers.
- Foster customer confidence in the banking system.

The principles of the Code apply to the overall relationship between authorised institutions and their customers in Hong Kong.

According to Annex 1 of the Code, “customer” is defined as “a private individual who:

(a) maintains an account in HK (including a joint account with another private individual or an account held as an executor or trustee, but excluding the accounts of sole traders, partnerships, companies, clubs and societies) with, or who receives other services from, an institution; or

(b) acts as guarantor or provider of third party security (whether or not the guarantor or provider of third party security is a customer of the institution) for a borrower who is an individual or otherwise.”

It is a non-statutory code issued on a voluntary basis; however, the two associations expect their members to observe the Code when running their businesses.

For more information on the Code of Banking Practice, please refer to Appendix 4.

In this section, we will focus on the general guidelines regarding the relationship between banks and their customers, in the following areas:

- Customer information management
- Equal opportunities
- Bank marketing
- Customer complaint management

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The following areas should also be noted:

- Terms and conditions
- Fees and charges
- Annualised percentage rates

2.3.1 Customer information management

Protecting bank customers' information is essential as banks collect, hold, process and use enormous amounts of customers' information in their daily operations, which may include names, contact details, identification document numbers, employment details, financial and credit information, etc., which are all considered sensitive personal information. If customer information is disclosed without consent or authorisation, the information may be used unlawfully and the related customers' interest will be at risk.

Since 2013, the Personal Data (Privacy) Ordinance has been enhanced and banks should handle customer information with extra care. The Ordinance specifies that customer consent should be obtained prior to using any personal data in direct marketing, i.e. the customer has the right to "opt-out" of such use of data by a bank as a data user.

The Office of the Privacy Commissioner for Personal Data, HK, issued a Guideline on the Proper Handling of Customers' Personal Data for the Banking Industry in October 2014.

The Ordinance will be discussed in further detail in the next chapter.

2.3.2 Equal opportunities

Discrimination on the grounds of family status, sexuality, disability or race is an offence in Hong Kong. In addition to the statutory requirements, institutions should not discriminate against any customers on the grounds of age. Banks should prohibit discrimination against any customer and require employees to comply with relevant ordinances and any codes issued under these ordinances.

In respect of customers with a disability, institutions should adopt a helpful approach, making available appropriate means to facilitate access to banking services and provide assistance, for example installing ramps at entrances to bank premises to facilitate access.

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It is unlawful for a service provider, such as a bank, to refuse to provide goods or services on the grounds of a person's race. In 2012, a complainant, a Pakistani, complained to the Equal Opportunities Commission, Hong Kong (EOC) about a bank for its refusal to open an account for him on the grounds of race. The case was settled through fast-track conciliation after the bank agreed to arrange for the complainant to re-apply for a bank account.

In 2011, a Filipino domestic worker lodged a complaint of race discrimination with the EOC against a bank which required her to provide her passport in order to open an account despite her provision of an HKID card and proof of address. The case was settled through conciliation after the bank issued an apology letter.

In January 2016, the Report on Legislation against Discrimination on the Grounds of Sexual Orientation, Gender Identity and Intersex Status, from a study commissioned by the EOC and conducted by the Gender Research Centre at The Chinese University of Hong Kong, was published. Public awareness was drawn to such discrimination. The Government also issued a Code of Practice against Discrimination in Employment on the Grounds of Sexual Orientation as early as 1998. The purpose was to facilitate self-regulation in eliminating discriminatory practices in employment and to promote equal employment opportunities among all persons, irrespective of their sexual orientation. The Government has invited organisations to pledge to adopt the abovementioned Code.

2.3.3 Bank marketing

Some bank employees are very aggressive when conducting marketing activities and, as a result, may not exercise sufficient care with their clients, perhaps misrepresenting the products or automatically enrolling clients in new services without proper notice. This type of irresponsible marketing behaviour should be discouraged.

Institutions should ensure that all advertising and promotional materials are fair and reasonable, do not contain misleading information and comply with all relevant legislation, codes and rules.

Institutions should exercise restraint in making unsolicited calls, i.e. cold calls to customers. An unsolicited call is allowed if it:

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- is made to a solicitor or CPA acting in his/her professional capacity, SFC-licensed person, registered institution, moneylender, professional investor, or an existing client; or
- qualifies for exemption under the Securities and Futures (Unsolicited Calls – Exclusion) Rules. Under these Rules, section 174 of the SFO does not apply to any unsolicited call that is either:
  - a permissible communication (defined to mean communication not made in the course of a visit in person, telephone conversation or other interactive dialogue); or
  - made by a registered institution (including a bank) in relation to a leveraged foreign exchange contract, if the call is made in compliance with applicable requirements under the HKMA's guideline[10].

The statutory restriction on cold calls is designed to protect the public from unwanted and undesirable approaches and sales tactics by SFC licensees (such as brokers), registered institutions (mostly banks) and their staff. The SFC has made it clear that an internal policy prohibiting cold calling or requiring compliance with the applicable laws and regulations is generally not enough. A licensed or registered corporation should ensure its staff have a reasonable understanding of the law as well as closely supervise and monitor their marketing or promotional efforts to ensure compliance.

In addition, the Personal Data Privacy Ordinance, Part VIA further requires the obtaining of customer consent prior to the use of personal data in direct marketing (please refer to the aforementioned section on the collection, use, holding and erasure of customer information.)

2.3.4 Customer complaint management

Bank customers have the right to make complaints about banking services and relevant charges. In fact, complaints are helpful, providing senior management with information on service quality and operational risk factors. The Code of Banking Practice includes

[10] Under Securities and Futures (Unsolicited Calls – Exclusion) Rules (Cap 571A), Monetary Authority guideline refers to the Guideline of the Monetary Authority issued in November 1995 and published in the Gazette under section 7(3) of the Banking Ordinance (Cap. 155) as G.N. 4679 of 1995 on 17 November 1995, as amended and published under that section from time to time.

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guidelines on handling customers' complaints in a fair and speedy manner. For further details, you may refer to Appendix 4 of this chapter or visit the HKAB's website.

The HKMA provides further guidance on procedures to handle complaints in connection with the provision of banking or other financial services to personal and small business customers in its Supervisory Policy Manual [11] . Banks have to ensure that customer complaints are fully and promptly investigated and resolved in a satisfactory manner for the public interest. Complaints may be indicative of misconduct by staff, including possible fraud or weaknesses in internal controls. Customers should be informed of how and where to complain, for example in the form of a leaflet or a notice on the institution's website.

Information related to a complaint should be treated as confidential and processed by the responsible staff strictly on a need-to-know basis. Response and redress should be provided to the complainant within a reasonable time, i.e. a written acknowledgement within seven days of receipt of the complaint and a final response normally not exceeding sixty days of receipt. Effective procedures should be set up to monitor complaints and regular reports made to senior management for review with proper records and regular audits.

Terms and conditions

Bank customers should be informed about the terms and conditions of banking services. This not only protects the interest of customers, but also helps prevent disputes between banks and their customers.

Institutions should provide the terms and conditions of banking services to prospective customers at the point of sale, and where not possible, should inform prospective customers where they can find the terms and conditions, including providing a link to the institution's website, and advise them to read and understand the key terms and conditions before applying for the services.

30 days' notice should be given before any change of the terms and conditions which affect fees and charges takes effect. For other variations, reasonable notice should be

[8]IC-4 V.1 -22.02.2002: Complaint Handling Procedures available at:
https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2002/IC-4.pdf (last assessed 24 Nov 2020)

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given to customers. For complicated variations or variations involving substantial changes to the existing terms and conditions, institutions should provide a written summary. Where a customer refuses to accept the variations to the terms and conditions and chooses to terminate the banking service within a reasonable period, the institution should repay any annual or other periodic fee for that banking service on a pro rata basis, if the fee can be separately distinguished and unless the amount involved is minimal.

Fees and charges

Bank customers usually expect the level of service fees and interest charges to be transparent. Although banks may adjust their fees from time to time, the affected customers should be given appropriate notice before any changes. Institutions should give at least 30 days' notice to affected customers before any change in the level of fees and charges takes effect except for fees and charges relating to cards (in respect of which at least 60 days' advance notice is required).

Annualised percentage rates

Sometimes, borrowers and depositors are misled by information on interest rates. For instance, some banks quote a flat rate per year; some quote the interest rate per month; some use a compound interest calculation; and so on. To protect the interests of bank customers, all banks are required to also provide the annualised percentage rate (APR): the effective interest rate for lending or borrowing for one year. With this information, bank customers can make real comparisons and shop for the best bank products for themselves

2.4 Ethical dilemmas

An ethical dilemma arises when one has to make a decision which will invariably lead to a conflict among the ethical values of oneself or as expected by the profession. For example, a Wealth Manager learns from a confidential research report about the poor performance of a mutual fund. The news has not been released but once the news is made public the value of the mutual fund will drop significantly. He knows that one of his clients, who is in her eighties and has trusted the bank for decades, invests much of her savings in the fund. On the one hand, the bank staff member realises his duty to keep the findings in

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the Research report confidential, but on the other hand he feels obliged to help his longstanding client avoid the loss. The Wealth Manager is facing an ethical dilemma.

There are various models to help people, including the bank staff, resolve ethical dilemmas. The ICAC, for instance, provides the ETHICS-PLUS Decision Making Model to assist in identifying the ethical issue at stake and guide one to reach a justified decision in a structured manner. The Model aims not to provide a definite answer or infallible solution to each ethical dilemma. The value of it is to encourage each decision-maker to go through a thoughtful and rational analysis and assess more deeply the underlying factors of a dilemma before arriving at a resolution. The Chartered Institute of Management Accountants (CIMA) in the UK also provides its members with some recommendations which can be a reference for financial professionals.

The ETHICS-PLUS Decision Making Model[12]

The ETHICS process – six major steps to follow

1. Establish the relevant facts and identity the ethical issues involved
2. Take stock of all the stakeholders or parties involved
3. Have an objective assessment of each stakeholder's position
4. Identify viable alternatives and their effects on the stakeholders
5. Compare and evaluate the likely consequences of each alternative with reference to the standards expected (the PLUS factors below)
6. Select the most appropriate course of action

The PLUS standards – four key factors to consider

1. Professional/company codes of conduct
2. Legal requirements, e.g. any breaches of the laws such as the Prevention of Bribery Ordinance, Banking Ordinance, anti-money laundering legislation, etc.
3. Uncompromising self-values, e.g. honesty, integrity, fairness, trustworthiness, etc.
4. Sunshine test, i.e. whether the issue can be discussed openly

[12] Source: "Bank on Integrity" A Practical Guide for Bank Managers, Attachment 3 <www.cpas.icac.hk> and Bank on Integrity: e-Learning Package for Banking Practitioners <www.hkbedc.icac.hk/bank>

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Case study (A Sinking Friendship) extracted from the "Bank on Integrity" Guide is given in Appendix 5 to demonstrate the application of the Model in tackling an ethical dilemma in the workplace.

CIMA - ETHICS Dilemmas Checklist[13]

CIMA states that key questions to consider when facing an ethical dilemma rest on a personal feeling – you generally know if something feels right. If you are unsure, ask yourself:

- Would I feel comfortable about my professional peers, family and friends knowing about the situation?
- How would I feel if I saw this in a newspaper?

CIMA UK has recommended using the following steps to further analyse the situation, and decide what the correct course of action is to resolve the issue:

1. Check all your facts – identify and document all relevant facts. Do not rely on assumptions.
2. Is it an ethical issue? – Have you referred to the Code of Conduct of your company? Does it breach any regulations/laws?
3. Identify principles – integrity, objectivity, professional competence and due care, confidentiality and professional behaviour.
4. Affected parties/course of action – Who are the key affected stakeholders? Consider the course of action or escalate internally/externally.
5. Seek legal/regulatory advice such as the CIMA ethics helpline.
6. Refuse to remain associated – if you can't resolve, then disassociate and ensure everything is documented.

2.4.1 Ethics in practice

All professionals will occasionally encounter ethical dilemmas. The following questions may be helpful when facing such challenges.

- Thinking ethically:

[13] Source : Ethics Dilemmas Checklist Worksheet Item 3 Exercise, Case Studies and Ethics Training, Ethics Support Guide Jan 2017, The Chartered Institute of Management Accountants <www.cimaglobal.com/ethics resources>

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  - Will my decisions and actions damage others?
  - Is this act illegal?
  - What will the outcomes of my actions be? Will they be good for society?
- Collecting the facts:
  - Can I gather more information before making my decision?
  - Who will benefit from my decisions and actions? Is there anything wrong with those beneficiaries, decisions or actions?
  - Can I consult anyone to obtain more insight?
- Identifying alternatives:
  - Are there any better options?
  - Will other actions result in better outcomes for others?
  - Will other actions benefit society more?

When in doubt, banking professionals can seek advice and guidance from their bank's Code of Conduct Officer or relevant department.

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3. Chapter Summary

Ethics is about right and wrong acts. Normative ethics is about setting up ethical standards for regulating right and wrong acts. Some people believe that there are absolute ethical standards that everyone must follow; others argue that ethical standards are more or less cultural.

Professional ethics aims to guide the behaviour of different professional groups. Banking professionals are subject to clear ethical guidelines provided by bank regulators, bank associations and their professional associations.

The HKMA requires banks to develop an employee code of conduct and enforce that code strictly. Also, all banks in Hong Kong are required to observe the *Code of Banking Practice* issued by The Hong Kong Association of Banks and the DTC Association.

By complying with the codes, banking professionals will help maintain their integrity and prevent any bribery or other criminal offences.

Professionals should protect the interests of their employers and customers, and avoid conflicts of interest.

Familiarity with the relevant Code of Conduct and Code of Banking Practice will help when dealing with ethical dilemmas. Professionals should evaluate whether a decision will be ethical before taking any action.

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5. Review Questions

1. Which of the following is NOT one of the "four key fiduciary duties"?

   A. No-profit
   B. Uncompromising self-values
   C. Undivided loyalty
   D. Confidentiality

2. Which of the following is NOT an element in enforcing an internal code of conduct within an AI?

   A. Maintenance of proper written records on any relevant activities.
   B. Involvement of senior management and the board of directors.
   C. Demolishing the "Chinese Wall"
   D. Comprehensive communication to bank employees regarding the code.

3. A customer asks a bank manager to open a bank account for him using a false identity in the documents and offers to pay him secret commission. The bank manager does so and receives the commission without the permission of the bank. The bank manager may have contravened which of the following two sections of the Prevention of Bribery Ordinance?

   i. Section 4
   ii. Section 9(1)
   iii. Section 9(2)
   iv. Section 9(3)

   A. i and ii
   B. i and iii
   C. ii and iv
   D. All of the above

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4. General Principle 6 of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission provides that:

   A. In conducting its business activities, a registered person should act honestly, fairly, and in the best interests of his/her clients and the integrity of the market.
   B. A registered person should have and employ effectively the resources and procedures which are needed for the proper performance of his/her business activities.
   C. A registered person should try to avoid conflicts of interest, and when they cannot be avoided, should ensure that his/her clients are fairly treated.
   D. A registered person should make adequate disclosure of relevant material information in his/her dealings with his/her clients.

5. Which of the following persons is not a customer as defined under the Code of Banking Practice?

   A. John, the director of ABC Ltd, acting as a guarantor for ABC Ltd, who borrows money from the bank.
   B. ABC Ltd, acting as a guarantor for John, the director of ABC Ltd, who borrows money from the bank.
   C. John, who maintains a current account at the bank
   D. Jill who maintains a joint account with John at the bank

Answers:

Question 1: B

Question 2: C

Question 3: C

Question 4: C

Question 5: B

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6. Further Reading

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7. Appendices

Appendix 1
Minimum standards in a bank's code of conduct

(Source: HKMA Supervisory Policy Manual, CG-3 Code of Conduct, v.1 – 21.06.02)

11.1 General

11.1.1 Each AI should develop its own Code of Conduct, commensurate with its structure, size and business operations. It is reasonable to expect Codes to differ from one another not only in format but also in content.

11.1.2 The Code may be comprehensive, covering all legal, regulatory and ethical issues. Alternatively, different codes may be used to cover different topics. For example, an AI may formulate separate codes or policy statements in relation to the prevention of money laundering, the Code of Banking Practice, connected lending, equal opportunities, protection of intellectual property rights, environmental protection issues, etc. AIs may also incorporate extracts from the relevant sections of Ordinances (e.g. §9 of the Prevention of Bribery Ordinance and §124 of the Banking Ordinance) as part of their Code for ease of reference.

11.1.3 There are certain minimum conduct requirements which are applicable to every AI and should be included in their main Code. These requirements, although not exhaustive, are set out in the subsections that follow.

11.2 Responsibility

11.2.1 Codes of Conduct should specify the name or title of the officer ('Code of Conduct officer') who is responsible for:

handling queries from staff regarding the contents of the Code and any related matters;

approving requests by staff to accept personal benefits exceeding limits imposed, or otherwise outside acceptable limits, in the Code (see subsection 2.8 below); and

taking appropriate actions to follow up cases reported by staff (see subsection 2.12 below).

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These functions may be assigned to the same or separate officers. The person(s) appointed should be of sufficient competence, experience, integrity and seniority to discharge them effectively. If an AI decides to appoint more than one person to be responsible for the above functions, the AI should appoint one of them as a central reference point for external liaison.

11.2.2 Normally, the officer responsible for approving the acceptance of personal benefits should have authority to:

permit a staff member to accept a personal benefit unconditionally or subject to such conditions as the officer may specify;

require a staff member to refuse the offer of a personal benefit or to return a personal benefit to its donor;

require a staff member to give a personal benefit which he has received to a charitable organisation nominated by the staff member and acceptable to the officer; or the person may be an AI's compliance officer, an internal legal counsel or some other party (e.g. head of human resources)

require a staff member to dispose of a personal benefit which he has received in such manner as the officer may direct.

11.2.3 Where appropriate, AIs may appoint a committee to oversee the implementation of and adherence to the Code.

11.3 Ethical values

11.3.1 Codes of Conduct should contain a set of ethical values that AIs expect their staff to follow in conducting business. Core ethical values would normally include honesty, integrity, diligence, fairness, responsible citizenship and accountability.

11.3.2 Such values should be consistently applied to avoid confusion to staff.

11.4 Conflicts of interest

11.4.1 All staff should avoid situations that may lead to or involve a conflict of interest, actual or potential and, in case of doubt, should seek the advice of the Code of Conduct officer.

11.5 Granting credit

11.5.1 All staff with lending authority should have specified limits that are commensurate with their rank or function as laid down in the AI's credit policy. No member of staff should grant credit to himself, his relatives or companies in which he or his relatives have a personal interest.

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11.6 Receiving credit

11.6.1 No member of staff, or his relatives, should borrow or receive credit from third parties on a favoured basis or on terms other than at arm's length unless previously approved in accordance with the Code of Conduct.

11.7 Conduct when obtaining business

11.7.1 No member of staff should offer any bribe or similar consideration to any person or company in order to obtain business for the AI.

11.8 Personal benefits

11.8.1 Members of staff should not use the power or authority deriving from their position to gain, or to influence other staff to take any action in order to gain, a personal benefit or an indirect benefit (e.g. for their relatives or other related parties).

11.8.2 All staff should observe the statutory provisions of §9 of the Prevention of Bribery Ordinance and §124 of the Banking Ordinance, which contain criminal penalties for accepting advantages in prescribed circumstances.

11.8.3 Members of staff should actively discourage customers from offering personal benefits of any kind, including any type of gift, favour, service, loan, fee or anything of monetary value.

11.8.4 No member of staff should solicit, accept and retain personal benefits from any customer of the AI or any individual or organisation doing or seeking to do business with it. Members of staff may, however, be permitted to accept and retain a personal benefit within the AI's acceptance criteria set out in the Code of Conduct provided that:

this complies with relevant legal requirements;

there is no reasonable likelihood of improper influence or prejudice on the performance of duties by the staff member on behalf of the AI.

11.8.5 Where a staff member wishes to accept a personal benefit which is not within the criteria set out in the Code, he should be required to seek the approval of the Code of Conduct officer, providing him with relevant information in writing such as:

the name of the donor;

a description and, to the extent possible, an assessment of the value of the benefit; any business connection between the donor and the AI; and any personal relationship between the staff member and the donor.

11.8.6 The staff member will then be advised whether the gift may be accepted,

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or should be returned to the donor or disposed of in some other way.

11.9 Use of information

11.9.1 All staff should handle carefully information relating to customers in compliance with relevant statutory requirements, e.g. the Personal Data (Privacy) Ordinance (PDPO), and common law customer confidentiality.

11.9.2 No member of staff should release customer information to a third party without written consent from the relevant customer, unless the release complies with the PDPO or he is required or permitted to do so by law.

11.9.3 No member of staff should, during or after termination of his employment with the AI, except in the proper course of his duties or with the written consent of the AI, divulge or make use of any secrets or of any correspondence, accounts, connections or dealings of the AI or its customers or of any knowledge gained in relation thereto during his employment.

11.9.4 No member of staff should use information so obtained for financial gain in any way.

11.10 Personal investments

11.10.1 No member of staff should deal in the shares or other securities of any listed company when possessing privileged or price-sensitive information that is not generally known to the shareholders of that company and to the public. Staff should not disclose such information to any third party.

11.10.2 Staff should immediately notify the AI in writing of the details of any dealings in which they may have inadvertently been concerned in the shares or other securities of any listed companies of which they possess privileged or price-sensitive information. If members of staff are unsure whether a deal would constitute insider dealings they should consult the appropriate officer in advance of such dealing.

11.11 Outside employment

11.11.1 No member of staff should take up any directorship, employment or part-time commercial duties, whether paid or unpaid, outside the AI except with prior written approval as required by the Code of Conduct.

11.11.2 Approval should only be given where the interests of the AI would not be prejudiced.

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11.12 Reporting responsibility

11.12.1 It is the responsibility of all staff to contribute to the good reputation of an AI. All staff should be alert to matters which could give rise to fraud, deception, theft, forgery, corruption or other illegal activities. If a staff member, acting reasonably, suspects that an illegal activity is being perpetrated; he should immediately report it to an appropriate officer as required in the Code of Conduct for appropriate follow up.

11.12.2 Staff should be warned that failure to report such activity immediately may result in disciplinary action.

11.13 Disciplinary action

11.13.1 Codes of Conduct should specify that all staff of the AI are subject to their provisions and that any breach will give rise to disciplinary action (e.g. verbal warning, issue of a warning letter, demotion or dismissal) and, where applicable, to criminal prosecution.

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Appendix 2

Systems for enforcing a code of conduct

(Source: HKMA Supervisory Policy Manual, CG-3 Code of Conduct, v.1 – 21.06.02)

3.1 Oversight by Board of Directors

3.1.1 The Board of Directors has an important role in establishing the overall ethical culture of AIs and ensuring AIs conduct their affairs with a high degree of integrity.

3.1.2 For instance, the Board (or a committee with delegated authority) is responsible for: laying down company-wide ethical standards and promoting them to all levels of staff; approving the Code of Conduct; ensuring that AIs have adequate systems to enforce the Code; resolving complex ethical dilemmas; and
ensuring that the reputation risk of AIs is carefully managed.

3.2 Board and management support

3.2.1 The values held and attitudes demonstrated by the Board and management have a great influence on the behaviour of the employees. AIs' directors and management should demonstrate their full support for the Code of Conduct and serve as role models for compliance.

3.3 Communication to staff

3.3.1 Enforcing a Code of Conduct requires understanding and active participation by all levels of staff in an AI. AIs should therefore communicate clearly to their staff the standards and requirements set out in the Code and, in particular, that:
strict adherence to those standards is expected of them; and
disciplinary action may be taken against them if they do not adhere to those standards.

3.3.2 It is important that staff are reminded at periodic intervals of the requirements of the Code. Apart from the use of internal circulars, AIs should develop training programmes (e.g. forming part of the induction course for new recruits and of refresher courses for existing staff) for various levels of their staff in relation to the Code or other relevant ethical issues.

3.4 Regular review

3.4.1 The Code should be reviewed periodically by the Board of Directors or a

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committee with delegated authority and updated to keep abreast of changes in the business environment and regulatory requirements.

3.5 Segregation of conflicting responsibilities

3.5.1 Staff should not be assigned conflicting responsibilities that may make them susceptible to abuses or result in undetected errors.

3.5.2 AIs should establish 'Chinese Walls' (i.e. functional segregation reinforced by physical separation) to prevent the accidental communication of confidential information between departments of the same AI.

3.5.3 Access rights to confidential information should only be granted to staff for legitimate business purposes on a need-to-know basis.

3.6 Written records of personal benefits

3.6.1 AIs should maintain a written record of all personal benefits received by staff which they have been permitted to retain. This record need not cover benefits which the Code of Conduct permits staff to accept or retain without further reference.

3.6.2 Such records should be subject to periodic reviews by the senior management or a designated staff member (e.g. the compliance officer) to ensure that:

they are properly maintained;

the approvals given to staff to retain personal benefits are justified; and

there is no likelihood that the staff receiving personal benefits have been placed in a position of obligation.

3.6.3 Upon request by the HKMA, such records should be made available to it for review. The AI's document retention policy should take account of all relevant legislation.

3.7 Reporting channels

3.7.1 Staff should be encouraged to report matters which could give rise to fraud, deception, theft, forgery, corruption or other illegal activities to the Code of Conduct officer through their internal complaint channels.

3.7.2 Complaints should be dealt with quickly and disciplinary action should be taken if necessary. The outcome of investigations into complaints of a serious nature should be reported to senior management.

3.7.3 AIs should also report the matters specified in para. 3.7.1 above to the HKMA and other relevant regulatory (e.g. the Securities and Futures

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Commission) or law enforcement authorities as soon as practicable.

3.8 Audit

3.8.1 Compliance audits should be performed regularly to assess the effectiveness of the systems required by the Code of Conduct.

3.8.2 The findings of these audits should be reported to the Board of Directors or the Audit Committee on a timely basis and appropriate remedial action should be taken to address any concerns or weaknesses raised.

3.9 Assistance from law enforcement and regulatory authorities

3.9.1 Where necessary, AIs may seek the assistance of the HKMA or other law enforcement or regulatory authorities in relation to their Code of Conduct and other ethical issues.

3.9.2 For instance, AIs may approach the regional offices of the Independent Commission against Corruption (ICAC) or the Hong Kong Ethics Development Centre under the ICAC's Community Relations Department for assistance in developing ethics programmes catering to their specific needs. These may include:

formulating or improving a Code of Conduct and offering advice on how to implement the Code effectively;

strengthening system of controls and work procedures to prevent corruption, fraud and other malpractices; and

providing training courses for various levels of staff on subjects such as legislation governing corruption and fraud in Hong Kong, measures to manage staff integrity and skills to handle ethical dilemmas at work.

3.9.3 AIs may also seek advice on corruption prevention from the Advisory Services Group of the Corruption Prevention Department of the ICAC.

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Appendix 3
Extracts of the Prevention of Bribery Ordinance (Cap. 201)

(Source: ICAC, "Bank on Integrity" A Practical Guide for Bank Managers, <cpas.icac.hk> and Bank on Integrity: e-Learning Package for Banking Practitioners www.hkbedc.icac.hk/bank)

Section 9: Corrupt transactions with agents

(1) Any agent who, without lawful authority or reasonable excuse, solicits or accepts any advantage as an inducement to or reward for or otherwise on account of his –

(a) doing or forbearing to do, or having done or forborne to do, any act in relation to his principal's affairs or business; or

(b) showing or forbearing to show, or having shown or forborne to show, favour or disfavour to any person in relation to his principal's affairs or business, shall be guilty of an offence.

(2) Any person, who, without lawful authority or reasonable excuse, offers any advantage to any agent as an inducement to or reward for or otherwise on account of the agent's –

(a) doing or forbearing to do, or having done or forborne to do, any act in relation to his principal's affairs or business; or

(b) showing or forbearing to show, or having shown or forborne to show, favour or disfavour to any person in relation to his principal's affairs or business, shall be guilty of an offence.

(3) Any agent who, with intent to deceive his principal, uses any receipt, account or other document –

(a) in respect of which the principal is interested; and

(b) which contains any statement which is false or erroneous or defective in any material particular; and

(c) which to his knowledge is intended to mislead the principal, shall be guilty of an offence.

(4) If an agent solicits or accepts an advantage with the permission of his principal, being permission which complies with subsection (5), neither he nor the person who offered the advantage shall be guilty of an offence under subsection (1) or (2).

(5) For the purposes of subsection (4) permission shall –

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(a) be given before the advantage is offered, solicited or accepted; or

(b) in any case where an advantage has been offered or accepted without prior permission, be applied for and given as soon as reasonably possible after such offer or acceptance,

and for such permission to be effective for the purposes of subsection (4), the principal shall, before giving such permission, have regard to the circumstances in which it is sought.

Section 4: Bribery

(1) Any person who, whether in Hong Kong or elsewhere, without lawful authority or reasonable excuse, offers any advantage to a public servant as an inducement to or reward for or otherwise on account of that public servant's-

(a) performing or abstaining from performing, or having performed or abstained from performing, any act in his capacity as a public servant;

(b) expediting, delaying, hindering or preventing, or having expedited, delayed, hindered or prevented, the performance of an act, whether by that public servant or by any other public servant in his or that other public servant's capacity as a public servant; or

(c) assisting, favouring, hindering or delaying, or having assisted, favoured, hindered or delayed, any person in the transaction of any business with a public body, shall be guilty of an offence.

(2) If a public servant other than a prescribed officer solicits or accepts an advantage with the permission of the public body of which he is an employee being permission which complies with subsection (4), neither he nor the person who offered the advantage shall be guilty of an offence under this section.

Section 8: Bribery of public servants by persons having dealings with public bodies

(1) Any person who, without lawful authority or reasonable excuse, while having dealings of any kind with the Government through any department, office or establishment of the Government, offers any

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advantage to any prescribed officer employed in that department, office or establishment of the Government, shall be guilty of an offence.

(2) Any person who, without lawful authority or reasonable excuse, while having dealings of any kind with any other public body, offers any advantage to any public servant employed by that public body, shall be guilty of an offence.

Section 2: Interpretation

"Advantage" means :

(a) any gift, loan, fee, reward or commission consisting of money or of any valuable security or of other property or interest in property of any description;

(b) any office, employment or contract;

(c) any payment, release, discharge or liquidation of any loan, obligation or other liability, whether in whole or in part;

(d) any other service, or favour (other than entertainment), including protection from any penalty or disability incurred or apprehended or from any action or proceedings of a disciplinary, civil or criminal nature, whether or not already instituted;

(e) the exercise or forbearance from the exercise of any right or any power or duty; and

(f) any offer, undertaking or promise, whether conditional or unconditional, of any advantage within the meaning of any of the preceding paragraphs (a), (b), (c), (d) and (e),

Ordinance (Cap. 554), particulars of which are included in an election return in accordance with that Ordinance.

"Entertainment" means:

The provision of food or drink, for consumption on the occasion when it is provided, and of any other entertainment connected with, or provided at the same time as, such provisions.

Section 11: Giver and acceptor of bribe to be guilty notwithstanding that purpose not carried out, etc.

(1) If, in any proceedings for an offence under any section in this Part, it is proved that the accused accepted any advantage, believing or

suspecting or having grounds to believe or suspect that the advantage was given as an inducement to or reward for or otherwise on account of his doing or forbearing to do, or having done or forborne to do, any act referred to in that section, it shall be no defence that—

(a) he did not actually have the power, right or opportunity so to do or forbear;

(b) he accepted the advantage without intending so to do or forbear; or

(c) he did not in fact so do or forbear.

(2) If, in any proceedings for an offence under any section in this Part, it is proved that the accused offered any advantage to any other person as an inducement to or reward for or otherwise on account of that other person's doing or forbearing to do, or having done or forborne to do, any act referred to in that section, believing or suspecting or having reason to believe or suspect that such other person had the power, right or opportunity so to do or forbear, it shall be no defence that such other person had no such power, right or opportunity.

Section 19: Custom not to be a defence

In any proceedings for an offence under this Ordinance, it shall not be a defence to show that any such advantage as is mentioned in this Ordinance is customary in any profession, trade, vocation or calling.

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Appendix 4
Code of Banking Practice

(Source: HKAB's website <www.hkab.hk> Published Resources.)

Terms and conditions

5.1 Institutions should make readily available to customers or prospective customers written terms and conditions of a banking service. Institutions should be prepared to answer any queries of customers or prospective customers relating to terms and conditions. In cases where the query relates to a service provided by a third party service provider, institutions may, where necessary, refer the query to the relevant third party service provider after obtaining the customer's consent or direct the customer to contact the third party service provider. Institutions should thereafter provide assistance to the customer if the customer so requests.

5.2 Institutions should provide written terms and conditions of a banking service to prospective customers upon application of the banking service as far as possible. Where the provision of written terms and conditions is not practicable at the point of sale, institutions should provide key terms and conditions orally to prospective customers and provide a full set of the terms and conditions to the customers as soon as practicable afterwards. Where the provision of written or oral terms and conditions is not practicable at the point of sale, institutions should inform prospective customers where they can find the terms and conditions (including providing a link to the institution's website) and advise them to read and understand the terms and conditions before applying for the banking service and provide a full set of terms and conditions as soon as practicable afterwards.

5.3 The terms and conditions should provide a fair and balanced description of the relationship between the customer and the institution.

5.4 The terms and conditions should be available in both Chinese and English unless the banking service is governed by law other than that of Hong Kong or there is little or no demand for bilingual information. Institutions should use plain language and avoid complex legal and technical terms wherever practicable. Where legal and technical language is used, appropriate explanation should be provided where practicable. The terms and conditions should be presented in a reasonable layout and font size that is readily readable.

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5.5 The terms and conditions should, where applicable, highlight any fees, charges, penalties and relevant interest rates (or the basis on which these will be determined) and the customer's liabilities and obligations in the use of a banking service.

5.6 In drawing up terms and conditions for banking services, institutions should have due regard to applicable laws in Hong Kong, including, in particular, the Personal Data (Privacy) Ordinance (Cap. 486), the Control of Exemption Clauses Ordinance (Cap.71), the Unconscionable Contracts Ordinance (Cap. 458), and the Supply of Services (Implied Terms) Ordinance (Cap. 457) and any other prevailing consumer protection legislation.

5.7 The terms and conditions should be consistent with this Code. Institutions should keep terms and conditions under review to ensure they are consistent with this Code.

5.8 Institutions should advise customers to read and understand the terms and conditions when applying for banking services.

5.9 Institutions should give customers 30 days' notice before any variation of the terms and conditions which affects fees and charges and the liabilities or obligations of customer takes effect. For all other variation, institutions should give customers reasonable notice before such variation takes effect.

5.10 A notice of any variation of the terms and conditions should show clearly the variation with an explanation in plain language, where appropriate and practicable, and the ways in which the customer may indicate refusal and the consequence. In case the customer decides to terminate the banking service, the institution should not charge any fees for the termination under the following conditions:

(a) the variation of the terms and conditions is considered key and relevant to the specific banking services;

(b) the variation in (a) may adversely affect the customer; and

(c) the customer indicates the decision to terminate the banking service within the notice period before the variation in (a) takes effect.

5.11 Where the variation involves substantial changes to existing terms and conditions or the changes are very complicated, the institution should provide a written summary of the key features of the revised terms and conditions.

5.12 Institutions should issue a full version of the revised terms and conditions to customers if there are sufficient changes to warrant it, regardless of the nature of the changes.

5.13 Where a customer refuses to accept the variation to the terms and conditions and chooses to terminate the banking service within a reasonable period, the institution

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should repay any annual or other periodic fee for that banking service on a pro rata basis , if the fee can be separately distinguished and unless the amount involved is minimal

5.14 In addition to the detailed terms and conditions, institutions should make readily available to customers general descriptive information of the key features of the various banking services as indicated in the following chapters of this Code.

5.15 For the avoidance of doubt, sections 5.1 and 5.8 above should apply also to services or products (e.g. insurance, retirement plans and investment products) offered or provided by the institution's third-party service providers notwithstanding that the relevant terms and conditions for the service or product are set out in a separate contract between the service provider and the customer. Institutions should advise their service providers of the requirements in the remainder of this section and request them to observe these requirements as far as possible.

Fees and charges

6.1 Institutions should make readily available to customers details of the fees and charges payable in connection with the banking services covered by the Code. A schedule of the institution's standard fees and charges should be displayed in its principal place of business and branches. All fees and charges should be of reasonable amounts.

6.2 Details of the basis of charges for services not subject to standard fees and charges should be advised at the time the services are offered or on request.

6.3 Institutions should give at least 30 days' notice to affected customers before any change in the level of fees and charges (including any change in the basis on which fees and charges are determined) takes effect except for fees and charges relating to cards.

6.4 Where institutions give a notice pursuant to sections 5.8 or 6.3, they should adopt effective means of notification which would provide reasonable assurance that their customers will be informed of the change and which do not rely unduly on the customers' own initiative. Individual notification of customers (whether by written notice, statement insert, message in an account statement, e-mail or SMS message) is likely to be effective in achieving these objectives. But where this is not appropriate on grounds of disproportionate costs or likely ineffectiveness (for example, in the case of passbook savings accounts where the latest address of the customers may

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not be known to the institution), institutions may adopt other means of notification, such as one or more of the following:

- press advertisement;
- prominent display of notice in banking halls; display of notice on ATM sites/screens; phone-banking message; and
- notice posted on the website of the institution.

6.5 Institutions should not impose administrative charges for handling cash deposits in Hong Kong dollars, except those in large quantities.

6.6 Institutions should inform customers of the nature and amount of charges debited to their accounts promptly after any such charge is debited unless a prior notice has already been given in accordance with section 6.7 below, and advise them of what can be done to avoid such charges or where they can obtain such information.

6.7 Institutions should give 14 days' prior notice to customers when a charge accrues on dormant accounts for the first time, and advise them of what can be done to avoid such charges or where they can obtain such information

Collection, use, holding and erasure of customer information

7.1 Institutions should treat their customers' (and former customers') banking affairs as private and confidential.

7.2 Institutions should at all times comply with the Personal Data (Privacy) Ordinance (PDPO) in the collection, use, holding and erasure of customer information. They should also comply with any relevant codes of practice issued or approved by the Privacy Commissioner for Personal Data giving practical guidance on compliance with the PDPO.

7.3 On or before collecting customers' personal information, institutions should notify customers as specifically as possible of the classes of person to whom they may wish to make disclosure of customer information and the purpose of such disclosure. Classes of person about which customers should be specifically notified include among others:

- debt collection agencies;
- data processors to which the processing of personal information is to be, or may be, outsourced;
- credit reference agencies;

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subject to section 8.4 below, persons to whom customers' contact details may be disclosed for marketing purposes including, related companies within the same group and other persons (classified in specific terms, such as co-branding partners of the institution or third party loyalty programme providers which in each case should be shown in application forms/ leaflets for the relevant services or products provided to customers); and such persons to whom disclosure may be required by applicable laws or regulatory guidelines issued from time to time.

7.4 Institutions should not, without the prescribed consent of their customers, provide bankers' references in respect of a customer. An institution that intends to use customer information for direct marketing purposes shall comply with the PDPO and any relevant codes of practice.

7.5 Where personal information is used by an institution for its own marketing purposes for the first time, the institution should inform the customer that the institution will, without charge to the customer, cease to so use the personal information if the customer so request.

7.6 Institutions should remind customers at least once every year or by including a standard notice in their

marketing materials of the right to make the request referred to in section 8.5 above.

7.7 When a customer objects to the disclosure of the information referred to in section 8.3(d) above or refuses to give the consent or an indication of no objection or withdraws any consent or indication of no objection required under the PDPO, the institution concerned should give effect to such objection, refusal or withdrawal and should not refuse to provide that customer with basic banking services.

7.8 Where personal information transferred to a third party service provider, for example, as part of an outsourcing arrangement, institutions should satisfy themselves that such information will be treated as confidential and adequately safeguarded by that service provider and adopt contractual or other means to prevent any information transferred to that service provider from being the subject of unauthorized or accidental access, processing, use, erasure or loss or kept longer than is necessary for the purposes stipulated in the outsourcing agreement. Institutions should remain accountable to customers for any complaints arising out of the handling of customer information by service providers and should not attempt to disclaim responsibility for any breach of customer confidentiality by service providers.

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Equal opportunity

8.1 Institutions should at all times comply with the relevant ordinances for the promotion of equal opportunity and any codes issued under these ordinances in the provision of banking services.

8.2 In respect of customers with a disability, institutions should adopt a helpful approach to making available to them appropriate means to access banking services. In particular, institutions are encouraged to install specialised machines or software and to provide physical access to facilitate the provision of banking services to persons with a disability.

8.3 Institutions should follow the relevant guidelines issued by the industry associations with respect to the provision of services for visually impaired customers.

8.4 In addition to the statutory requirements, institutions should not discriminate against any customers simply on the grounds of family status (for example, single parents), sexuality, age or race in the provision of banking services and in the quality and terms of services provided.

8.5 Institutions should provide suitable training to front-line staff to raise awareness of the principles and guidelines relating to equal opportunity and the provision of assistance to customers with a disability.

Bank marketing

9.1 Institutions should exercise care in the use of direct mail and in particular should exercise restraint and be selective:

- where customers are minors; and when promoting loans and overdrafts.

9.2 Institutions should ensure that all advertising and promotional materials are fair and reasonable, do not contain misleading information and comply with all relevant legislation, codes and rules. Where benefits are subject to conditions, such conditions should be clearly displayed in the advertising materials wherever practicable. Where there are limitations as to space, e.g. in poster advertisements and television commercials, the advertisement should include reference to the means by which further information may be obtained.

9.3 In any advertising and promotional material for a banking service that includes a reference to an interest rate, institutions should also indicate the annualised

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percentage rate (APR), where relevant, and other relevant fees and charges, and that full details of the relevant terms and conditions are available on request.

9.4 Institutions should exercise restraint in making unsolicited (that is, cold) calls to customers, taking account of the general principles stated in relevant guidelines of the HKMA pertaining to marketing activities conducted by institutions.

9.5 When introducing a new or enhanced service or product to customers which involves a cost or potential liability or potential risk of financial loss to them, institutions should not automatically enrol customers into the service or product, i.e. should not enrol them without the prescribed consent of the customers. In cases where the new or enhanced service or product does not involve an additional cost or potential liability or potential risk of financial loss to customers, institutions should allow a period of at least 14 days for customers to decline acceptance of the service or product, and provide a convenient channel for customers to indicate that they decline acceptance. Institutions should notify customers explicitly that customers may decline acceptance of the service or product and the channel(s) through which customers may do so.

9.6 Where a "benefit" is conferred on customers involving no additional cost or potential liability or potential risk of financial loss to the customers, this should not be treated as an "enhanced service or product" in relation to which the requirements under section 11.5 above apply. In determining what constitutes a "benefit", the following principles should be satisfied: -

(a) it does not involve present or future cost or liability or potential risk of financial loss to the customers;

(b) it is available to all customers who subscribe to the related service or product and it is not practicable to offer a choice to a particular customer whether to enjoy the "benefit"; and

(c) to enjoy the "benefit", customers are not required to deviate from the normal usage of the related product or service but may be required to initiate action(s) that fulfils certain condition(s).

9.7 For the avoidance of doubt, sections 11.5 to 11.6 above do not apply to introduction of enhanced security features by institutions or other similar situations.

9.8 In distributing insurance products, retirement plans and investment products as agents for third party service providers, institutions should ensure that the following information is provided to customers or prospective customers separately or as part of the relevant marketing materials -

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(d) the institution is an agent of the third party service provider and the product is a product of the third party service provider but not the institution; and

(e) in respect of an eligible dispute arising between the institution and the customer out of the selling process or processing of the related transaction, the institution is required to enter into a financial dispute resolution scheme process with the customer; however any dispute over the contractual terms of the product should be resolved between directly the third party service provider and the customer.

9.9 While banking services provided by institutions are exempted from the Trade Descriptions Ordinance, in providing banking services and to the extent applicable to those services, institutions should endeavour not to engage in unfair trade practices described in Part 2B of the Trade Descriptions Ordinance, which include misleading omissions, aggressive commercial practices, bait advertising, bait-and-switch, and wrongly accepting payment.

Annualised percentage rates

10.1 Institutions should where relevant quote APRs of banking products to facilitate comparison between different charging structures. Where interest rates for the product are commonly quoted in terms of annualised floating rates (e.g. deposits, overdrafts and mortgage loans), institutions are not obliged to quote the corresponding APR, but they should show all relevant fees and charges normally incurred related to the product in a clear and prominent manner.

10.2 Institutions should be prepared to respond to inquiries from customers concerning APRs and the methods of calculation, and also to advise customers the APRs of specific products. The method set out in the relevant guidelines issued by the industry associations should be adopted in the calculation of the APR.

10.3 While institutions are exempt from the Money Lenders Ordinance so that the interest rates they charge are not restricted, they should not charge customers extortionate interest rates. If the APRs charged by them on regular performing loans or delinquent revolving loans or loans re- priced due to delinquency or the annualized interest rates charged by them on amount in default or overdue exceed the level which is presumed to be extortionate under the Money Lenders Ordinance, they should be able to justify why such high interest is not unreasonable or unfair. Unless justified by exceptional monetary conditions, the APRs charged on regular performing loans or

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delinquent revolving loans or loans re-priced due to delinquency or the annualized interest rates charged on amount in default or overdue should not exceed the legal limit as stated in the Money Lenders Ordinance. For the avoidance of doubt, fees and charges in fixed amounts should not be included in the calculation of annualized interest rates. Fees and charges in fixed amounts imposed on loans in default should be reasonable.

Handling complaints

11.1 Institutions should establish procedures for handling customer complaints in a fair and speedy manner. The complaint procedures should take into account the following criteria:

11.2 Transparency - the applicable procedures should be documented; accessibility—the procedures should be easily invoked by customers; and

11.3 Effectiveness - the procedures should provide for the speedy resolution of disputes in a fair and equitable manner.

11.4 Details of how to invoke complaint procedures should be made available to customers and other interested parties such as personal referees and guarantors so that they know what steps to take if they wish to make a complaint. Institutions are encouraged to make available details of how to invoke complaint procedures in tape recording or in Braille for the visually impaired.

11.5 Institutions should ensure that all their staff who deal directly with customers are made aware of the complaint procedures and are able to help customers by giving correct information about these procedures.

11.6 Institutions should send an acknowledgment to the complainant within seven days upon receiving a written complaint (where the complaint cannot be resolved within seven days) and a written response to the complaint within a reasonable period, normally not exceeding 30 days. Correspondence with the complainant should be sent in Chinese or English in accordance with the language of the complaint.

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Appendix 5
Ethical Dilemmas

(Source: ICAC, "Bank on Integrity" A Practical Guide for Bank Managers, Attachment 3 The ETHICS-PLUS Decision Making Model <http://cpas.icac.hk> and Bank on Integrity: e-Learning Package for Banking Practitioners < www.hkbedc.icac.hk/bank>)

Case Study: A Sinking Friendship

The following case study aims to demonstrate how to apply the ETHICS-PLUS Decision Making Model to tackle an ethical dilemma related to work.

Sharon has been serving as a branch manager of a bank for over five years. She has established good customer relationships and maintained an extensive personal network, especially with Ben, the owner of an SME trading company. As the daughters of both Sharon and Ben are close friends studying in the same school, where Ben is also the Parent-Teacher Association (PTA) Chairman, Sharon always meets Ben and his wife in school activities and they have become close friends.

Ben comes to meet Sharon at her office this morning to review his investment portfolio and ways to recover the financial loss caused by the recent slump of the stock market. As the loss has severely affected his company's cash flow, Ben requests Sharon to help secure a large loan from her bank. To facilitate the loan application, Ben urges Sharon to do him a favour and keep his financial problems hidden when she makes her recommendation to the bank. Knowing that Sharon's daughter would like to join a popular study tour sponsored by the PTA in the summer holiday, Ben hints that he can use his influence as PTA Chairman to "guarantee" a place on the study tour for her daughter as a token of thanks.

Should Sharon help Ben overcome his financial problems or turn down his request? By using the ETHICS-PLUS Decision Making Model, the analysis is outlined below:

Step 1: Establish the relevant facts and identify the ethical issues

Facts:

- Sharon and Ben, having had official dealings for some years along with their children studying in the same school, have become close friends.

- Ben is confronted with severe financial problems caused by the recent slump of the stock market.
- Ben asks Sharon to help secure a large loan from her bank to help ease his financial burden.
- Ben hints to "guarantee" a place for her daughter on the study tour by making use of his capacity as PTA Chairman as a token of thanks.

Ethical Issue:

- To help Ben get over his financial problems or turn down his request?

Step 2: Take stock of all stakeholders or parties involved

In this case, the stakeholders are:

- Sharon
- Ben
- Sharon's daughter
- Sharon's bank

Step 3: Have an objective assessment of each stakeholder's position

Sharon:

- If she helps Ben cover up his financial problems during the course of his application for the bank loan, she cannot fulfill her fiduciary responsibility of protecting the bank's interests as Ben may not be able to repay the loan. Even worse, she may be liable to prosecution.
- She will fail to uphold her professional competence if she covers up the financial problems of Ben and assists him in applying for the loan.
- Her reputation and career prospects may be impaired when her act of covering up Ben's problems is exposed to the bank's management.
- The relationship between Sharon and Ben may be jeopardised if Sharon turns down Ben's request.

Ben:

- He may be liable to prosecution for offering an advantage to Sharon, i.e. to offer a favour to Sharon by using his influence as the PTA Chairman to secure a place for her daughter on the study tour.

- His company may become bankrupt without Sharon's assistance in obtaining the bank loan.
- He may not be able to repay the loan on schedule and thus affect his financial credibility.

Sharon's Daughter:

- If Sharon accedes to Ben's request, her daughter will secure a place on the study tour. She may broaden her horizons and enrich her personal portfolio.

Sharon's Bank:

- Her bank's reputation may be tarnished if Sharon's act becomes known to the public.
- Her bank may suffer a financial loss if Ben fails to repay the loan.
- Her bank's corporate culture may be adversely affected as Sharon, being a branch manager, sets a bad example to her subordinates.
- Tolerance of Sharon's act may lead to the loss of customers' trust and affect staff morale if it becomes known.

Step 4: Identify viable alternatives and their effects on the stakeholders

(a) Agree to help Ben keep his financial problems hidden and accept his offer.

(b) Agree to help Ben but apply for the study tour through the normal procedure.

(c) Advise Ben to resolve his financial crisis through other means instead of obtaining a bank loan.

(d) Refuse Ben's request and report the matter to the management.

(e) Any other alternatives.

Step 5: Compare and evaluate the possible consequences of each alternative with reference to the PLUS standards expected by the professional codes of conduct imposed by the regulatory authorities /company rules

Major rules under the Supervisory Policy Manual CG-3 "Code of Conduct" issued by the Hong Kong Monetary Authority:

- Staff should not use the power or authority deriving from their position to gain a personal benefit or an indirect benefit (e.g. for their relatives or other related parties).
- Staff should be alert to matters which could give rise to fraud, deception, corruption or other illegal activities. They should immediately blow the whistle on suspected illegal activities.

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- Staff should avoid situations that may lead to or involve a conflict of interest, actual and potential.

As a bank employee, Sharon should truly reflect Ben's financial problems when she makes her recommendation for his loan application. Her acceptance of Ben's offer of a "guaranteed" place on the study tour will lead to an actual conflict of interest that is against the banking rules or the company's code of conduct. Even worse, it will be a breach of the law (see "Legal requirements" below).

Legal requirements:

- If Sharon accepts Ben's offer of a "guaranteed place" in return for assisting him in obtaining the loan, both Sharon and Ben may commit a corruption offence under Section 9 of the Prevention of Bribery Ordinance (POBO) and Sharon may also breach Section 124 of the Banking Ordinance. According to the POBO, "advantage" refers to both tangible and intangible items, including Ben's exercise of his power as PTA Chairman to "guarantee" a place on the study tour for Sharon's daughter.
- If Sharon makes use of false or erroneous documents to deceive the bank and helps Ben cover up his financial problems during the loan application process, Sharon may also breach Section 9(3) of the POBO and Section 123 of the Banking Ordinance.

Uncompromising self-values:

- Sharon has to ask herself whether a particular alternative is commensurate with her personal values, such as loyalty to her bank, honesty, fairness and professional competence in conducting her official duties and above all her personal integrity.

Sunshine test:

- Can Sharon disclose her decision to any parties, including her bank, colleagues, friends and family members, without misgivings?

Step 6: Select the most appropriate course of action

- After comparing and evaluating each alternative against the PLUS standards, select an appropriate course of action which can maximise the important values and the interests of all stakeholders.

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Our Suggestion:

- Since helping Ben cover up his financial problems in the course of his loan application will breach the corporate guidelines and even the anti-corruption law, Sharon should decline Ben's request without hesitation.
- To avoid being suspected of conspiring with Ben to defraud the bank and to stop Ben's attempt to bribe other bank staff, Sharon should consider reporting the matter to the bank and appropriate authority as necessary.

Conclusion

The ETHICS-PLUS Decision Making Model aims to provide a way for the actor to exercise moral rationality before jumping to a quick decision or action and enlighten the actor to the different angles to consider, including the dilemmas and the consequences of each possible solution. The point is that by going through a thoughtful and rational analysis, the actor should ultimately be able to make a more balanced and justified decision.

It is also worth pointing out that the toughest choice sometimes lies not in refraining from wrongdoings but between the alternatives that are all seemingly right, viable and important. Here is an example:

- Your bank sets up a one-off fund to subsidise an overseas study programme for staff. A high-flying officer submits her application one day after the deadline since she has just returned from an official trip. It is RIGHT to reject her late application; however, it is also RIGHT to process her application to groom her for a senior position.

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Chapter 2

ETHICS AND THE CORPORATION

Learning outcomes:

Upon completion of this chapter, learners will be able to:

- Explain the relationship between corporate social responsibility, corporate scandals, reputation risk management & corporate sustainability.
- List the expectations regarding corporate social responsibility, corporate accountability and corporate citizens.
- Identify key factors in reducing reputation risk.
- Adhere to both international and national guidelines on corporate social & environmental responsibilities in their daily work.

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Chapter 2 Terminology

CSR	Corporate Social Responsibility
EPFIs	Equator Principles Financial Institutions
ESG	Environmental, Social and Governance
ESMP	Environmental and Social Management Plan
ESMS	an Environment and Social Management System
EU	European Union
FinCEN	American Treasury's Financial Crimes Enforcement Network
GRI	Global Reporting Initiative
KPI	Key performance indicators
LIBOR	London inter-bank offered rate
OECD	Organisation for Economic Co-operation and Development
PBOC	People's Bank of China

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1. Ethics and the Corporation

1.1 Introduction

Business ethics is a set of moral or ethical standards applied to making business decisions and organising business activities in the right way.

Whilst ethics can be applied to both corporations and individuals, corporate ethics generally include corporate social responsibility, accountability and other attributes of corporate citizenship, with variations on the theme that corporations should offer something good to society. These ethical standards require corporations to be liable and answerable to society for their actions.

Corporate social responsibility is closely linked with ethics for the responsible conduct of business, environmental protection, consumer protection, sustainable development, the supply of safe and healthy products and so on. Advocates believe that such corporate ethics will bring benefits to both society and the enterprises themselves. The potential business benefits include the following:

- Better human resources – efforts to improve corporate ethics help enterprises recruit more ethical employees, who tend to pay more attention to both internal and external compliance. This helps ensure the quality of products and services. Also, employees who intentionally choose enterprises with better corporate ethics tend to have more loyalty towards the enterprises due to the same shared values. Such employees are generally more willing to participate in charity work and activities, which in turn, help present to society an even more positive perception of the enterprises.
- Lower operational and reputation risk – non-compliance belongs to the regime of operational risk as defined in the Basel II document. Corporate ethics, however, motivate bank employees to follow rules and regulations, thus reducing the chance of non-compliance such as mis-selling and money laundering, which could result in huge penalties and impair the reputation of the institution. In addition, non-compliance scandals are likely to result in damage to the corporation's reputation, the driving away of customers and investors and even the closing down of operations altogether. By way of example, after the Phony Accounts Scandal in

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2016, Wells Fargo's new credit card applications were down 43% in the fourth quarter of 2016 compared to the previous year, and new current account openings fell 40%. Its employees had created as many as two million unauthorised credit card and current accounts over the course of years, in order to meet sales goals. The bank also faced more than a dozen investigations, inquiries and lawsuits. Banks with an emphasis on corporate social responsibility, on the contrary, tend to have lower operational and reputation risk.

- Better branding – some enterprises promote sports, while others promote green business, in an attempt to create a unique and vivid brand. High ethical standards can form the basis of a branding strategy that especially appeals to customers with higher ethical standards and a strong sense of social responsibility themselves. Moreover, enterprises that have strong corporate ethics tend to have better corporate governance and more stable profits—a positive image that appeals to investors and clients.

Corporations without ethical employees will find it hard to become ethical corporations. The next chapter will discuss the internal codes of conduct applicable to bank employees and the industry code of practice in Hong Kong.

Corporations are part of society and are obliged to follow the laws, rules and regulations of society. Yet, human history contains numerous examples of corrupt corporations that intentionally cheat their consumers, pollute their surroundings, exploit their shareholders' interests and put their employees at risk, despite the existence of laws, rules and regulations which may have been implemented to provide the minimal ethical standards.

LIBOR (London inter-bank offered rate), a global benchmark for interest rates, is commonly used in pricing many financial instruments. In brief, it is calculated by averaging the interest rates submitted to the Thomson Reuters data collection service by panels of between eleven and eighteen global banks. In around 2010, various bankers and traders, such as swap traders from the US and Europe, were found to have colluded in submitting the interest rates used for calculating LIBOR. From the emails and phone records disclosed during the investigation, it was revealed that traders openly asked one another to set the interest rate at a rate at which they would profit from the colluded LIBOR, and the bank employees submitted the manipulated rates that would benefit the traders, instead of submitting the actual rates that the banks paid to borrow money. This is known as the

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LIBOR scandal or LIBOR rigging. Not surprisingly, those traders and bank employees were criminally charged and some were sentenced to years in prison; the banks were fined millions of dollars by the regulators (estimated to be over USD9 billion globally), and a large number of lawsuits followed (the amount of private legal settlements is estimated to be USD35 billion). Most important of all, public trust and confidence in the financial market was eroded.

As such, corporations need to put in place an internal compliance culture based on ethical values to mitigate the risks of non-compliance with laws and regulations.

1.1.1 Corporate social responsibility

In general, corporations are expected to be socially responsible, to be good corporate citizens, and to remain accountable to their shareholders, customers, employees and other stakeholders as well as to society as a whole.

How can these expectations be met? The answers are linked to corporate culture and internal controls—in other words, how a corporation is governed and managed. Good corporate governance is essential in order to produce a socially responsible and accountable organisation.

The board and senior management need to formulate strategies and policies that promote ethical corporate behavior. How corporations design, promote, enforce ethical behavior will be discussed further in Chapter 4. In this Chapter we will focus on how corporations think carefully about what it means to be an ethical organization.

Within Ethics ‘good’ and ‘bad’ behaviour is defined by the consensus of society. Corporations need to find out what ethical values are agreed upon by the society in which they operate; multinational corporations will need to observe the value systems of all the countries in which they operate.

The following sections will give examples on the consensus in corporate ethics–the OECD Guidelines, the CSR Guidelines for banks in China and the Equator Principles on Project Finance.

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The OECD Guidelines on Corporate Social Responsibility (CSR)

The Organisation for Economic Co-operation and Development (OECD)[1] Guidelines for Multinational Enterprises provide guidance on corporate social responsibility and corporate accountability. This set of guidelines is the result of a consensus, including multinational agreements, among banks and the legal or regulatory guidelines in force in various countries.

The guidelines give a clearer idea of how corporate ethics is defined in the international community and make corporate ethics more actionable. The guidelines aim to ensure that corporations work in harmony with the societies and governmental policies of the countries in which they operate, and also to facilitate foreign investment and contribute to economic, environmental and social progress with a view to achieving sustainable development.

In brief, enterprises should, among other things –

1. adopt and maintain high standards of information disclosures for both internal and public interests. Disclosures should be timely, regular and reliable. Material information includes the enterprise's activities, structure, ownership and governance, financial situation and performance, which can provide transparency for stakeholders and the public. Banks which are public companies, i.e. listed on stock exchanges, have to strictly comply with the disclosure requirements under the applicable listing rules in force in the countries in which they are listed.
2. respect and protect human rights. Enterprises should not do business with those entities whose reputation is tainted by poor human rights records, such as the use of child labour or exploitation of workers. It is worth noting that responsible banks decline to establish relationships with those businesses with poor human rights records.
3. create employment with equal opportunities, comply with employment laws and regulations as well as international labour standards, and facilitate industrial relations. Banks, as with other enterprises, should comply with applicable employment laws, for example, employee compensation laws to protect their

[1] The OECD is an inter-governmental organisation that represents a group of major developed and market-oriented economies: member countries include Australia, Austria, Belgium, Canada, the Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, South Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, the Slovak Republic, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States.

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employees upon the occurrence of accidents in the course of employment, and health and safety laws to protect bank staff and enhance work safety in the workplace.

4. protect the environment, promote public health and safety, and contribute to sustainable development. This is particularly relevant to banks' lending business, in particular the financing of projects that will induce environmental hazards such as water pollution, deforestation or animal cruelty. The Equator Principles on Project Finance are adopted by many international banks for project financing, which we shall discuss in the later sections of this chapter. It is worth noting that many international banks have advocated and implemented green policies in their daily operations, e.g. eliminating paper wastage by e-filing and the use of electronic reporting, and initiating "Green Campaigns", for instance Green Monday in staff canteens by providing vegetarian food at lunchtime.
5. combat bribery, bribe solicitation and extortion. Enterprises should develop and adopt proper internal controls and compliance measures to prevent and combat any risk of bribery. As banks deal in money, taking deposits and granting loans, it is a pre-requisite for any new recruits to be alert to any potential bribe solicitation or extortion, and topics of anti-bribery/financial crimes are included in induction courses. Banks should establish sound internal control systems with clear policies and procedures, effective risk management and compliance as well as adequate staff training so as to prevent any bribery or bribe solicitation.
6. protect consumer interests. Socially responsible enterprises should deal with consumers in accordance with fair business, marketing and advertising practices, and take all reasonable steps to ensure the quality and reliability of goods and services supplied. The provision of accurate and clear information is particularly essential for the pricing of banking products, and banks provide updated information regularly on their websites and via various forms of communication to their customers, such as information posters shown at branches and through mailing. After the 2008 global financial crisis, banks have revamped their operations, management and control in their selling/provision of complex securities and investment products, e.g. derivative products, so as to ensure products sold suit the needs and circumstances of customers with relevant trading investment experience.
7. endeavour to ensure their activities are compatible with the science and technology policies and plans of the countries in which they operate with a view to cater for the needs of customers and commercial needs as well as the protection of intellectual

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property rights. A good example is local banks' use of blockchain in processing mortgage applications in response to the Hong Kong Government's Fintech drive.

8. comply with competition laws and regulations. Enterprises should refrain from entering into or carrying out anti-competitive agreements among competitors. Banks, like other businesses, have to comply with relevant competition laws and regulations under different jurisdictions.
9. comply with tax laws and regulations and make timely tax payments. Banks, like other enterprises, have to comply strictly with relevant tax laws. In recent years, as various governments are trying to tackle the problem of tax evasion, financial institutions including banks have to enhance their customer information systems and provide relevant customer account information to the tax authorities. We shall discuss the US Foreign Account Tax Compliance Act, and the OECD's approach, i.e. the Common Reporting Standard, that are currently adopted for combating tax evasion in Chapter 3.

For details of the OECD Guidelines, please refer to Appendix 1.

CSR in China & Guidelines for banks

In November 2016, the Paris Climate Agreement came into force with 55 countries committed to reduce the emission of greenhouse gases by undertaking efforts to combat climate change. Together with the EU countries, China has also re-affirmed her commitment, which indicated her determination towards the protection of the environment. Apart from infrastructure development, China will also assist developing countries on environmental issues via the "Belt and Road Initiative".

Back in 2012, the 18th National Congress of the Chinese Communist Party stressed the importance of resource conservation and environmental protection.

With the fast economic growth and social development, a number of laws and guidelines were enacted in the millennium year to uphold CSR with a view to align with the international market practice. The Law on Work Safety came into effect in 2002 to protect workers and prevent work accidents, and the New Company Law in 2006 completely revamped the old versions.

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In January 2009, the China Banking Association issued new guidelines for Chinese banks on corporate social responsibility. The guidelines emphasise the inter-relationship between ethical business operation, economic & financial development, and social & environmental responsibility. For details of the Guidelines, please refer to Appendix 4.

It is worth noting that the guidelines encourage banks and other financial institutions to actively refer to the Equator Principles on Project Finance and carry out relevant research suitable for the economic and financial development of China. The Equator Principles are voluntary guidelines for banks that offer project finance and will be discussed in the next section.

In 2008, Industrial Bank Co Ltd. became the first bank in China to adopt the Equator Principles.

It is also worth noting that in 2006, the People's Bank of China (PBOC), in collaboration with the Ministry of Environmental Protection, launched the "green lending campaign", which included pollution records in the database for corporate credit. Commercial banks in China were urged to conduct a strict environmental screening process when lending money to companies. The Green Credit Guidelines also demand banks to restrict loans to polluting industries and companies, and offer reduced interest rates for environmentally friendly projects.

1.1.2 Corporate accountability

One theoretical view of social responsibility is the accountability theory. In short, it states that businesses should be responsible and accountable to society for how they behave because business comes from society, without which there could be no business (Falconer, 2014). Thus, corporations should use their powers responsibly and be accountable to all stakeholders, including their shareholders, customers, employees and society as a whole. Corporations are expected to be socially responsible.

For example, Ranking Digital Rights, a team of researchers, evaluates a number of global telecommunications, internet, and mobile companies on how well they disclose policies affecting users' freedom of expression and privacy and scores them in terms of an index known as the Ranking Digital Rights Corporate Accountability Index. The recent 2017

Index showed that most, if not all, companies "failed to sufficiently disclose policies affecting users' freedom of expression and privacy" (Ranking Digital Rights, 2017)[2].

As for the banking industry, according to a Gallup poll in 2015, about 90% of the consumers in the US have trust in their primary bank in keeping their personal data safe, which is a lot higher compared to some other businesses such as health insurance companies and email network providers.[3]

1.1.3 Corporate citizenship

The concept of corporate citizenship is based on the enlarged concept of social contract extending from individuals to corporations (Crowther, D. in Das Gupta, A. (2008)).

According to the World Economic Forum, "Corporate citizenship is about the contribution a company makes to society through its core business activities, its social investment and philanthropy programmes, and its engagement in public policy. The manner in which a company manages its economic, social and environmental relationships, and the way it engages with its stakeholders (such as shareholders, employees, customers, business partners, governments and communities), has an impact on the company's long-term success." (Global Corporate Citizenship Initiative, n.d.) [4] In other words, corporate citizenship goes beyond the boundary of a commercial relationship and extends towards the responsibility to other stakeholders.

1.2 Social environmental issues facing modern business organisations

Equator Principles on Project Finance

In international banking, many banks follow the ten 'Equator Principles' in their project financing in order to fulfil their corporate social responsibility. Project financing is a special type of financing applied mostly to large scale and long-term infrastructure development —

[2] https://rankingdigitalrights.org/index2017/findings/keyfindings/
[3] http://www.gallup.com/businessjournal/181904/consumers-doubt-personal-info-safe.aspx
[4] Global Corporate Citizenship Initiative, World Economic Forum, Available at: http://web.worldbank.org/archive/website00818/WEB/OTHER/GLOBAL-3.HTM

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toll roads, tunnels, bridges, power stations, railway systems, oil refineries, coal mines, airports and so on.

With such large projects, the first few years are spent in the developmental and engineering phases, which do not generate any income. The organisations undertaking the projects therefore seek loans to carry out their operations. They offer a guarantee from sponsors of the project (usually governments, major users or major suppliers) or secure the loan against future income. The loan will be repaid during the implementation phase of the project, i.e. when the project starts to generate regular income. Repayment may take 10 to 20 years.

The Equator Principles are voluntary guidelines for banks that offer project financing, and are aimed at encouraging corporate social and environmental responsibility on the part of the project owners and sponsors. Financial institutions who adopt these principles are called 'Equator Principles Financial Institutions' ('EPFIs').

The Equator Principles (EPs) is a risk management framework, adopted by financial institutions, for determining, assessing and managing environmental and social risk in projects and is primarily intended to provide a minimum standard for due diligence and monitoring to support responsible risk decision-making.

The EPs apply globally, to all industry sectors and to four financial products 1) Project Finance Advisory Services 2) Project Finance 3) Project-Related Corporate Loans and 4) Bridge Loans. The relevant thresholds and criteria for application is described in detail in the Scope section of the EPs.
Currently 112 international Financial Institutions (EPFIs) in 38 countries have officially adopted the EPs, covering the majority of international project finance debt within developed and emerging markets.

EPFIs provide finance to projects that conform to the ten principles and briefly, they are as follows:

- Review and categorisation – EPFIs should perform internal social and environmental reviews and due diligence, and categorise a project based on its potential impact and risks using the International Finance Corporation's screening criteria.

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- Environmental and social assessment – EPFIs should ensure that the project owner has conducted an assessment process to address the relevant environmental and social risks and impact of the proposed project, and that the results are satisfactory.
- Applicable environmental and social standards – EPFIs should ensure that the assessment process evaluates the project as being compliant with applicable standards, laws and regulations that pertain to environmental and social issues.
- Environmental and social management system and Equator Principles action plan – EPFIs should require the project owner to develop or maintain an Environment and Social Management System (ESMS) and has an Environmental and Social Management Plan (ESMP) in place to address issues raised in the assessment process and incorporate actions required to comply with the applicable standards, laws and regulations.
- Stakeholder engagement – EPFIs should require the project owner to demonstrate effective stakeholder engagement as an ongoing process and ensure that communities adversely impacted by a project have been consulted in a structured and culturally appropriate manner.
- Grievance mechanism – EPFIs should ensure that the project owner offers consultation, disclosure and community engagement throughout the construction and operation of the project, and establishes a clear and accessible grievance mechanism.
- Independent review – EPFIs should ensure that an independent social or environmental expert is engaged to review the project's assessments and ensure it complies with the Equator Principles.
- Covenants – EPFIs should ensure that the financing documentation contains covenants to comply with all the relevant social and environmental laws, regulations and permits in all material respects. If the client does not comply with the covenants, EPFIs will work with the client to re-establish compliance within an agreed grace period for remediation.
- Independent monitoring and reporting – EPFIs should ensure the project has ongoing monitoring and an independent expert is appointed to verify the monitoring information to be shared with the EPFI.
- Reporting and transparency – EPFIs should ensure the project owner fulfils the reporting requirements under the Equator Principles.

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For the full text of the principles and for more information, visit:
www.equator-principles.com

Green finance

As part of the CSR initiatives, most banks have now developed policies and procedures that, together with the Equator Principles, aim to achieve high environmental and social standards. The policy may state how far the bank is willing to commit to environmental sustainability. Measures such as better utlilisation of resources, reduction of greenhouse gases, promoting environmentally responsible business practice, green procurement for suppliers and stakeholder engagement may be proposed.

Where the bank is a listed company in Hong Kong, they must disclose environmental information including some key performance indicators (‘KPI’), among others, on an annual basis in accordance with the Environmental, Social and Governance (ESG) Reporting Guide (Main Board Listing Rules Appendix 27[5]) issued by the Hong Kong Exchanges and Clearing Limited. The board of directors of the bank has overall responsibility for the bank’s ESG strategy and reporting. The bank must report on matters in the “comply or explain” provisions of the ESG Reporting Guide. If they do not report the information on those provisions, they must provide reasons in the ESG report.

As an example, under the ‘Comply or Explain” provisions on ‘Use of Resources’, the bank must provide General Disclosure Policies on the efficient use of resources, including energy, water and other raw materials. Resources include those used in production, in storage, transportation, in buildings, electronic equipment, etc. Examples of KPIs are direct and/or indirect energy consumption by type (e.g. electricity, gas or oil) in total (kWh in ’000s) and intensity (e.g. per unit of production volume, per facility); water consumption in total and intensity (e.g. per unit of production volume, per facility); description of energy use efficiency initiatives and results achieved.

[5] The Hong Kong Exchanges and Clearing Limited, Appendix 27 Environmental, Social and Governance Reporting Guide, Available at: https://en-rules.hkex.com.hk/rulebook/environmental-social-and-governance-reporting-guide-0

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For the full text of the Appendix 27 Environmental, Social and Governance Reporting Guide, please visit
http://en-rules.hkex.com.hk/en/display/display_main.html?rbid=4476&record_id=3841

Bank could also consult the Global Reporting Initiative (GRI) G4 Sustainability Reporting Guidelines [6] in their reporting. GRI is an independent international organisation that promotes sustainability reporting and it has received support from a number of governments and their agencies. In the report, the bank has to disclose their most critical impacts – be they positive or negative – on the environment, society and the economy.

1.3 Public perception & reputation risk

Reputation is based on public perception and expectations. For example, there is an increasing expectation from the public for corporations to take up social and environmental responsibilities. A corporation could build up its reputation by integrating social and environmental responsibilities into their business practice in response to the expectations of society, such as by taking care of the weaker members of the society like the elderly and the disabled, and by adopting green policies in its strategic planning. A good reputation is an important intangible asset and corporations need time and effort to build up and maintain their reputation.

For a bank, if depositors lose their confidence and a bank run erupts, the bank will immediately have a liquidity problem and its long-term profitability will be at stake as well. As a bank's reputation is closely linked with how well it fulfils its social and environmental responsibilities, bank regulators tend to require banks to apply 'reputation risk-management' measures to address these issues. This will be further discussed in section 1.5 below.

1.4 Globalisation

Managing reputation risk is particularly challenging today because globalisation enables corporations to operate in different countries, and thus encounter different ethical

[6] The G4 Guidelines have been superseded by the GRI Sustainability Reporting Standards (GRI Standards) for all reports published on or after 1 July 2018. See, for example: https://respect.international/g4-sustainability-reporting-guidelines-implementation-manual/ (Last accessed: 25 Nov 2020)

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standards. To mitigate reputation risk, a responsible company should have a committee that investigates risk issues in different countries, including those relating to social and environmental responsibilities, and considers all relevant global and local standards, guidelines or codes of practice.

1.5 Reputation & sustainability

"Reputation plays a key role in determining whether an Authorised Institution has a sustainable future for its business." - HKMA
(Source: Module RR-1 "Reputation Risk Management" (2008) of the HKMA Supervisory Policy Manual)

It needs no explanation that a good brand adds a great deal of value to sales and marketing. Products with a positive brand name can be sold at better prices. While building a brand takes time, a single scandal can ruin it overnight. Hence, once a brand is successfully established, its owner should be careful to sustain its reputation. The brand is simply the public perception of the company and its products, and so scandals or malpractice can endanger the brand and put the reputation of the company at risk.

Corporate scandals make the news headlines periodically around the world, and social and environmental responsibility remains a hot topic.

The 2017 United Airlines incident of ejecting a passenger from an overbooked flight by force resulted in a lawsuit, compensation and adverse impact on its corporate image and reputation.

These types of corporate scandals illustrate that some corporations and their senior executives seem to be lax in safeguarding the interests of their customers, staff or society in general. They reveal two issues that not only must be remedied within the affected organisations but also serve as warning signals to all corporations. The organisations involved in the scandals seemed to have:

- a corporate culture that de-emphasised social responsibility in favour of profits and revenues, resulting in senior executives who were profit-oriented even at the expense of their customers, shareholders and society as a whole;

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- a lack of effective internal control systems, resulting in the misconduct of senior executives and, in certain instances, their employees.

Society expects corporations to be socially and environmentally responsible, and to act in a way that is good for society and not harmful—in other words, to be ethical when conducting their business. This includes:

- complying with local and applicable global laws and regulations;
- considering the interests of their customers, employees and society;
- considering the environmental impact of their business and operations.

Corporate social responsibility has thus become an issue that may have an impact on reputation as well.

For banks, in particular, a good reputation is an essential intangible asset. Bank customers put their trust and confidence in banks to safeguard and manage their money and assets. Adverse market rumours, compliance breaches, operational deficiencies or errors, breach of or compromise on ethical standards or rules of conduct, regulatory sanctions or heavy financial losses can damage a bank's reputation. With negative publicity, depositors will lose confidence in the bank and immediately withdraw their money, which will lead to liquidity problems or even a bank run.

Banco Delta Asia, a Macau bank, faced a bank run in September 2005 with depositors withdrawing HKD300m (USD38m), i.e. 10% of the total deposits held by the bank, within one week. This occurred when the American Treasury's Financial Crimes Enforcement Network (FinCEN) branded the bank "a willing pawn for the North Korean government to engage in corrupt financial activities", including counterfeiting money and laundering suspicious cash deposits for North Korean firms allegedly related to the North Korean government. The bank then suspended its relationship with those firms.

A bank's reputation is closely linked with how well it fulfils its corporate, social and environmental responsibilities. Bank regulators require banks to apply appropriate 'reputation risk management' measures to address these issues as well as to control and mitigate the related risks. According to the HKMA's Guideline on Reputation Risk Management, Supervisory Policy Manual Module RR-1, reputation risk management "includes identifying and assessing threats to a corporation's reputation and exploring

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opportunities for enhancing it". For a full explanation of Reputation Risk Management by the HKMA, you may refer to the relevant sections of the Guideline extracted in Appendix 2 of this chapter or download the full guideline from the HKMA's website.

The HKMA has identified the following twelve key drivers/factors affecting banks' reputation:

1. corporate governance – leadership of the Board and senior management is vital to give a clear vision for steering the business ahead with good business strategies and objectives, displaying their capability to run the business and manage risks;
2. management integrity – apart from capability, personal ethics and conduct of the directors and senior management are essential to build stakeholders' confidence in the institution;
3. staff competence and support – recruiting the right personnel with adequate capability is important to achieve the business objectives. Without competent staff, it can lead to high staff turnover, poor services and customer complaints, damaging the institution's reputation;
4. corporate culture – an enterprise which upholds business ethics is likely to possess a corporate culture that supports prudent risk management and contributes towards proper staff behaviour, leading to positive customer outcomes and high ethical standards in the industry. The HKMA has stressed the importance of corporate culture and issued a Circular on "Bank Culture Reform" on 2 Mar 2017 to provide guidance to the banking industry on the three pillars to promote a sound bank culture. In brief, the three pillars are: (a) the Board and senior management of a bank are advocated to lead and set a good example in order to establish the institution's culture and behavioural standards that promote prudent risk-taking and the fair treatment of customers; (b) incentive systems should not only reward good business performance, but also take into account adherence (and non-adherence) to the institution's culture and behavioural standards with a long-term view to safeguard the interests of customers and reputation of the institution; (c) banks should develop sound assessment and feedback mechanisms to monitor adherence of business units and relevant staff to the culture and behavioural standards.[7]
5. risk management and control environment – this is necessary to safeguard the institution's assets and capital, and prevent fraud and abuse. The institution should

[7] For further details of the Three Pillars for Promoting Sound Bank Culture) https://www.hkma.gov.hk/eng/key-functions/banking/banking-conduct-supervision/bank-culture/

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seek independent assurance that existing risk management and control systems are properly running, for example by internal audits or risk assurance.

6. financial soundness/business viability – substantial financial losses will immediately damage the reputation of an authorised institution, resulting in stakeholders' loss of confidence. Proper financial reporting systems are important to exhibit that financial exposures are fairly represented and relevant financial information is always readily available, which in turn helps to enhance the institution's reputation.
7. business practices – authorised institutions are expected to run their business in a responsible, honest and prudent manner, upkeep CSR by implementing environmentally friendly policies, e.g. green policies or energy saving programmes. AIs should be guided by, and closely adhere to, relevant ethical standards and codes of conduct.
8. customer satisfaction – it is most important for banks to satisfy customer needs and expectations on a continuing basis in face of a highly competitive banking environment. Failure to do so, for example, overcharging customers or mis-handling customer information, may result in loss of customer confidence, falling business or adverse publicity.
9. legal and regulatory compliance – contravening any relevant laws, regulations or guidelines can lead to serious consequences, including regulatory investigation, costly and high profile litigation, substantial claims for damages and harmful publicity. Banks should put in place robust systems to ensure compliance, i.e. effective assessment of legal and regulatory risks and enhancement of staff competence.
10. contagion risk/rumours – contagion effects on AIs' reputation may result from regulatory sanctions against its parent company or related companies, or problematic relationships with customers or counterparties engaging in unlawful or corrupt activities. An AI will be more vulnerable to rumours if its market perception is weak. Adequate contingency procedures should be developed to deal with such situations.
11. crisis management – this is particularly essential in the current internet age, where an AI's inadequate response to a crisis, or even a minor incident, that attracts media attention could quickly arouse stakeholder concerns about management competence. AIs should ensure that they are ready to deal with possible crises and close attention should be paid to managing media communications.

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12. transparency accountability – with transparency, stakeholders can obtain relevant information to understand the AI's financial position, strategies and prospects. Adequate accountability for the integrity of information disclosures should be supported by robust management monitoring and reporting systems.

For the full list of these key drivers, please refer to the extract from the Reputation Risk Management Guideline in Appendix 3[8] . We will discuss some of the above major drivers/factors in detail in the next two Chapters.

You are advised to read the HKMA's Guideline to understand the importance of reputation risk management and how to manage such risk through the adoption of a formalised and systematic approach. There are three key elements of reputation risk management: (i) good corporate governance; (ii) an effective reputation risk management process; and (iii) adequate management of reputation events.

Good corporate governance forms the foundation of effective reputation risk management, by helping to ensure that everyone within a corporation makes an effort in moulding and upholding its reputation. This can be achieved by implementing a governance infrastructure and adopting governance practices that meet stakeholders' expectations.

An effective reputation risk management process should be adopted or formalised to prevent any perceived risks from developing into direct threats to a corporation's reputation. The key elements should include:

- policies, codes of conduct, guidelines and procedures;
- risk identification, assessment and control;
- risk monitoring and reporting (including early warning systems);
- communications and disclosure; and
- independent reviews and audits.

The process in place should enable senior management to monitor reputation risk and act quickly.

[8] Annex B, – RR-1 < Reputation Risk Management) V.1 – 17.12.08 HKMA Supervisory Policy Manual

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Despite good corporate governance and stringent risk control measures, reputation events may still occur. It is crucial for corporations to develop a systematic and comprehensive approach to managing reputation events, so that the corporation's management will be able to take swift and proper measures to restore its reputation and minimise the damage. Effective implementation of the approach can lower the chance of having to deal with a full-blown crisis, or even enhance a corporation's reputation.

By now, you are aware that a corporation with a positive reputation or low reputation risk tends to be sustainable into the future, and reputation is closely related to senior executives' positive attitude towards protecting the environment, safeguarding the well-being of the community, providing economic value to their shareholders and other stakeholders, and maintaining financial soundness/business viability.

In addition, corporations should have effective corporate governance, compliance and internal controls that encourage employees to act and behave in ethical ways themselves as well as to comply with company policies and legal/regulatory requirements and meet management's goals. The coming chapters will feature more discussion on regulatory.

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2. Chapter Summary

Business ethics are a set of moral or ethical expectations applied to making business decisions and organising business activities. Ethics can be applied to both corporations and individuals, with corporate ethics generally including corporate social responsibility, corporate accountability and corporate citizenship. A socially responsible corporation will have better human resources, lower operational and reputation risk, and a better brand.

Corporate scandals arouse public concern regarding corporate social and environmental responsibilities. Scandals are linked to ineffective internal control systems and insufficient emphasis on the corporate culture relating to social responsibility.

Consensus theory proposes that truth is a matter of social agreement. Applied to corporate ethics, this means corporations need to find out what ethical values are agreed upon by the society in which they operate. The OECD's Guidelines for Multinational Enterprises are the product of an international consensus on corporate social responsibility.

After the financial crisis in 2008, the Chinese government issued guidelines for banks on corporate social responsibility. The guidelines emphasise ethical business operation, and economic, social and environmental responsibility.

The Equator Principles on Project Financing are voluntary guidelines applied to banks that participate in project finance, aiming at encouraging better corporate social responsibility on the part of the project owners and sponsors.

Reputation risk management focuses on improving social and environmental responsibility, corporate governance, management integrity, corporate culture, risk management and the control environment, business practices, customer satisfaction, compliance, transparency and accountability. It promotes corporate sustainability in the long run. Corporate scandals trigger public concerns and are related to ineffective internal control systems and insufficient focus on social responsibility.

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4. Review Questions

1. The potential business benefits of good corporate social responsibility in a corporation include the following EXCEPT:

   A. Better human resources
   B. Lower operational risk
   C. Better advertisement
   D. Lower reputation risk

2. Under the OECD Guidelines on CSR and Corporate Accountability, enterprises are encouraged to:

   i. Contribute to economic, environmental and social progress with a view to achieving sustainable development.
   ii. Respect the internationally recognised human rights of those affected by their activities.
   iii. Avoid causing or contributing to adverse impact on matters covered by the guidelines through their own activities, and address such impacts when they occur.
   iv. Abstain from any improper involvement in local political activities.

   A. I, II and III only
   B. I, II and IV only
   C. II, III and IV only.
   D. I, II, III and IV

3. Which of the following statements about reputation and reputational risk is incorrect?

   A. Reputation is mainly about people’s perception and expectations.
   B. Reputation is a tangible asset and can be quantified.
   C. A lot of persistent effort is required to maintain reputation.
   D. Anyone within an AI may potentially affect its reputation.

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4. Which of the following is NOT a key driver that may affect reputation risk?

   A. Organisational structure
   B. Corporate culture
   C. Legal/regulatory compliance
   D. Customer satisfaction

5. Under the CSR guidelines for banks in China issued by the China Banking Association in January 2009, the corporate social responsibility of banking institutions shall at least include:

   i. Economic responsibility
   ii. Social responsibility
   iii. Environmental responsibility
   iv. Technological responsibility

   A. I, II and III only
   B. I, II and IV only
   C. II, III and IV only.
   D. I, II, III and IV

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Answers:

Question 1: C

Question 2: D

Question 3: B

Question 4: A

Question 5: A

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6. Appendices

Appendix 1
The OECD Guidelines on CSR and Corporate Accountability

GUIDELINES FOR MULTINATIONAL ENTERPRISES:

RECOMMENDATIONS FOR RESPONSIBLE BUSINESS CONDUCT IN A GLOBAL CONTEXT[9]

I. General Policies

A. Enterprises should:

1. Contribute to economic, environmental and social progress with a view to achieving sustainable development.
2. Respect the internationally recognised human rights of those affected by their activities.
3. Encourage local capacity building through close co-operation with the local community, including business interests, as well as developing the enterprise's activities in domestic and foreign markets, consistent with the need for sound commercial practice.
4. Encourage human capital formation, in particular by creating employment opportunities and facilitating training opportunities for employees.
5. Refrain from seeking or accepting exemptions not contemplated in the statutory or regulatory framework related to human rights, environmental, health, safety, labour, taxation, financial incentives, or other issues.
6. Support and uphold good corporate governance principles and develop and apply good corporate governance practices, including throughout enterprise groups.

[9] Extracts from: https://legalinstruments.oecd.org/public/doc/241/body-text.en.html (Last accessed: 25 Nov 2020)

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7. Develop and apply effective self-regulatory practices and management systems that foster a relationship of confidence and mutual trust between enterprises and the societies in which they operate.
8. Promote awareness of and compliance by workers employed by multinational enterprises with respect to company policies through appropriate dissemination of these policies, including through training programmes.
9. Refrain from discriminatory or disciplinary action against workers who make bona fide reports to management or, as appropriate, to the competent public authorities, on practices that contravene the law, the Guidelines or the enterprise's policies.
10. Carry out risk-based due diligence, for example by incorporating it into their enterprise risk management systems, to identify, prevent and mitigate actual and potential adverse impacts as described in paragraphs 11 and 12, and account for how these impacts are addressed. The nature and extent of due diligence depend on the circumstances of a particular situation.
11. Avoid causing or contributing to adverse impacts on matters covered by the Guidelines, through their own activities, and address such impacts when they occur.
12. Seek to prevent or mitigate an adverse impact where they have not contributed to that impact, when the impact is nevertheless directly linked to their operations, products or services by a business relationship. This is not intended to shift responsibility from the entity causing an adverse impact to the enterprise with which it has a business relationship.
13. In addition to addressing adverse impacts in relation to matters covered by the Guidelines, encourage, where practicable, business partners, including suppliers and sub-contractors, to apply principles of responsible business conduct compatible with the Guidelines.
14. Engage with relevant stakeholders in order to provide meaningful opportunities for their views to be taken into account in relation to planning and decision making for projects or other activities that may significantly impact local communities.
15. Abstain from any improper involvement in local political activities.

B. Enterprises are encouraged to:

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1. Support, as appropriate to their circumstances, cooperative efforts in the appropriate fora to promote Internet Freedom through respect of freedom of expression, assembly and association online.
2. Engage in or support, where appropriate, private or multi-stakeholder initiatives and social dialogue on responsible supply chain management while ensuring that these initiatives take due account of their social and economic effects on developing countries and of existing internationally recognised standards.

II. Disclosure

To promote corporate social responsibility and make this value visible in the society, the OECD guidelines recommend high standards of information disclosures for both internal and public interests. These disclosure standards include:

1. Enterprises should ensure that timely and accurate information is disclosed on all material matters regarding their activities, structure, financial situation, performance, ownership and governance. This information should be disclosed for the enterprise as a whole, and, where appropriate, along business lines or geographic areas. Disclosure policies of enterprises should be tailored to the nature, size and location of the enterprise, with due regard taken of costs, business confidentiality and other competitive concerns.
2. Disclosure policies of enterprises should include, but not be limited to, material information on:
   - (a) the financial and operating results of the enterprise;
   - (b) enterprise objectives;
   - (c) major share ownership and voting rights, including the structure of a group of enterprises and intra-group relations, as well as control enhancing mechanisms;
   - (d) remuneration policy for members of the board and key executives, and information about board members, including qualifications, the selection process, other enterprise directorships and whether each board member is regarded as independent by the board;
   - (e) related party transactions;
   - (f) foreseeable risk factors;
   - (g) issues regarding workers and other stakeholders;

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(h) governance structures and policies, in particular, the content of any corporate governance code or policy and its implementation process.

3. Enterprises are encouraged to communicate additional information that could include:
   (a) value statements or statements of business conduct intended for public disclosure including, depending on its relevance for the enterprise's activities, information on the enterprise's policies relating to matters covered by the guidelines;
   (b) policies and other codes of conduct to which the enterprise subscribes, their date of adoption and the countries and entities to which such statements apply;
   (c) its performance in relation to these statements and codes;
   (d) information on internal audit, risk management and legal compliance systems;
   (e) information on relationships with workers and other stakeholders.
4. Enterprises should apply high quality standards for accounting, and financial as well as non-financial disclosure, including environmental and social reporting where they exist. The standards or policies under which information is compiled and published should be reported. An annual audit should be conducted by an independent, competent and qualified auditor in order to provide an external and objective assurance to the board and shareholders that the financial statements fairly represent the financial position and performance of the enterprise in all material respects.

III. Human Rights

States have the duty to protect human rights. Enterprises should, within the framework of internationally recognised human rights, the international human rights obligations of the countries in which they operate as well as relevant domestic laws and regulations:

1. Respect human rights, which means they should avoid infringing on the human rights of others and should address adverse human rights impacts with which they are involved.
2. Within the context of their own activities, avoid causing or contributing to adverse human rights impacts and address such impacts when they occur.

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3. Seek ways to prevent or mitigate adverse human rights impacts that are directly linked to their business operations, products or services by a business relationship, even if they do not contribute to those impacts.
4. Have a policy commitment to respect human rights.
5. Carry out human rights due diligence as appropriate to their size, the nature and context of operations and the severity of the risks of adverse human rights impacts.
6. Provide for or co-operate through legitimate processes in the remediation of adverse human rights impacts where they identify that they have caused or contributed to these impacts.

IV. Employment and Industrial Relations

Enterprises should treat employees according to applicable law, regulations and prevailing labour relations and employment practices and applicable international labour standards:

1.
   (a) Respect the right of workers employed by the multinational enterprise to establish or join trade unions and representative organisations of their own choosing.
   (b) Respect the right of workers employed by the multinational enterprise to have trade unions and representative organisations of their own choosing recognised for the purpose of collective bargaining, and engage in constructive negotiations, either individually or through employers' associations, with such representatives with a view to reaching agreements on terms and conditions of employment.
   (c) Contribute to the effective abolition of child labour, and take immediate and effective measures to secure the prohibition and elimination of the worst forms of child labour as a matter of urgency.
   (d) Contribute to the elimination of all forms of forced or compulsory labour and take adequate steps to ensure that forced or compulsory labour does not exist in their operations.
   (e) Be guided throughout their operations by the principle of equality of opportunity and treatment in employment and not discriminate against their workers with respect to employment or occupation on such grounds as race, colour, sex, religion, political opinion, national extraction or social origin, or

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other status, unless selectivity concerning worker characteristics furthers established governmental policies which specifically promote greater equality of employment opportunity or relates to the inherent requirements of a job.

2.
   (a) Provide such facilities to workers' representatives as may be necessary to assist in the development of effective collective agreements.
   (b) Provide information to workers' representatives which is needed for meaningful negotiations on conditions of employment.
   (c) Provide information to workers and their representatives which enables them to obtain a true and fair view of the performance of the entity or, where appropriate, the enterprise as a whole.
3. Promote consultation and co-operation between employers and workers and their representatives on matters of mutual concern.
4.
   (a) Observe standards of employment and industrial relations not less favourable than those observed by comparable employers in the host country.
   (b) When multinational enterprises operate in developing countries, where comparable employers may not exist, provide the best possible wages, benefits and conditions of work, within the framework of government policies. These should be related to the economic position of the enterprise, but should be at least adequate to satisfy the basic needs of the workers and their families.
   (c) Take adequate steps to ensure occupational health and safety in their operations.
5. In their operations, to the greatest extent practicable, employ local workers and provide training with a view to improving skill levels, in co-operation with worker representatives and, where appropriate, relevant governmental authorities.
6. In considering changes in their operations which would have major employment effects, in particular in the case of the closure of an entity involving collective lay-offs or dismissals, provide reasonable notice of such changes to representatives of the workers in their employment and their organisations, and, where appropriate, to the relevant governmental authorities, and co-operate with the worker representatives and appropriate governmental authorities so as to mitigate to the maximum extent practicable adverse effects. In light of the specific circumstances of each case, it would be appropriate if management were able to give such notice prior to the final

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decision being taken. Other means may also be employed to provide meaningful co-operation to mitigate the effects of such decisions.

7. In the context of bona fide negotiations with workers' representatives on conditions of employment, or while workers are exercising a right to organise, not threaten to transfer the whole or part of an operating unit from the country concerned nor transfer workers from the enterprises' component entities in other countries in order to influence unfairly those negotiations or to hinder the exercise of a right to organise.
8. Enable authorised representatives of the workers in their employment to negotiate on collective bargaining or labour-management relations issues and allow the parties to consult on matters of mutual concern with representatives of management who are authorised to take decisions on these matters.

V. Environment

Enterprises should, within the framework of laws, regulations and administrative practices in the countries in which they operate, and in consideration of relevant international agreements, principles, objectives, and standards, take due account of the need to protect the environment, public health and safety, and generally to conduct their activities in a manner contributing to the wider goal of sustainable development. In particular, enterprises should:

1. Establish and maintain a system of environmental management appropriate to the enterprise, including:
   (a) Collection and evaluation of adequate and timely information regarding the environmental, health, and safety impacts of their activities;
   (b) Establishment of measurable objectives and, where appropriate, targets for improved environmental performance and resource utilisation, including periodically reviewing the continuing relevance of these objectives; where appropriate, targets should be consistent with relevant national policies and international environmental commitments; and
   (c) Regular monitoring and verification of progress toward environmental, health, and safety objectives or targets.
2. Taking into account concerns about cost, business confidentiality, and the protection of intellectual property rights:

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(a) Provide the public and workers with adequate, measureable and verifiable (where applicable) and timely information on the potential environment, health and safety impacts of the activities of the enterprise, which could include reporting on progress in improving environmental performance; and

(b) Engage in adequate and timely communication and consultation with the communities directly affected by the environmental, health and safety policies of the enterprise and by their implementation.

3. Assess, and address in decision-making, the foreseeable environmental, health, and safety-related impacts associated with the processes, goods and services of the enterprise over their full life cycle with a view to avoiding or, when unavoidable, mitigating them. Where these proposed activities may have significant environmental, health, or safety impacts, and where they are subject to a decision of a competent authority, prepare an appropriate environmental impact assessment.

4. Consistent with the scientific and technical understanding of the risks, where there are threats of serious damage to the environment, taking also into account human health and safety, not use the lack of full scientific certainty as a reason for postponing cost- effective measures to prevent or minimise such damage.

5. Maintain contingency plans for preventing, mitigating, and controlling serious environmental and health damage from their operations, including accidents and emergencies; and mechanisms for immediate reporting to the competent authorities.

6. Continually seek to improve corporate environmental performance, at the level of the enterprise and, where appropriate, of its supply chain, by encouraging such activities as:

(a) adoption of technologies and operating procedures in all parts of the enterprise that reflect standards concerning environmental performance in the best performing part of the enterprise;

(b) development and provision of products or services that have no undue environmental impacts; are safe in their intended use; reduce greenhouse gas emissions; are efficient in their consumption of energy and natural resources; can be reused, recycled, or disposed of safely;

(c) promoting higher levels of awareness among customers of the environmental implications of using the products and services of the enterprise, including, by providing accurate information on their products (for example, on greenhouse gas emissions, biodiversity, resource efficiency, or other environmental issues); and

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(d) exploring and assessing ways of improving the environmental performance of the enterprise over the longer term, for instance by developing strategies for emission reduction, efficient resource utilisation and recycling, substitution or reduction of use of toxic substances, or strategies on biodiversity.

7. Provide adequate education and training to workers in environmental health and safety matters, including the handling of hazardous materials and the prevention of environmental accidents, as well as more general environmental management areas, such as environmental impact assessment procedures, public relations, and environmental technologies.
8. Contribute to the development of environmentally meaningful and economically efficient public policy, for example, by means of partnerships or initiatives that will enhance environmental awareness and protection.

VI. Combating Bribery, Bribe Solicitation and Extortion

When dealing with consumers, enterprises should act in accordance with fair business, marketing and advertising practices and should take all reasonable steps to ensure the quality and reliability of the goods and services that they provide. In particular, they should:

1. Ensure that the goods and services they provide meet all agreed or legally required standards for consumer health and safety, including those pertaining to health warnings and safety information.
2. Provide accurate, verifiable and clear information that is sufficient to enable consumers to make informed decisions, including information on the prices and, where appropriate, content, safe use, environmental attributes, maintenance, storage and disposal of goods and services. Where feasible this information should be provided in a manner that facilitates consumers' ability to compare products.
3. Provide consumers with access to fair, easy to use, timely and effective non-judicial dispute resolution and redress mechanisms, without unnecessary cost or burden.
4. Not make representations or omissions, nor engage in any other practices, that are deceptive, misleading, fraudulent or unfair.
5. Support efforts to promote consumer education in areas that relate to their business activities, with the aim of, inter alia, improving the ability of consumers to: i) make informed decisions involving complex goods, services and markets, ii) better

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understand the economic, environmental and social impact of their decisions and iii) support sustainable consumption.

6. Respect consumer privacy and take reasonable measures to ensure the security of personal data that they collect, store, process or disseminate.
7. Co-operate fully with public authorities to prevent and combat deceptive marketing practices (including misleading advertising and commercial fraud) and to diminish or prevent serious threats to public health and safety or to the environment deriving from the consumption, use or disposal of their goods and services.
8. Take into consideration, in applying the above principles, i) the needs of vulnerable and disadvantaged consumers and ii) the specific challenges that e-commerce may pose for consumers.

VII. Consumer Interests

When dealing with consumers, enterprises should act in accordance with fair business, marketing and advertising practices and should take all reasonable steps to ensure the quality and reliability of the goods and services that they provide. In particular, they should:

1. Ensure that the goods and services they provide meet all agreed or legally required standards for consumer health and safety, including those pertaining to health warnings and safety information.
2. Provide accurate, verifiable and clear information that is sufficient to enable consumers to make informed decisions, including information on the prices and, where appropriate, content, safe use, environmental attributes, maintenance, storage and disposal of goods and services. Where feasible this information should be provided in a manner that facilitates consumers' ability to compare products.
3. Provide consumers with access to fair, easy to use, timely and effective non-judicial dispute resolution and redress mechanisms, without unnecessary cost or burden.
4. Not make representations or omissions, nor engage in any other practices, that are deceptive, misleading, fraudulent or unfair.
5. Support efforts to promote consumer education in areas that relate to their business activities, with the aim of, inter alia, improving the ability of consumers to: i) make informed decisions involving complex goods, services and markets ii) better

understand the economic, environmental and social impact of their decisions and iii) support sustainable consumption.

6. Respect consumer privacy and take reasonable measures to ensure the security of personal data that they collect, store, process or disseminate.
7. Co-operate fully with public authorities to prevent and combat deceptive marketing practices (including misleading advertising and commercial Fraud) and to diminish or prevent serious threats to public health and safety or to the environment deriving from the consumption, use or disposal of their goods and services.
8. Take into consideration, in applying the above principles, i) the needs of vulnerable and disadvantaged consumers and ii) the specific challenges that e-commerce may pose for consumers.

VIII. Science and Technology

Enterprises should:

1. Endeavour to ensure that their activities are compatible with the science and technology (S&T) policies and plans of the countries in which they operate and as appropriate contribute to the development of local and national innovative capacity.
2. Adopt, where practicable in the course of their business activities, practices that permit the transfer and rapid diffusion of technologies and know-how, with due regard to the protection of intellectual property rights.
3. When appropriate, perform science and technology development work in host countries to address local market needs, as well as employ host country personnel in an S&T capacity and encourage their training, taking into account commercial needs.
4. When granting licenses for the use of intellectual property rights or when otherwise transferring technology, do so on reasonable terms and conditions and in a manner that contributes to the long term sustainable development prospects of the host country.
5. Where relevant to commercial objectives, develop ties with local universities, public research institutions, and participate in co-operative research projects with local industry or industry associations.

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IX. Competition

Enterprises should:

1. Carry out their activities in a manner consistent with all applicable competition laws and regulations, taking into account the competition laws of all jurisdictions in which the activities may have anticompetitive effects.
2. Refrain from entering into or carrying out anti-competitive agreements among competitors, including agreements to:
   (a) fix prices;
   (b) make rigged bids (collusive tenders);
   (c) establish output restrictions or quotas; or
   (d) share or divide markets by allocating customers, suppliers, territories or lines of commerce.
3. Co-operate with investigating competition authorities by, among other things and subject to applicable law and appropriate safeguards, providing responses as promptly and completely as practicable to requests for information, and considering the use of available instruments, such as waivers of confidentiality where appropriate, to promote effective and efficient co-operation among investigating authorities.
4. Regularly promote employee awareness of the importance of compliance with all applicable competition laws and regulations, and, in particular, train senior management of the enterprise in relation to competition issues.

X. Taxation

1. It is important that enterprises contribute to the public finances of host countries by making timely payment of their tax liabilities. In particular, enterprises should comply with both the letter and spirit of the tax laws and regulations of the countries in which they operate. Complying with the spirit of the law means discerning and following the intention of the legislature. It does not require an enterprise to make payment in excess of the amount legally required pursuant to such an interpretation. Tax compliance includes such measures as providing to the relevant authorities timely information that is relevant or required by law for purposes of the correct determination of taxes to be assessed in connection with their operations and conforming transfer pricing practices to the arm’s length principle.

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2. Enterprises should treat tax governance and tax compliance as important elements of their oversight and broader risk management systems. In particular, corporate boards should adopt tax risk management strategies to ensure that the financial, regulatory and reputational risks associated with taxation are fully identified and evaluated.

Appendix 2
Reputation Risk Management

1.2.2 Reputation plays a key role in determining whether an AI has a sustainable future for its business. Where an authorised institution (AI) has established a good reputation, it helps strengthen the trust and confidence of the AI's major stakeholders, which serves to bolster its safety and soundness, competitiveness and business value. A good reputation may also increase the AI's chance of overcoming a market crisis when it occurs. If, however, an AI's reputation has been badly damaged, thereby undermining public confidence in the AI, its business prospects and survival could be at stake. Managing reputation risk (or, more precisely, those risks affecting reputation) and dealing with its underlying problems and effects therefore warrant AIs' special attention and priority. (Broadly speaking, stakeholders may include an AI's shareholders, investors, employees, customers, counterparties, business partners, service providers and other interested parties such as governments, regulators, rating agencies, analysts, non-governmental organisations, pressure groups, the media and those communities in which the AI operates.)

1.2.3 Typically, reputation could be damaged by an AI's failure to properly manage the risks it faces (such as credit, strategic, operational or other material risks) as well as some external factors that are beyond its control (e.g. market rumours). Such damage may lead to serious consequences with immediate or long-term implications. For example, if the source of reputation risk is from staff fraud resulting in substantial losses, the potential consequences may involve criminal/regulatory investigations, falling share price, ratings downgrade, loss of business, depletion of earnings and capital, or liquidity problems.

1.2.4 Reputation risk management is essentially concerned with protecting an AI from potential threats to its reputation (e.g. by dealing with those threats proactively) and, should there be a reputation event, minimising the effects of such an event. The ultimate aim is to avert the likelihood of any crisis. Nevertheless, managing reputation risk poses particular challenges for AIs.

1.2.5 Reputation, being largely based on people's perception and expectations, is intangible in nature and thus cannot be easily analysed or quantified. A lot of persistent effort is required to maintain reputation. While a good reputation may take many years to build up, it can be tarnished instantly by, for example, some tactless

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remarks from a director or an operational blunder committed by a few employees. Indeed, reputation is subject to a whole host of risk drivers, and anyone within an AI may potentially affect its reputation.

1.2.6 Moreover, it is worth noting that an AI's reputation depends not only on winning the trust and confidence of the AI's shareholders and customers, but also on procuring the support of other major stakeholders who can influence its ability to run a successful business. Thus, a key responsibility of the AI is to identify its major stakeholder groups for the purposes of managing reputation risk and consider how their needs and expectations can be satisfied.

1.2.7 Respect for, and commitment to, high standards of business conduct and integrity, among other things, are fundamental to maintaining a sustainable reputation. Any breach of or compromise on ethical standards and rules of conduct (e.g. engaging in improper selling practices) runs the risk of impairing stakeholder confidence and may have serious business and regulatory consequences. Reputation can also be damaged by association, even unknowingly, with unethical or corrupt customers (e.g. those engaging in money laundering or bribery activities).

1.2.8 AIs should be aware of increasing expectations from the public for them to take up social responsibilities and operate in an environmentally responsible manner. These include, for example, taking care of the special needs of the elderly or handicapped customers when formulating business strategies and adopting green policies to reduce wastage and pollution. Corporate social responsibility has thus become an issue that may have an impact on reputation as well.

1.2.9 Despite the various challenges mentioned above, there is growing recognition that managing reputation is crucial for business success and sustainability. It is therefore in AIs' interests to actively manage reputation risk, which includes identifying and assessing threats to their reputation and exploring opportunities for enhancing it. This module contains relevant guidance that AIs could adopt in their risk management processes.

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Appendix 3
Key drivers of reputation

B1 Introduction

B1.1 This Annex provides AIs with more information about the key drivers of reputation mentioned in subsection 3.2. In particular, it analyses how each of these drivers may affect reputation risk and highlights some considerations for managing their effects on reputation.

B2 Corporate governance

B2.1 Good corporate governance is vital to an AI's reputation. This is because the leadership of the Board and senior management and their capability to run the business and manage risks will directly affect stakeholders' perception of the AI. Reputation can be impaired if, for example, the AI lacks a clear vision for the future, its leadership is seen to be poor and incompetent, or a number of governance issues have hampered effective functioning of the AI.

B3 Management integrity

B3.1 Management integrity has been the cause of some bank scandals in the past. As the personal ethics and behaviour of an AI's directors and senior management (e.g. the Chief Executive and key managers) are important determinants of stakeholder confidence, the probity and conduct of such persons will always be under close scrutiny by its stakeholders.

B4 Staff competence/support

B4.1 Staff competence and support is essential for business success. Given that human capital is an important asset, AIs' ability to harness it to meet their business objectives will enhance reputation. This will depend, for example, on whether they can recruit, develop and retain high quality staff; and motivate staff and satisfy their needs (e.g. by providing appropriate remuneration and incentive schemes, a healthy and safe working environment, etc.).

B4.2 Deficiencies in employment and staff management practices, however, could lead to various problems, including high staff turnover, insufficient staffing, poor service quality, staff incompetence/misconduct, customer complaints and employee disputes. Some of these problems may result in damaging headlines and adverse publicity.

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B5 Corporate culture

B5.1 If an AI's corporate culture is seen to inadequately support the achievement of its business objectives and effective risk management, it may arouse stakeholder concerns and result in a loss of confidence.

B5.2 It is therefore crucial for AIs to promote a corporate culture where the adoption of ethical and responsible behaviour that can protect and enhance their reputation is encouraged; compliance issues or lax control standards are not tolerated; and there is an established mechanism for employees to voice concerns if they are aware of any potential threats to reputation (e.g. business malpractices, suspicion of fraud, etc.).

B6 Risk management and control environment

B6.1 A sound risk management and control environment is essential for AIs to safeguard their assets and capital, and to mitigate reputation risk. Although there is no guarantee that the institution of adequate risk management and controls will always prevent fraud and abuse, such acts will be able to be perpetrated more easily if the overall risk management and control environment is weak. AIs should seek independent assurance that existing risk management and control systems are running properly (e.g. through internal audits) and be vigilant for, and take necessary actions to counter, any deterioration in risk management and control standards.

B7 Financial soundness/business viability

B7.1 An AI's reputation is likely to suffer if its financial soundness or business viability is called into question. For example, substantial losses resulting from an AI's unsuccessful investments or business operations may spark immediate concerns from stakeholders (in particular, shareholders, investors, or analysts) about whether the AI is still a safe investment or of long term business value. Such concerns may spread quickly to other aspects of reputation (e.g. management competence) as well.

B7.2 To safeguard and bolster reputation, AIs should build up stakeholders' trust in their financial reporting systems (e.g. that their financial exposures are fairly represented, and be able to manage stakeholders' expectations by providing relevant factual information to facilitate their assessment of AIs' financial performance (e.g. explaining any problems promptly, with timely actions to rectify them) and future prospects (e.g. outlining future

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business plans and sources of growth).

B8 Business practices

B8.1 AIs are required to run their businesses in a responsible, honest and prudent manner. Business practices which deviate from this basic standard could erode stakeholder confidence and irreparably damage their reputation, and any resultant breach of laws and regulations (e.g. adopting improper selling practices, engaging in unauthorised activities, etc.) may lead to investigations, disciplinary actions and criminal charges. In dealing with customers and other counterparties, AIs should be guided by, and closely adhere to, all relevant ethical standards and codes of conduct.

B8.2 AIs' reputation will also be influenced by their willingness and ability to honour their own obligations and commitments, whether contractual or otherwise. In this regard, AIs should be particularly alert to situations in which they might have entered into arrangements that carry reputation risk (e.g. by taking on moral obligations to support those arrangements in case of need). A typical example of such arrangements is bank-sponsored structured investment vehicles ('SIVs') in which the sponsoring bank may feel compelled on reputation grounds to come to the rescue of a troubled SIV.

B8.3 Increasingly, AIs should be aware of the possible impact on their reputation of other social and environmental responsibilities expected of them by such stakeholders as customers and pressure groups. For example, AIs may be expected to implement environmentally friendly policies (e.g. green policies or energy saving programmes) and provide for customers with special needs (e.g. handicapped or visually impaired customers).

B9 Customer satisfaction

B9.1 AIs' ability to satisfy customer needs and expectations on a continuing basis is of paramount importance in sustaining their business in a highly competitive banking environment. Failure to do so, as illustrated by the following examples, may result in loss of customer confidence, falling business, adverse publicity or, in some cases, legal sanctions:

- Unfair treatment of customers—customers may have been overcharged or inaccurately billed, or have suffered losses due to

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an AI's errors or omissions (e.g. customer instructions not properly executed) without obtaining fair compensation;

- Mishandling of customer information—customers' confidential information may have been inadvertently destroyed, lost or exposed to third parties, thereby breaching AIs' confidentiality obligations and privacy rules relating to personal data
- Unreliable/inefficient banking services—frequent system outages, significant operational errors and oversights, and inefficient processing systems will weaken customer confidence in an AI's capacity to deliver quality services. Lack of new/innovative products and services to suit changing customer needs may also arouse discontent;
- Mishandling of customer complaints—customers expect AIs to be responsive to their concerns. A poor complaint-handling system runs the risk of damaging customer goodwill and overlooking early indicators of potential threats to reputation; and
- Business malpractices—customer confidence will be greatly impaired if AIs are found to have engaged in improper or illegal business practices (as mentioned above).

B10 Legal/regulatory compliance

B10.1 Breaking the law or contravening any relevant regulatory standards and guidelines (either deliberately or inadvertently) can lead to serious consequences, including regulatory investigations, costly and high profile litigation, public censure, civil and criminal sanctions, harmful publicity, claims for damages, or even the loss of authorisation. There may be significant damage to an AI's reputation even if the AI is ultimately acquitted of any illegal conduct.

B10.2 AIs should therefore adequately appraise legal and regulatory risks, and put in place robust systems to ensure compliance, including enhancing staff awareness of compliance issues and identifying areas of potential threat and vulnerability.

B11 Contagion risk/rumours

B11.1 AIs operating as part of a group (comprising banking or non-banking entities) will be susceptible to reputation events affecting their parent,

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non-bank holding company, or other members of the group (e.g. sister companies, subsidiaries and affiliates). For example, an AI's reputation may be damaged by regulatory sanctions against its parent bank for, say, breach of anti-money laundering regulations or by publicised concerns about the parent bank's safety and soundness (e.g. due to substantial trading losses).

B11.2 Such contagion effects on AIs' reputation may also result from other problematic relationships, such as any close association (whether knowingly or unknowingly) with major customers, counterparties or service providers that are revealed to be engaged in unethical, unlawful or corrupt activities.

B11.3 Rumours, even though unfounded, about an AI (or parties closely associated with the AI) may have a damaging impact on the AI's reputation and the level of public confidence in the AI if no quick, decisive actions are taken to quell the rumours. Therefore, AIs should always be on the alert to the spreading of rumours and the effects of rumours, which could be exacerbated by such factors as the general weakening of public sentiment due to unfavourable or worsening market conditions or the instigation of adverse news reports on particular AIs. It should also be noted that rumours about an AI may spread more easily if market perception is that the AI is weak.

B11.4 Adequate contingency procedures should be developed to deal with the above situations.

B12 Crisis management

B12.1 An AI's inadequate response to a crisis, or even a minor incident, that attracts media attention could arouse stakeholder concerns about management competence, thereby jeopardising the AI's reputation. On the other hand, effective crisis management arrangements (including communications with stakeholders and the media) could quickly allay stakeholder fears, restore their confidence and even enhance reputation.

B12.2 AIs should therefore ensure that they are ready to deal with possible crises (which may be unprecedented and totally unexpected), with detailed and well-rehearsed crisis management plans in place. Close attention should also be paid to managing media communications (e.g. making sure AIs are accessible and available for comment during a

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crisis).

B13 Transparency/accountability

B13.1 AIs' ability to be responsive to and satisfy stakeholders' information needs (e.g. by disclosing information in respect of material issues of interest to stakeholders in a transparent, honest and prompt manner) has itself become a key determinant of business competence. Such information will help stakeholders in understanding AIs' values, strategies, performance and future prospects.

B13.2 Stakeholder confidence, as well as AIs' credibility and reputation, will however be weakened if information disclosed is found to be misleading, inaccurate or incomplete. As such, there should be adequate accountability for the integrity of information disclosures, which should be backed by robust management monitoring and reporting systems.

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Appendix 4
CSR guidelines for banks in China issued by the China Banking Association in January 2009

Chapter I General Provisions

- Article 1: For the purpose of urging banking institutions to implement the scientific view of development and undertake their corporate social responsibilities and enhancing the harmonious and sustainable development of economy, society and environment, these Guidelines are formulated according to the Company Law of the People's Republic of China, the Law of the People's Republic of China on Commercial Banks, the Banking Supervision Law of the People's Republic of China, the Bylaws of China Banking Association and other relevant laws and regulations.
- Article 2: These Guidelines shall apply to the banking institutions which have the corporate status in China, including commercial banks, urban credit cooperatives, rural credit cooperatives and other financial institutions that are legally established within the territory of the People's Republic of China and absorb public deposits, policy banks, financial assets management companies, petty loan companies, etc.
- Article 3: For the purpose of these Guidelines, the term 'corporate social responsibility' refers to the economic, legal, ethical and charitable responsibilities that the banking institutions shall bear to their shareholders, employees, consumers, business partners, government, communities and other interested parties and for enhancing the sustain- able development of society and environment. The corporate social responsibility of banking institutions shall at least include:
  - economic responsibility, which requires them to maintain a fair, safe and stable competition order in the banking sector and use high-quality professional operations to continually create economic values for the country, shareholders, employees, customers and the general public, conditioned upon abiding by the law;
  - social responsibility, which requires them to follow the business operation notions meeting the requirements of social ethics and public welfare, actively protect the public interests of consumers, employees and community members, advocate charitable responsibility, actively dedicate themselves to activities for the public good, build up social harmony and promote social development; and

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  - environmental responsibility, which requires them to support the industrial policies and environmental protection policies of the state, save resources, protect and recover the ecological environment and support the sustainable development of the society.

- Article 4: Banking institutions shall abide by laws, regulations and company bylaws, observe social morality and business ethics, and strengthen their corporate social responsibility management.
- Article 5: Banking institutions shall have correct notions of value and business operation, create a corporate culture with a sense of social responsibility, advocate ethical business operations, make contributions to the building of a harmonious society and enhance the sustainable development of the society.

Chapter II Economic Responsibility

- Article 6: Banking institutions shall actively improve their operational effectiveness according to law, endeavour to realise good economic benefits, actively get involved in ensuring the financial safety and protecting a financial order that advocates equal competition, strengthen the prevention of financial risks, actively support the economic policies of the government, enhance the stable and sustainable development of the economy, and provide quality professional services for the national economy.
- Article 7: Banking institutions shall strengthen their regulatory compliance management, standardise their business operations, abide by such industrial rules as the code of conduct for practitioners in the banking sector, the anti-unfair competition convention and the anti-commercial bribery convention, engage in fair competition, maintain a good competition order in the banking market, and enhance the healthy development of the banking sector.
- Article 8: Banking institutions shall improve their corporate governance structure, operate business safely and steadily, strictly control affiliated transactions, fulfil the obligation of information disclosure, ensure the rights and interests of their shareholders, small and medium ones particularly, as vested by laws, regulations and company bylaws, and create value for shareholders.
- Article 9: Banking institutions shall follow the principles of distribution according to work and equal pay for equal work, set up a reasonable incentive and restraint

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mechanism, protect the rights and interests of employees, promote the development of employees in various aspects, and create values for them.

- Article 10: Banking institutions shall attach great importance to protecting the rights and interests of consumers, make effective risk alert, disclose information appropriately, treat consumers equally, strengthen the management of customer complaints, improve the customer information confidentiality system, improve the service quality, and create value for customers.

Chapter III Social Responsibility

- Article 11: Banking institutions shall undertake the responsibility for educating consumers, hold educational activities to popularise financial knowledge, guide and cultivate the financial awareness and risk awareness of the general public, and make contributions to increasing the property income of the general public.
- Article 12: Banking institutions shall voluntarily undertake the responsibility for building the credit system, give publicity to good faith, guide and cultivate the credit awareness of the general public, endeavour to promote the coordination and cooperation with other sectors, strengthen the integration and sharing of the credit information of the banking sector, and steadily push forward the building of the credit system in the banking sector of China.
- Article 13: Banking institutions shall advocate the philosophy of 'people first', attach importance to the health and security of their employees, care about their employees' livelihood, improve the human resource management, strengthen the training of employees, improve the professional quality of employees, raise the professional value of employees, inspire employees to be more enthusiastic, active and creative, foster financial talent, and create a positive and harmonious occupational environment which develops soundly.
- Article 14: Banking institutions shall support the economic development of communities, provide convenient financial services for communities, actively conduct various communal service activities which are rich in content such as publicity of financial knowledge, poverty relief and assistance to people in hardship, and endeavour to make contributions to the development of communities.
- Article 15: Banking institutions shall be concerned with the social development, set mind on charity, donation and volunteer events, actively devote themselves to

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activities for the public good, and by making use of the financial leverage, endeavour to build up social harmony and boost social advancement.

Chapter IV Environmental Responsibility

- Article 16: Banking institutions shall make business strategies, policies and operating rules, optimise the allocation of resources and give support to the sustainable development of the society, economy and environment, according to the requirements of the industrial policies and environmental protection policies of the state and by referring to the international treaties, international practices and industrial guidelines.
- Article 17: Banking institutions shall make relevant research on the Equator Principles as much as possible and actively refer to and borrow the relevant content suitable for the economic and financial development of China.
- Article 18: Banking institutions shall form a special institution or appoint a relevant department to take charge of the environmental protection issues, and allocate necessary full-time and part-time staff for that purpose.
- Article 19: Banking institutions shall make plans on saving resources and protecting environment, minimise their daily operations' adverse impact on the environment, provide environmental protection training for their employees on a regular or irregular basis, and encourage their employees to participate in the external training, exchange and cooperation on environmental protection.
- Article 20: Banking institutions shall use credit and other financial instruments to encourage their customers to save resources and protect the environment, direct and encourage customers to increase their awareness of social responsibility and act on it, and attach great importance to providing customers with environmental protection training which includes, but is not limited to, the specific operation procedure for environmental impact assessment and the preparation of green credit documents. They shall advocate the practice of making independent field investigations and examinations of the environmental impact of financing projects, rather than making decisions merely based on the environmental impact assessment reports and other materials provided by customers.
- Article 21: Banking institutions shall actively and voluntarily participate in the environmental protection practice and publicity to make their contributions to

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increasing the environmental protection awareness of customers and the whole country.

Chapter V Corporate Social Responsibility Management

- Article 22: Banking institutions shall deepen their understanding of ethical business operation, integrate the social responsibility into their development strategies, governance structure, corporate culture and operation flow, set up corresponding decision- making and execution institutions in organisational structure, and establish a long-term effect mechanism for fulfilling the social responsibility with the support from strategy, organisational structure and operation flow.
- Article 23: Banking institutions shall strengthen the systemisation of corporate social responsibility management, establish a flow management system including such stages as making plans, effecting plans, follow-up checks, ending evaluation and releasing reports, improve their ethical decision-making capability, and do their best to realise the organic combination of their fulfilment of corporate social responsibility and their daily business operation so as to ensure that their fulfilment of corporate social responsibility develops in a circulative and benign way.
- Article 24: Banking institutions shall set up a proper internal and external evaluation mechanism to regularly evaluate their fulfilment of corporate social responsibility, including the impact of such core businesses as credit on the society and environment, and combine such evaluation with the improvement of internal management so as to improve their business management performance.
- Article 25: Banking institutions shall actively establish a corporate social responsibility disclosure system, submit a corporate social responsibility report of the last year before the end of June each year as a general principle, encourage the application of the third-party independent verification of the fulfilment of social responsibility, fortify the nationwide coordinated social responsibility evaluation system for the banking sector, and disclose information about their fulfilment of corporate social responsibility through such channels as newspapers, periodicals and websites.

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Chapter 3

REGULATORY FRAMEWORK AND REGULATORY REQUIREMENTS

Learning outcomes:

Upon completion of this chapter, learners will be able to:

- Explain the regulatory framework for the financial services industry.
- List the important laws, regulations and guidelines with which banks should comply
  - Guidelines on 'Know Your Customer'
  - Anti-money laundering legislation
  - Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission
  - Market misconduct under the Securities and Futures Ordinance
  - Treat Customers Fairly Charter
  - Personal Data (Privacy) Ordinance
  - Anti-discrimination legislation
  - Prevention of Bribery Ordinance

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Chapter 3 Terminology

AEOI	Automatic Exchange of Information
AI	Authorised institutions
AML	Anti-Money Laundering
AMLO	Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance
CDD	Customer due diligence
CFT	Counter-Financing of Terrorism
DTROP	Drug Trafficking (Recovery of Proceeds) Ordinance
ECF	Enhanced competency framework
Guoyuan	Guoyuan Securities Brokerage (Hong Kong) Limited
HBMX	Hongkong and Shanghai Banking Corporation Limited Mexico
HKMA	Hong Kong Monetary Authority
HKSAR	Hong Kong Special Administrative Region
HSBC	Hongkong and Shanghai Banking Corporation Limited
FATF	Financial Action Task Force
FCA	Britain's Financial Conduct Authority
FFI	Foreign financial institution
FI	Financial Institutions
IA	Insurance authority
IEC	Investor Education Centre
IGA	Intergovernmental Agreements
IRS	U.S. Internal Revenue Service
JFIU	Joint Financial Intelligence Unit
ML/TF risks	Money laundering (ML) or terrorist financing (TF) risk
ML transactions	Money laundering transactions
MPFA	Mandatory Provident Fund Schemes Authority
MPFSO	Mandatory Provident Fund Schemes Ordinance
OSCO	Organized and Serious Crimes Ordinance
PEP	Politically Exposed Persons
SDD	Simplified customer due diligence
SFC	Securities and Futures Commission
STR	Suspicious transaction report
UNATMO	United Nations (Anti-Terrorism Measures) Ordinance
UNSCR	United Nations Security Council Resolution

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1. Regulatory Framework

1.1 Introduction

Article 109 of the Basic Law of the Hong Kong Special Administrative Region states that, "the Government of the HKSAR shall provide an appropriate economic and legal environment for the maintenance of the status of Hong Kong as an international financial centre."

As an international financial centre, a sound regulatory framework is important not only in safeguarding the interests of investors and enterprises and promoting their confidence in the market; but also in maintaining the financial stability of Hong Kong.

The principal governmental official overseeing Hong Kong's financial markets is the Financial Secretary. His primary role is to assist the Chief Executive in overseeing policy formulation and implementation in relation to financial, monetary, economic and trade matters. Under the Financial Secretary is the Financial Services and the Treasury Bureau which formulates policies and legislation relating to the financial services industry and it works closely with financial regulators and the market.

In Hong Kong, different financial services industries are regulated by different market regulators. The four main financial regulators are the Hong Kong Monetary Authority (HKMA), the Securities and Futures Commission (SFC), the Insurance Authority (IA) and the Mandatory Provident Fund Schemes Authority (MPFA) which respectively oversees the banking industry, the securities and futures industry, the insurance industry, and mandatory provident fund and occupation retirement schemes. The industries are regulated by ordinances, subsidiary legislation, rules, codes and guidelines which are enforced by their respective regulators. Through the concerted efforts of government and these regulators in supervising and regulating the market, financial regulation in Hong Kong is maintained at international standards and, as a result, the role of Hong Kong as an important financial centre is preserved.

The Competition Commission has been recently set up as the principal competition authority in Hong Kong with aims, among others, to investigate conduct that may contravene the competition rules and enforce the provisions of the Competition Ordinance;

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to promote public understanding of the value of competition; and to promote the adoption of appropriate internal controls and risk management systems by companies in Hong Kong.

1.2 The Hong Kong Monetary Authority (HKMA)

The Hong Kong Monetary Authority (HKMA) was established in 1993. It is a government authority reporting to the Financial Secretary. Its role is mainly governed by the Exchange Fund Ordinance and the Banking Ordinance and its overall responsibility is to maintain monetary and banking stability in Hong Kong.

In relation to monetary stability, the principal function of the HKMA is to manage the Exchange Fund and to maintain currency stability within the framework of the Linked Exchange Rate System. Section 5A of the Exchange Fund Ordinance states that the Financial Secretary shall appoint a person to be the Monetary Authority and the Monetary Authority shall:

(a) assist the Financial Secretary in the performance of his functions under the Exchange Fund Ordinance;
(b) perform such functions as the Financial Secretary may direct; and
(c) perform functions imposed on or assigned to the Monetary Authority by any Ordinance other than the Exchange Fund Ordinance.

In relation to maintaining stability in the financial system, the HKMA's other functions are to promote the integrity and stability of the financial system in Hong Kong and to help maintain Hong Kong as an international financial centre. In particular, section 7(1) of the Banking Ordinance provides that the principal function of the Monetary Authority is to promote the general stability and effective working of the banking system. This can be achieved through authorisation of licensed banks, restricted licence banks and deposit-taking companies in Hong Kong, and regulating and supervising the banking business and the business of taking deposits in Hong Kong. Examples of the HKMA's recent regulatory and supervisory work include, among others, the following:

- enhancing the risk governance framework and credit and liquidity risk management systems of authorised institutions;
- issuing alerts and circulars to authorised institutions in relation to minimising operational and technological risks of these institutions to cyber threats;

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- undertaking on-site examinations and desk-based reviews of authorised institutions to ensure their compliance with the HKMA's policies and guidelines in the prevention of money laundering and terrorist financing;
- supervising authorised institutions' selling practices for investment and insurance products for better customer protection;
- laying down policies for local implementation of international supervisory and accounting standards, including the net Stable Funding Ratio, large exposure limits, International Financial Reporting Standard 9, and the resolution framework after the enactment of the Financial Institutions (Resolution) Ordinance.

1.3 The Securities and Futures Commission (SFC)

The Securities and Futures Commission (SFC) was established in 1989 under the Securities and Futures Ordinance and is an independent statutory body. It regulates Hong Kong's securities and futures industry.

Section 4 of the Securities and Futures Ordinance states the regulatory objectives of the SFC:

(a) to maintain and promote the fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry;

(b) to promote understanding by the public of financial services including the operation and functioning of the securities and futures industry;

(c) to provide protection for members of the public investing in or holding financial products;

(d) to minimise crime and misconduct in the securities and futures industry;

(e) to reduce systemic risks in the securities and futures industry; and

(f) to assist the Financial Secretary in maintaining the financial stability of Hong Kong by taking appropriate steps in relation to the securities and futures industry.

As a subsidiary of the SFC, the Investor and Financial Education Council (IFEC) was established in 2012 to take the lead in improving financial literacy in Hong Kong. It is supported by the Education Bureau and all four financial regulators. The IEC aims at improving the financial skills and knowledge of the public, and supports the development of more responsible financial habits, behaviours and decision making. The Chin Family

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website, set up in 2016, provides the public "with comprehensive, credible and impartial financial information, tools and education resources".[1]

1.4 The Insurance Authority (IA)

The new Insurance Authority (IA) was established in 2015 under the Insurance Companies (Amendment) Ordinance 2015. It is a statutory body independent of the government and its principal function is to regulate and supervise the insurance industry for the promotion of the general stability of the insurance industry and for the protection of existing and potential policy holders (section 4A(1) Insurance Ordinance).

More specifically the functions of the independent Insurance Authority, set out in section 4A(2) of the Insurance Ordinance, are as follows:

(a) To be responsible for supervising an insurer's and an insurance intermediary's compliance with the provisions of the Insurance Companies Ordinance;
(b) To consider and propose reforms of the law relating to the insurance business;
(c) To promote and encourage proper standards of conduct and sound and prudent business practices amongst insurers;
(d) To promote and encourage proper standards of conduct of insurance intermediaries and, where necessary, review and revise the regulatory system for the same;
(e) To promote and develop self-regulation by the market and professional bodies of the insurance industry;
(f) To regulate the conduct of insurance intermediaries through a licensing regime;
(g) To promote the understanding by policy holders and potential policy holders of insurance products and the insurance industry;
(h) To formulate effective regulatory strategies and facilitate the sustainable market development of the insurance industry, and promote the competitiveness of the insurance industry in the global insurance market;
(i) To conduct studies into matters affecting the insurance industry;
(j) To assist the Financial Secretary in maintaining the financial stability of Hong Kong by taking appropriate measures in relation to the insurance industry;

[1] IEC, About the IEC, Available at https://www.thechinfamily.hk/web/iec/en/about-iec.html

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(k) To co-operate with and assist the financial services supervisory authorities of Hong Kong or of any place outside Hong Kong, whenever appropriate; and

(l) To perform functions imposed or conferred on the Insurance Authority by the Insurance Ordinance or any other Ordinance.

1.5 The Mandatory Provident Fund Schemes Authority (MPFA)

The Mandatory Provident Fund Schemes Authority (MPFA) was established in 1998 under the Mandatory Provident Fund Schemes Ordinance (MPFSO). It is also a statutory body.

The functions of the MPFA, set out in section 6E of the MPFSO, are as follows:

(a) to be responsible for ensuring compliance with the MPFSO;

(b) to register provident fund schemes as registered schemes;

(c) to approve qualified persons to be approved trustees of registered schemes;

(d) to regulate the affairs and activities of approved trustees and to ensure as far as reasonably practicable that those trustees administer the registered schemes for which they are responsible in a prudent manner;

  (i) to regulate sales and marketing activities, and the giving of advice, in relation to registered schemes;

(e) to make rules or guidelines for the payment of mandatory contributions and for the administration of registered schemes with respect to those contributions;

  (i) to consider and propose reforms of the law relating to occupational retirement schemes or provident fund schemes;

  (ii) to promote and encourage the development of the retirement scheme industry in Hong Kong, including the adoption of a high standard of conduct and sound prudent business practices by trustees and other service providers;

(f) to exercise such other functions as are conferred or imposed on the Authority by or under the MPFSO or any other Ordinance.

The MPFA is also the Registrar of occupational retirement schemes.

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2. Regulatory Requirements

2.1 Customer Due Diligence

The HKMA requires banking institutions to conduct customer due diligence (CDD) to ensure proper implementation of controls to prevent money laundering and terrorist financing.

Banks are required to take reasonable CDD measures to identify the customer's identity at the time of account opening and on an on-going basis:

- verify the identity of the customer by obtaining reliable and genuine source documents;
- ensure the purpose and intended nature of the business relationship;
- complete the CDD process before the establishment of a business relationship (i.e. account opening) or a specified occasional transaction with a customer who does not have an ongoing business relationship with the bank (e.g. a remittance or fund transfer) where the value of the transaction exceeds the applicable threshold;
- assess the risk level of the customer;
- keep up-to-date customer information;
- maintain a proper system to detect abnormal transactions.

With the onset of the AMLO, banks have enhanced their policies, procedures and systems, reviewed compliance deficiency and controls, and strengthened staff training on AML & CFT.

The HKMA has provided guidance to banks to conduct CDD on all customers using a risk-based approach with more frequent reviews and stringent measures implemented on high risk customers. It is recommended that high risk customers are subject to a minimum of an annual (or more frequent if deemed necessary by the bank) review of their customer profile to ensure the CDD information retained remains up-to-date and relevant[2].

[2] "Guideline on Anti-Money Laundering and Counter-Terrorist Financing (For Authorized Institutions)", Revised March 2015, HKMA, Paragraph 4.7.13. Retrieved on 6 September 2017 from http://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/guideline/g33.pdf

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Those high risk customers include:

- Politically Exposed Persons ('PEP'), i.e. senior government officials and political figures.
- Corporate customers with capital in the form of 'bearer shares' are also considered as having higher ML/TF risks since the corporation is wholly owned by whoever holds the physical stock certificate and ownership is never recorded. To eliminate AML and CFT risks, banks are required to take stringent measures to establish the identities of holders and beneficial owners of bearer shares. With the coming into force of AMLO, many banks have taken measures to conduct such verification on pre-existing 'bearer share' accounts[3]. Failure to pass the CDD has led to closure of these accounts.
- Persons from or in jurisdictions that do not or insufficiently apply the Financial Action Task Force (FATF) recommendations or otherwise posing higher ML/TF risks.

A simplified CDD ('SDD') can be conducted for customers with comparatively lower risks such as corporations listed on Stock Exchanges, Financial Institutions (FI) as defined in the AMLO, an institution that carries on a business similar to that carried on by an FI, or the Government or any public body in Hong Kong, etc. For more details, please refer to section 4.10.3 of the HKMA Guideline on AML and CFT.

2.2 Laws & regulations applicable to financial services

Financial institutions, such as banks, securities firms and insurance companies, must comply with various laws and regulations in the provision of financial and banking services. These laws may differ across the various countries in which a multinational organisation operates.

In this section, we will examine the different types of laws and regulations with specific emphasis on banking institutions in Hong Kong.

Anti-money Laundering and Counter Terrorist Financing

In Hong Kong, legislation on AML and CFT includes the following:

[3] Pre-existing 'bearer shares' accounts refer to business relationships established prior to the AMLO coming into effect on 1 Apr 2012.

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- Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance (AMLO);
- Drug Trafficking (Recovery of Proceeds) Ordinance (DTROP);
- Organized and Serious Crimes Ordinance (OSCO); and
- United Nations (Anti-Terrorism Measures) Ordinance (UNATMO).

Following the 9/11 terrorist attacks, the AML requirements and obligations were reviewed to introduce more effective tools and control measures in Hong Kong to combat money laundering and terrorist financing.

The "AMLO" codifies pre-existing regulatory requirements on financial institutions regarding customer due diligence and record keeping.

The DTROP, OSCO and UNATMO continue to require the reporting of suspicious transactions involving money laundering or terrorist financing to the Joint Financial Intelligence Unit (JFIU).

It is very important for banking professionals and staff to fully understand their respective responsibilities under the legislation.

International standards of anti-money laundering and counter financing of terrorism are established by an inter-government body called 'FATF' – Financial Action Task Force, established in 1989. Its mandate was extended in October 2001 to combat the financing of terrorism. Hong Kong is a member of the FATF and implements the Recommendations promulgated by this organisation. It is essential that Hong Kong complies with the international AML and CFT standards in order to maintain its status as an international financial centre.

Thus, from time to time, the HKMA issues Circulars to AIs about the updated FATF Statements to identify high-risk jurisdictions that have strategic deficiencies in their AML and CFT regimes, reminding financial institutions of the need to adopt enhanced due diligence measures to business relationships and transactions associated with these countries. For more information, you may access the FATF website.[4]

[4] Improving Global AML/CFT Compliance: On-going Process - 24 February 2017. FATF. Retrieved on 7 August 2017 at

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Furthermore, the Hong Kong Government has proposed stepping up measures to enhance the transparency of the beneficial ownership of companies, by amending the Companies Ordinance. The current law focuses on the disclosure of legal ownership and does not require a company to ascertain, keep or file information about its ultimate beneficial owner(s) (i.e. the natural person(s) who ultimately own(s) or control(s) the company), except for the Securities and Futures Ordinance which requires a listed corporation to keep a register of those individuals or entities owning 5% or more interest in any voting shares. Under the proposal, every company incorporated in Hong Kong, except listed companies, will be required to maintain a register of individual beneficial owners with significant control of the company, or legal entities immediately above the company in the ownership chain through which individual beneficial owners control the company. Significant control is defined as (a) 25% shareholding or voting rights, (b) the right to appoint or remove the majority of the directors, or (c) significant influence or control through other means. The legislation amendment is scheduled to take effect from March 2018.

The HKMA has published a Guideline under section 7 of the AMLO and section 7(3) of the Banking Ordinance to provide guidance to all Authorised Institutions (AIs, including banking institutions). This Guideline gives a summary of the applicable AML & CFT legislation in Hong Kong and provides guidance to assist bank officers and management in designing and implementing policies, procedures and controls suitable for their own banks' circumstances, with a view to meeting the relevant AML & CFT legal and regulatory requirements. In the following sections, we shall discuss the AML and CFT requirements under this Guideline.

The SFC has also provided guidelines on AML and CFT to assist licensed corporations & associated entities and their management in developing and implementing their own policies and controls so as to comply with relevant statutory and regulatory requirements.

What is money laundering?

Money laundering, according to the AMLO definition, is an act intended to have the effect of making any property representing the proceeds obtained from an indictable offence under the laws of Hong Kong (such as drug-trafficking, bribery, fraud, smuggling, etc.), not

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http://www.fatf-gafi.org/publications/high-riskandnon-cooperativejurisdictions/documents/fatf-compliance-february-2017.html

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to appear to be or so represent such proceeds. For the full definition, please refer to s.1. Sch.1, AMLO.

There are three common stages in the laundering of money[5], namely:

(a) Placement – the physical disposal of cash proceeds derived from illegal activities;

(b) Layering – separating the illicit proceeds from their source by creating complex layers of financial transactions designed to disguise the source of the money, subvert the audit trail and provide anonymity; and

(c) Integration – creating the impression of apparent legitimacy to criminally derived wealth.

When the layering process succeeds, the laundered proceeds will simmer back into the general financial system and appear to be the result of legitimate business activities.

What is terrorist financing?

Terrorist financing, according to the AMLO, is the provision or collection of any property for the commission of terrorist acts, or the collection of property or solicitation of financial services for a terrorist or a terrorist associate. For the full definition, please refer to s.1, Sch.1, AMLO.

Section 5 of the AMLO makes it a criminal offence if a Financial Institution (FI) or its employees/management (1) knowingly; or (2) with the intent to defraud the relevant supervising authority, contravenes a specified provision of the AMLO.

Effective monitoring & suspicious transaction reporting

The HKMA has recommended proper on-going data maintenance and screening of AIs' complete customer base and payments, and enhanced checks on suspicious wire transfers and other transactions, so as to detect and prevent money laundering, terrorist financing and sanctions violations. Any suspicious transactions should be reported to JFIU (Joint Financial Intelligence Unit).

[5] Guideline on Anti-Money Laundering and Counter- Terrorist Financing (For Authorized Institutions), HKMA, Chapter 1. Retrieved on 7 August 2017 at
http://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/guideline/g33.pdf

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Tipping Off

A person commits a 'tipping off' offence if, knowing or suspecting that a disclosure has been made to the appropriate authorities, he/she discloses to (i.e. tips off) "any other person any information or other matter which is likely to prejudice an investigation into money laundering or terrorist financing activities. He/she will contravene section 25A(5) of the DTRPO and the OSCO, as well as section 12(5) of the UNATMO."

The penalty upon conviction for the offence is a maximum fine of HKD500,000 and imprisonment for up to 3 years.

For more information, you may refer to the Guideline on Anti-Money Laundering and Counter- Terrorist Financing (For Authorized Institutions), HKMA.

Suspicious ML transactions

Examples of suspicious ML transactions which could occur in the daily operations of a bank in various aspects are extracted[6] as follows:

Using cash transactions (s. 7.39):

(a) Unusually large cash deposits made by an individual or company whose ostensible business activities would normally be generated by cheques and other instruments;

(b) Substantial increases in cash deposits of any individual or business without apparent cause, especially if such deposits are subsequently transferred within a short period out of the account and/or to a destination not normally associated with the customer;

(c) Customers who constantly pay-in or deposit cash to cover requests for banker's drafts, money transfers or other negotiable and readily marketable money instruments;

(d) Customers whose deposits contain counterfeit notes or forged instruments;

(e) Purchasing or selling of foreign currencies in substantial amounts by cash settlement despite the customer having an account with the institution;

[6] Supervisory Policy Manual, ML-1, Guideline on Anti-Money Laundering and Counter-Terrorist Financing 27.03.15, HKAM, s.7.39, 7.40, 7.41, 7.42, 7.43 & 7.44. Retrieved on 7 August 2017 at http://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/guideline/g33.pdf

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(f) Customers making large and frequent cash deposits but cheques drawn on the accounts are mostly to individuals and firms not normally associated with their retail business.

Using bank accounts (s. 7.40):

(a) customers who wish to maintain a number of trustee or client accounts which do not appear consistent with their type of business, including transactions which involve nominee names;
(b) customers who have numerous accounts and pay in amounts of cash to each of them in circumstances in which the total amount of credits would be large;
(c) any individual or company whose account shows virtually no normal personal banking or business related activities, but is used to receive or disburse large sums which have no obvious purpose or relationship to the account holder and/or his/her business (e.g. a substantial increase in turnover on an account);
(d) reluctance to provide normal information when opening an account, providing minimal or fictitious information or, when applying to open an account, providing information that is difficult or expensive for the institution to verify;
(e) large cash withdrawals from a previously dormant/inactive account, or from an account which has just received an unexpected large credit from abroad;
(f) companies' representatives avoiding contact with the branch;
(g) an account operated in the name of an off-shore company with structured movement of funds.

Using investment related transactions (s. 7.41):

(a) purchasing of securities to be held by the institution in safe custody, where this does not appear appropriate given the customer's apparent standing;
(b) requests by customers for investment management services (either foreign currency or securities) where the source of the funds is unclear or not consistent with the customer's apparent standing;
(c) larger or unusual settlements of securities transactions in cash form; and
(d) buying and selling of a security with no discernible purpose or in circumstances which appear unusual.

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Involving off-shore international activity (s. 7.42):

(a) customers introduced by an overseas branch, affiliate or other bank based in countries where the production of drugs or drug trafficking may be prevalent;

(b) use of Letters of Credit and other methods of trade finance to move money between countries where such trade is not consistent with the customer's usual business;

(c) customers who make regular and large payments, including wire transactions, that cannot be clearly identified as bona fide transactions to, or receive regular and large payments from, countries which are commonly associated with the production, processing or marketing of drugs;

(d) numerous wire transfers received in an account but each transfer is below the reporting requirement in the remitting country.

Involving an Authorised Institution's employees and agents (s. 7.43):

(a) changes in employee characteristics, e.g. lavish life styles ; and

(b) any dealing with an agent where the identity of the ultimate beneficiary or counterparty is undisclosed, contrary to normal procedure for the type of business concerned.

By secured and unsecured lending (s. 7.44):

(a) customers who repay problem loans unexpectedly;

(b) request by a customer to borrow against assets held by the institution or a third party, where the origin of the assets is not known or the assets are inconsistent with the customer's standing;

(c) request by a customer for an institution to provide or arrange finance where the source of the customer's financial contribution to a deal is unclear, particularly where property is involved; and

(d) a customer who is reluctant or refuses to state the purpose of a loan or the source of repayment, or provides a questionable purpose and/or source.

Joint Financial Intelligence Unit (JFIU)

JFIU was set up to manage the suspicious transaction reports regime for Hong Kong and distribute them to the appropriate investigative units.

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JFIU states:

"AML and CFT is everyone's responsibility. When you come across any property suspected to be drug trafficking or crime proceeds or terrorist property, you should make a suspicious transaction report (STR) to JFIU."

It further explains: "However, some sectors will have a greater risk of coming across crime proceeds or terrorist property than others, e.g. practitioners in our financial markets, remittance agents, money lenders, estate agents, trust and company service providers, jewelers, accountants, lawyers, etc."

"Failure to report knowledge or suspicion of crime proceeds or terrorist property is a criminal offence."

"If you go on to deal with such property despite knowing or having reasonable grounds to believe that the property represents crime proceeds, then you may have committed the offence of money laundering."

Under section 25(1) of the Drug Trafficking (Recovery of Proceeds) Ordinance (DTROP) and section 25(1) of the Organized and Serious Crimes Ordinance (OSCO), it is an offence for a person who, knowing or having reasonable grounds to believe that any property, in whole or in part, directly or indirectly, represents the proceeds of drug trafficking or an indictable offence, deals with that property. The maximum penalty is a HKD5m fine and 14 years' imprisonment

Under the United Nations (Anti-Terrorism Measures) Ordinance (UNATMO), it is an offence if a person:

- provides or collects property, with the intention or knowing or having reasonable grounds to believe, that the property be used or will be used to commit one or more terrorist acts (section 7)

- makes property or financial services available to or for the benefit of a terrorist or terrorist associate (section 8)

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The maximum penalty is a fine and 14 years' imprisonment

For more details, please refer to the JFIU website.

Proper record-keeping & compliance

Proper record-keeping is important to form an audit trail for the detection and investigation of suspected money laundering or terrorist financing and the confiscation of criminal or terrorist property or funds. According to s. 8.2 of the HKMA Guideline on AML & CFT, financial institutions should maintain customer, transaction and other records that are necessary and sufficient to meet the record-keeping requirements under the AMLO and regulatory requirements, and that are appropriate to the scale, nature and complexity of their businesses. In general, documents and records should be kept throughout the business relationship with the customer and for a period of six years after the end of the business relationship. For transactions, documents and records should be kept for a period of six years after the completion of a transaction, regardless of whether the business relationship ends during the period.

Staff training

A good detection system would not be effective if staffs are not educated and well-trained to be aware of AML/CFT risks and be alert to abnormal/suspicious transactions, for instance, abnormally large cash transactions or fund transfers to third parties inconsistent with the customer's profile or normal practice.

The HKMA Guideline states, "On-going staff training is an important element of an effective system to prevent and detect money laundering/terrorist financing activities."

It further highlights that, "The effective implementation of even a well-designed internal control system can be compromised if staff using the system is not adequately trained. Staff should be trained in what they need to do to carry out their particular roles in the FI with respect to AML/CFT."[7]

[7] Ibid, 5, s.9 & 9.2.

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In 2014, the HKMA launched an industry-wide Enhanced Competency Framework (ECF) for Banking Practitioners. This is a set of common and transparent competency standards for the industry. Authorised institutions should provide sufficient staff training on an ongoing basis to ensure that their staffs meet the benchmarked competency.

For more details on the Enhanced Competency Framework (ECF), please refer to Chapter 4.

Real-life cases

By now, you are aware that a bank plays an important role in detecting and reporting suspected AML & CFT transactions. Bank staff should be sufficiently trained in AML and CFT and they form part of an effective system to counter money laundering and terrorist financing.

Real-life cases are given below to further highlight the strenuous efforts of the relevant authorities in combating money laundering and terrorist financing in recent years:

Case study 1 – Deutsche Bank was fined USD630m (£504m) by US and UK regulators in connection with a Russian money laundering plan[8]

Scenario:

Under the scheme, clients illegally moved USD10bn out of Russia via shares bought and sold through the bank's Moscow, London and New York offices. Clients would then purchase stocks in roubles in Moscow before their counterparts sold the same stock at the same price through the bank's London branch.

New York authorities and Britain's Financial Conduct Authority (FCA) found that so called "mirror" trades had been carried out through the bank between 2011 and 2015. These trades had no discernible economic purpose and the scheme was a sheer means to evade compliance with applicable laws.

Regulators commented the bank had conducted its business in an “unsafe and unsound” manner and its anti-financial crime teams were ineffective and understaffed. Apart from

[8] Deutsche Bank fined by regulators over money laundering claims, 31 January 2017, BBC News. Retrieved on 7 August 2017 at http://www.bbc.com/news/business-38805085

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the pecuniary penalties totalling USD630m, the bank was required to hire an outside monitor to review its internal compliance measures.

Case study 2 – US authorities fined HSBC for failing to stop criminals using its banking systems to launder money. The Bank paid USD1.9bn to settle the allegations[9]

Scenario:

According to the main findings of the US Senate Permanent Subcommittee investigation report, despite HSBC Mexico (HBMX) operating in a country "under siege from drug crime, violence and money laundering", it had inadequate money laundering controls and had moved USD7bn alleged drug money, for instance, into HSBC US.

Mexican and US authorities expressed concern that drug traffickers were able to circumvent the anti-money laundering controls at US banks by transporting US dollars to Mexico, and then using HBMX to transfer the funds to the US. At the material time, HSBC US had classified Mexico as a low-risk country and therefore failed to monitor the transfers and other related dealings.

The report stated HBMX had:

- high-profile clients involved in drug trafficking
- millions of dollars of suspicious bulk travellers cheques
- a resistance to closing accounts linked to suspicious activities

The penalty also included a five-year agreement with the US Department of Justice under which the bank would install an independent monitor to assess enhanced internal controls. The bank's top executives would defer part of their bonuses for the whole of the five-year period.

Since then, the bank has spent substantial resources to revamp and enhance its risk management and controls on money laundering/counter financing of terrorism and other financial crimes.

[9] HSBC pays record $1.9bn fine to settle US money-laundering accusations, 11 December 2012, The Guardian. Retrieved on 7 August 2017 at https://www.theguardian.com/business/2012/dec/11/hsbc-bank-us-money-laundering

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Case study 3 – State Bank of India HK Branch was ordered to pay HKD7.5m for internal control failures relating to AML/CFT systems[10]

Scenario:

The HKMA's investigation found that between April 2012 and November 2013, the bank contravened four specific provisions (namely sections 3(1), 5(1), 19(1) and 19(3)) of Schedule 2 to the AMLO. In brief, the bank failed to:

- carry out customer due diligence before establishing business relationships with 28 corporate customers;
- continuously monitor its business relationship with its customers so as to update or review its customers' money laundering and terrorist financing risk ratings on a periodic or timely basis;
- identify transactions that were complex, unusually large in amount or of an unusual pattern, due to the bank's reliance on system-generated reports which were ineffective;
- establish and maintain effective procedures for determining whether its customers or beneficial owners of its clients were politically exposed persons;
- establish detailed procedures to ensure compliance with the specific provisions (sections 3 and 5) of Schedule 2 to the AMLO: the HKMA found that the bank's policies & procedures were more or less mere duplicates of relevant parts of the HKMA's AML Guideline.

Apart from the pecuniary penalty, the bank was ordered to submit to the HKMA a report prepared by an independent external advisor assessing the remedial plan and its related effectiveness.

[10] Monetary Authority takes disciplinary action against State Bank of India, Hong Kong Branch for contraventions of specified provisions under the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance, Press Release, HKMA, 31 July 2015. Retrieved on 7 August 2017 at http://www.hkma.gov.hk/eng/key-information/press-releases/2015/20150731-5.shtml

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Case study 4 – The SFC reprimanded and fined Guoyuan Securities Brokerage (HK) Ltd. HKD4.5m for breaches of AML guidelines 5 Apr 2017[11]

Scenario:

The Securities and Futures Commission (SFC) reprimanded Guoyuan Securities Brokerage (Hong Kong) Limited (Guoyuan) and fined it HKD4.5 million for its failure to conduct proper enquiries and scrutiny to mitigate the risks of money laundering and terrorist financing when processing third party fund transfers for clients between September 2010 and July 2012.

Specifically, the SFC's investigation found that:

- Guoyuan failed to conduct proper enquiries and sufficient scrutiny when processing a large number of frequent and unusual fund transfers between Guoyuan's clients and third parties which were unverified and unrelated to the clients. Two clients' accounts alone recorded an aggregate of fund transfers to and from third parties totaling HKD665.3 million. These third party fund transfers, which were purportedly repayment to or receipt from "friends" or "business partners", were routinely processed and accepted by Guoyuan's senior management without making further enquiries.
- Suspicious patterns suggesting the two clients' accounts were used as depository accounts or conduits for transfers were evident in some instances where monies from third parties were deposited in the clients' accounts and equivalent or roughly similar amounts were withdrawn shortly thereafter, and then transferred to numerous other third parties without any securities trading in the clients' accounts at the material time. Furthermore, the activities in some of Guoyuan's clients' accounts which received third party funds from the two clients were inconsistent with the clients' declared net worth or annual income.
- Despite such red flags, Guoyuan failed to identify them as suspicious transactions and/or follow up on them, and/or failed to adequately record enquiries which were allegedly made on these transactions.
- Guoyuan also failed to properly implement and communicate policies and

[11] SFC reprimands and fines Guoyuan Securities Brokerage (Hong Kong) Limited $4.5 million for breaches of anti-money laundering guidelines, News, SFC, 5 April 2017. Retrieved on 7 August 2017 at https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=17PR43

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procedures regarding anti-money laundering and counter financing of terrorism to relevant staff members.

The SFC is of the view that Guoyuan's conduct was in breach of the Prevention of Money Laundering and Terrorist Financing Guidance Note, the Guideline on Anti-Money Laundering and Counter-Terrorist Financing, and the Code of Conduct which requires licensed corporations to:

- conduct ongoing due diligence and scrutiny on clients' transactions and pay special attention to all complex, unusual large transactions and all unusual patterns of transactions which have no apparent economic or lawful purpose. The findings and outcomes of these examinations should be properly documented in writing; and
- take all reasonable measures to ensure that proper safeguards exist to mitigate the risks of money laundering and terrorist financing, including implementation of appropriate policies and procedures and ensuring their effectiveness and compliance with all relevant legal and regulatory requirements.

Following the SFC's findings, Guoyuan agreed to engage an independent reviewer to conduct a review of its internal controls, implemented new policies and procedures in relation to anti-money laundering and counter financing of terrorism, and took steps to remedy its internal control deficiencies. The former senior management team left.

Case study 5 –SFC reprimands and fines HSBC Broking Securities (Asia) Limited (HSBCBS) $9.6 Million for Regulatory Breaches Over Bond Sale[12]

Scenario:

The SFC alleged that HSBCBS Broking failed to: -

- conduct proper and adequate product due diligence on individual bonds before making recommendations or solicitations to its clients;
- have an effective system in place to assess its clients' risk profile and to ensure that the recommendations or solicitations make to its client in relation to bonds were suitable for and reasonable in all the circumstances;
- provide adequate product information to its sales staff to ensure that they fully

[12] https://apps.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=18PR86

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understood the features and the risks involved so that they could provide adequate disclosure and explanation to the clients during the sale process; and

- maintain proper documentary records of the investment advice or recommendations given to its clients.

In determining the penalty, the SFC accounted for the following:

- HSBCBS failed to put in place an effective system to ensure suitability of bonds recommended and/or solicited to clients despite the SFC's repeated reminders to licensed corporations on the importance of compliance with their suitability obligations, and specific guidance regarding the selling of fixed income products, complex and high-yield bonds;
- A strong message has to be sent to the market to deter similar misconduct;
- HSBCBS has taken remedial measures to enhance its suitability framework;
- There is currently no evidence suggesting any client has complained about HSBCBS's selling practices or suffered losses; and
- HSBCBS cooperated with the SFC in resolving its concerns.

Following the SFC's finding HSBC was reprimanded and fined HKD9.6 million.

Sanctions risk

Banks should be well aware of the financial sanctions imposed by the relevant authorities. In practice, banks in Hong Kong strictly abide by sanctions against individuals and entities decided by the United Nations Security Council, which are implemented in Hong Kong pursuant to the United Nations Sanctions Ordinance and its subsidiary legislations which include lists of sanctioned countries.

The Financial Action Task Force (FATF) also identifies jurisdictions with deficiencies in combating money laundering and terrorist financing and which pose a risk to the international financial system. In its Public Statement on 21 June 2019, the Democratic People's Republic of Korea (North Korea) was subject to a FATF call on its members to apply counter-measures to protect the international financial system from ML/FT risks. Similarly Iran is subject to a FATF call on its members to apply enhanced due diligence measures.

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Banks should have set up relevant policies and procedures to reject any account opening requests from, and transactions associated with, these sanctioned countries, individuals and entities, including companies and financial institutions, and review any related business transactions.

Early in 2001, the United Nations Security Council Resolution (UNSCR) 1373 called on "all member states to act to prevent and suppress the financing of terrorist acts" and related organisations.

Tax evasion

During the past decade, various governments have been working diligently to enforce tax compliance and to enhance tax transparency with a view to combat tax evasion.

FATF Recommendations 2012 included tax crimes as predicate offences for money laundering. Tax crimes are not defined in the Recommendations and, in general, are defined as willful and fraudulent tax evasion.

The HKMA states in the Guidance Paper on AML Controls over Tax Evasion (March 2015) that financial institutions should ensure that tax evasion-related risks are adequately assessed and where they exist, care is taken to ensure that AML controls can effectively mitigate these risks.

Foreign Account Tax Compliance Act

FATCA was enacted by the U.S. Congress in 2010 to counter tax evasion and improve tax transparency. It targets tax non-compliance by U.S. taxpayers using accounts with non-U.S. financial institutions to conceal income and assets from the U.S. Internal Revenue Service (IRS).

It requires foreign financial institution (FFIs) to report to the IRS any financial accounts held by U.S. taxpayers, or by foreign entities in which U.S. taxpayers hold a substantial ownership interest.

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Hong Kong is one of the partner jurisdictions to sign the Intergovernmental Agreements (IGA) on 30 June 2014, agreeing to cooperate and facilitate the implementation of FATCA via:

- exchange of information relating to tax matters;
- financial institutions directly reporting the required financial information to the IRS.

With the IGA signed, financial institutions in HK have to register and conclude separate individual agreements with the IRS (FFI agreements). These agreements require these institutions to seek the consent of their account holders who are U.S. taxpayers in order to report their account information to the IRS annually. Institutions who fail to participate face repercussions in the form of a withholding tax imposed by the IRS on relevant U.S.-sourced payments to them. Participating banks have revamped their systems on customer identification and enhanced customer information management as a whole.

For detailed information, please refer to:

- U.S. IRS website: https://www.irs.gov/businesses/corporations/foreign-account-tax-compliance-act-fatca
- FAQ issued by the FSTB: http://www.fstb.gov.hk/fsb/topical/doc/fatca-faq2_e.pdf
- HKMA FAQ on FATCA and CRS: http://www.hkma.gov.hk/eng/key-functions/banking-stability/consumer-corner/faq/
- Hong Kong Association of Banks, 'Fact Sheet - Automatic Exchange of Financial Account Information': https://www.hkab.org.hk/download.jsp?isTemp=N§ion_id=5&file_name=AEOI+Fact+Sheet_Eng_Feb+2019.pdf

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Automatic Exchange of Information and Common Reporting Standards

At the G20 London Summit in 2009, governments pledged to restore confidence in the financial system and build a fairer economy. One of the issues was to improve the transparency and exchange of information to prevent cross-border tax evasion due to globalisation.
After the London Summit, the OECD responded by further promoting and speeding up the implementation of an internationally agreed standard on the exchange of information for tax purposes. This would be achieved through the Automatic Exchange of Information which is “the systematic and periodic transmission of tax information by countries to the residence country concerning various categories of income.” (OCED, 2017), and a new international standard for the automatic exchange of financial account information in tax matters (AEOI) was promulgated by the OCED in 2014. That means in order to verify the compliance of their taxpayers, the tax authorities have to co-operate with each other in bringing the national tax administration in line with the globalised regime.

There exists yet another obstacle. Bank secrecy is a norm for most jurisdictions and in the past governments refused to share information partly because of such legal obstacle. Thus, legislative changes in the countries which committed to implement AEOI were also required.

As an international financial centre, Hong Kong also indicated its support for implementing AEOI. International agreements were signed with a number of jurisdictions. Amendments were made to the Inland Revenue Ordinance in order to provide the legislative framework for the conduct of AEOI: see, e.g., the Inland Revenue (Amendment) (No. 3) Ordinance 2016 and Inland Revenue (Amendment) (No. 3) Bill 2017. The new law requires banks and other financial institutions to identify and report information relating to financial accounts held by customers that are tax residents of reportable jurisdictions to the Inland Revenue Department. The first reporting of relevant financial account information to the Inland Revenue Department for exchange with reportable jurisdictions is expected to take place by the end of 2018. To facilitate reporting, new measures have been introduced by banks. One noticeable step is to collect information at account opening. Customers are required to complete forms to self-declare whether the person is a U.S. person under the “FATCA” enacted in the United States and to collect the related information based on the jurisdiction of tax residence.

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The Common Reporting Standard (CSR), established by the Organisation for Economic Cooperation and Development ("OECD[13]") in July 2014, is an international standard by which different countries can perform AEOI. Enabling the cooperation amongst governments and financial institutions, it builds on the FATCA IGA to maximise efficiency and minimise costs. Financial account information is exchanged in accordance with the Competent Authority Agreement ("CAA") between two jurisdictions (generally named as the AEOI Agreement in the HKMA Guidelines) taking into account domestic reporting requirements and the legal framework.

The CRS provides the legal framework, technical standards, guidance and training for the automatic exchange of financial accounts information between different jurisdictions, with a view to ensure the highest standard of data confidentiality and safeguards.

The CRS consists of:

1. the due diligence rules for financial institutions to collect and then report the information;
2. the Model Competent Authority Agreement ("CAA") that links the CRS to the legal basis for exchange, specifying the required financial information;
3. commentaries to illustrate and interpret the CAA and the CRS; and
4. guidance on technical solutions.

As the number of countries sharing tax information internationally increases, one could not use bank secrecy to hide information for tax purposes and this makes cross-border tax evasion more difficult.

For details on the Common Reporting Standard (CRS), please refer to the "Standard for Automatic Exchange of Financial Account Information in Tax Matters: Implementation Handbook" on the OECD website.

For details on complying with financial institutions' obligations under Part 8A of the Inland Revenue Ordinance, please refer to Guidance for Financial Institutions at:
http://www.ird.gov.hk/eng/tax/aeoi/guidance.htm

[13] Foreign Account Tax Compliance Act (FATCA) became US law in 2010 to combat tax evasion, followed by the OECD endorsing FATCA as a blueprint in 2013 to implement 'CRS' for AEOI (Common Reporting Standard for Automatic Exchange of Financial Account Information).

2.3 Suitability obligations & mis-selling

Suitability obligations

When financial products are sold to customers, financial institutions are subject to 'suitability obligations', which require them to ensure that the products are suitable for the customers. This is a requirement under the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (SFC Code of Conduct). Nowadays, banking institutions, as registered institutions under the SFC regulatory regime, provide securities services and act as distributors of investment products to their customers, and therefore need to comply with the suitability requirement whenever they make an investment recommendation or solicitation to a customer.

"Suitability obligations are the cornerstone of investor protection", said the SFC's Executive Director of the Intermediaries Division.

Paragraph 5.2 of the SFC Code of Conduct defines the suitability obligations as follows:

"Having regard to information about the client of which the licensed or registered person is or should be aware through the exercise of due diligence, the licensed or 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."

What the suitability obligation is about

Financial institutions must comply with the "Know Your Client" ("KYC") requirement to take all reasonable step to seek information from their customers about their financial situation, investment objectives and investment experience (by types of products) for the purpose of assessing their risk tolerance. Supplemental information of investment knowledge, investment horizon, risk tolerance, and, where appropriate, capacity to make regular contributions and meet extra collateral requirements. Further, each customer's information should be fully documented and, where appropriate, updated on a continuous basis. The following are the four major mis-matching:

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Last updated: 23 March 2021

PRODUCT	**CLIENT**
Tenor	Investment Horizon
Complexity	Investment Knowledge
Risk Level	Risk Tolerance
Investment Amount	Financial Assets

Product due diligence work should have been conducted prior to recommending an investment product to each customer. The SFC states that suitability involves licensed or registered persons matching the risk return profile of each recommended investment product with each client's personal circumstances.

Compliance with the suitability obligations does not end with providing customers with copies of a prospectus or a list of risks relating to the product or even having a customer sign a form that says they have read and understood the documentation. Financial institutions should help customers make informed decisions by providing them with all the relevant information concerning a proposed product, including disclosure of all relevant risks and a proper explanation as to why the institution considers the product suitable for a particular customer.

Proper records should be kept on what information has been given to each customer with the rationale for each investment recommendation. Sufficient documentation should also be kept on all client transactions including orders placed to product providers. The SFC requires that "For non-exchange traded products, such records should be retained for at least 7 years. For exchange traded products, such records should be retained for at least 2 years."

For example, if a bank manager sees that one of its staff members has sold a high-risk derivative product to an elderly customer, the manager should double-check the deal, as it may violate the suitability obligations. The HKMA requires AIs to put in place enhanced policies and procedures for the selling of investment products to vulnerable customers such as elderly persons, including independent monitoring procedures to review these

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transactions on a sample basis and to take follow-up action in case any irregularity is identified[14].

See HKMA's Circular 23/10/2008 on 'Selling of Investment Products to Retail Customers' (http://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2008/20081211e1a1.pdf).

Enhancements of the suitability obligations

After the 2008 financial crisis which led to the downfall of Lehman Brothers, and which triggered a series of mis-selling claims against banks in Hong Kong who had sold Lehman Brothers products to clients, the regulators imposed further requirements on the suitability obligations, particularly with regard to derivative products, with a view to further protect investors' interests. Financial institutions have to ensure that customers are aware of the related risks and investment exposure, except for professional investors.
Financial institutions have thereafter enhanced their account opening process for securities accounts and related KYC processes. Banks have revamped the procedures for assessing the suitability of derivative and other investment products for customers with different levels of risk tolerance, and provided further training to relevant staff.

Measures taken by banks include the segregation of banking and investment services at retail branches, and enhancement of the risk tolerance assessment process prior to the opening of securities and investment accounts. For corporate clients, any person dealing with the bank on the client's behalf in the booking or trading of derivative transactions must be appropriately qualified and have at least 3 years of proven experience of dealing in derivative products.

You may also refer to relevant circulars issued by the HKMA for more information, including but not limited to:

- "Implementation of Recommendations in the HKMA's Report on Issues Concerning the Distribution of Structured Products Connected to Lehman Brothers" dated 25 March 2009

[14] Selling of Investment Products to Retail Customers, HKMA's Circular 23 October 2008, http://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2008/20081211e1a1.pdf

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- "Applicability of Enhanced Measures to Sales of Investment Products to Private Banking Customers" dated 20 January 2012
- "Applicability of Enhanced Measures to Sales of Investment Products to Corporate Customers" dated 20 December 2012
- "Selling of investment products" dated 6 January 2015
- "Guidance on selling of investment products and handling of client securities" dated 23 February 2017

Financial institutions are exempt from complying with the suitability obligations where they deal with:

1. institutional professional investors (as defined in section 1, Part 1 of Schedule 1 by the SFO); and
2. corporate professional investors (as defined under the Securities and Futures (Professional Investor) Rules), but only in cases where the institution has complied with the requirements of paragraphs 15.3A and 15.3B of the SFC Code of Conduct.

In December 2016, the SFC provided further clarification on what may trigger the suitability obligations, particularly when brokers or distributors deal with clients in person, by telephone or by other direct means of communication, e.g. posting advertisements, or providing research and marketing materials, such as stock commentaries or analyst reports to clients. The crucial consideration in each case is whether the broker or distributor is merely providing factual, fair and balanced information about a product, market or industry to the client, or representations are made or actions taken involving solicitation or recommendation to invest in a particular product. The SFC also clarified that the suitability obligations apply to discretionary account services, and elaborated on how such obligations are to be discharged in the context of such services. The SFC also provided guidance on what needs to be done when the suitability obligations are triggered, including elaboration on the KYC requirement and suitability assessments, and further guidance on customer risk profiling and product due diligence. For details of the SFC requirements, please refer to the updated versions of the FAQs on 'Triggering of Suitability Obligations' and 'Compliance with Suitability Obligations' both dated 23 Dec 2016.[15]

[15] http://www.sfc.hk/web/EN/faqs/intermediaries/supervision/triggering-of-suitability-obligations/triggering-of-suitability-obligations.html
http://www.sfc.hk/web/EN/faqs/intermediaries/supervision/suitability-obligations-of-investment-advisers/compliance-with-suitability-obligations.html

Case study 6

Scenario:

A real-life case can clearly illustrate the care and duty that a bank and its staff need to undertake to comply with the suitability obligations.

In the case "Chang Pui Yin & others v Bank of Singapore" [2016] 5 HKC 329 (Court of First Instance judgment delivered on 8 August 2016), the judgment was given to the plaintiffs, the Changs, who were an elderly couple in their 70s and 80s at the material time. They alleged that the bank and Mrs Li, a relationship manager, had breached their contractual advisory duty by investing the couple's money in high-risk products incompatible with the risks that the couple could undertake and their investment objectives and experience.

The judge at first instance concluded that "Mrs Li and the Bank breached the contractual duty they owed to the Changs and to Nextday International Ltd (being the couple's investment vehicle) by:

- failing to exercise reasonable care and skill to ascertain and to have regard to their investment objectives and risk appetite;
- failing to exercise reasonable care and skill when offering products which were not suitable to their investment objectives and risk appetite;
- only highlighting returns without explaining risks;
- changing the clients' risk profile to high risk without notifying them or obtaining their consent, in order that the high-risk products they had been sold would not be unsuitable for them (after Compliance had pointed out the mismatch) and she could continue to sell them high risk products; and
- by failing to exercise reasonable care and skill to warn them of the risks inherent in the investments that were being offered to them.

The judge also accepted the opinion of an expert witness which included the following statement: "In my opinion, [Nextday's] portfolio was not only very high risk but also so badly constructed that it would have been unsuitable even for a professional gambler."

The Bank's appeal to the Court of Appeal was dismissed (judgment delivered on 20 July 2017).

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Mis-selling

Users of financial services are protected by numerous consumer protection laws, including the common law principle, which means that contracts may be revoked if there has been any misrepresentation in the selling process. Mis-selling means either:

(i) selling unsuitable products; or

(ii) failing to make full & accurate disclosures to the customer to enable him/her to make an informed decision, i.e. misrepresentation in the selling process. The financial institution may bear the risk of the contract.

Wrong products have been sold to wrong customers. As per BBC news on 29 Jun 2012, some of Britain's biggest banks were found guilty of mis-selling in that there were "serious failings" in the way they sold to small businesses complicated financial products, e.g. interest rate swaps, with one of the victims being a butcher. The UK's financial services regulator at the time, the former Financial Services Authority (FSA), requested banks to stop selling structured products to small businesses.

The 2008 financial crisis revealed that various international banks had been selling mortgage-backed securities to layman investors. In Hong Kong, the Lehman Brothers incident highlighted that some banks had focused on the pursuit of targets and growth of profits, and had employed improper selling practices.

To further illustrate the consequences of mis-selling, two cases have been extracted from the SFC website as follows:

Case study 7[16]

Scenario:

The SFC reprimanded and fined Philip Securities (HK) Ltd. HKD1m over the mis-selling of a fund to four clients in around August 2004, involving a transaction amount of approximately HKD819,000. The fund was liquidated in July 2011 and the clients were not able to recover their investment. The SFC stated that Philip Securities failed to:

- conduct adequate due diligence on the fund before selling it to clients;

[16] SFC reprimands and fines Phillip Securities (Hong Kong) Limited $1 million over mis-selling of investment product, Enforcement news, SFC, 16 Jun 2015. Retrieved on 7 August 2017 at http://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/enforcement-news/doc?refNo=15PR65

- provide adequate training or sufficient product information to its sales staff;
- implement sufficient measures to ensure that its sales staff had assessed the suitability of the fund for its clients; and
- monitor and review the selling process.

Case study 8[17]

Scenario:

The Securities and Futures Appeals Tribunal (SFAT) affirmed an SFC decision to suspend the licence of Mr Barber, a licensed representative and officer of Barber Asia Ltd. (BAL), for giving unsuitable investment advice to his client, Susan Field.

A civil suit was also brought by Susan Field against Barber Asia Ltd. (BAL) alleging that Mr Barber, the investment adviser, had negligently advised the client causing her financial loss. Relying on his advice, Field bought an investment product known as a "Loan and Guarantee Scheme" in August 1998, and she suffered substantial losses when she was forced to close out her whole position in December 1999 after repeated margin calls. He was found by the court to have given negligent advice by advising the client to invest in an unsuitable product without explaining to her the inherent risks of the product, and the SFC questioned his fitness and properness as a professional adviser.

In Sep 2004, the SFC suspended Barber's licence for six months. With new oral and documentary evidence, Barber appealed to the SFAT.

The SFAT decided that Barber had been insufficiently diligent in explaining to his client the downside risks of the investment he had introduced and he had also failed to properly assess the suitability of the investment for the client. It also rejected Barber's argument that the client concerned was an "execution-only" client where no advice was contracted for. However, in light of the new evidence adduced by Barber, the SFAT reduced the period of suspension of his licence to one month.

Barber's appeal against the SFAT's decision was subsequently dismissed by the Court

[17] SFC Suspends Andrew Nicholas Barber for Unsuitable Investment Advice, News, SFC, 4 July 2005. Retrieved on 7 August 2017 at https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=05PR153

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of Appeal [2006] HKCA 356.

<4 Jul 2005>www.sfc.hk/News and announcements/News/All news/SFC suspends Andrew Nicholas Barber for Unsuitable Investment Advice

2.4 Market misconduct under the SFO

Insider trading

Insider trading is prohibited in many countries, to ensure the integrity of their capital markets. Insider trading/dealing refers to the buying or selling of securities or related derivatives, while in possession of non-public, price-sensitive information relating to the issuer of the securities. It includes counselling or procuring another person to deal in securities or related derivatives, knowing or having reasonable cause to believe the other person will deal in them. In Hong Kong, any person engaging in insider dealing will be prosecuted under the Securities and Futures Ordinance (SFO).

Thus, financial institutions with non-public, price sensitive information about a listed corporation should keep it confidential and prevent their employees from using the information to make profits in the financial markets. Staff should not deal in the shares of any listed company when possessing such information.

To prevent breaches of insider trading laws by employees, banks invariably establish internal Insider Trading policies and procedures. Relevant bank employees who may come into the possession of insider information in the course of the performance of their duties should comply with such policies and procedures. For instance, the relationship manager of a listed corporate customer is prohibited from trading in the securities of the company and any related group companies.

In practice, “Chinese Wall” rules are strictly adopted by multi-functional banks to restrict any flow of business information between their investment banking division and the commercial/corporate banking divisions within the same banking group. Mergers and acquisitions (M&A) is a particularly critical area in the enforcement of insider trading laws as M&A transactions involve an enormous amount of sensitive and confidential information

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of the concerned corporations, any leakage of which can lead to abnormal movement of the share price of the corporations.

The following real-life cases can further illustrate the importance of compliance with insider trading laws:

Case study 9 – The U.S. Securities and Exchange Commission (SEC) Charges Former Dow Jones Board Member and Three Other Hong Kong Residents in USD24 Million Insider Trading Settlement, 5 Feb 2008

Scenario:

The SEC's complaint filed in the U.S. District Court for the Southern District of New York alleged that David Li Kwok Po, a Dow Jones board member at the time who also was Chairman and CEO of the Bank of East Asia and a member of Hong Kong's Legislative Council and Executive Council, learned of the then-secret News Corp. offer and illegally tipped his close friend Michael Leung Kai Hung.

The SEC complaint also alleged that Leung, with the help of his daughter Charlotte Ka On Wong Leung and son-in-law Kan King Wong, purchased approximately USD15 million worth of Dow Jones securities in their account at Merrill Lynch. They stood to make approximately USD8 million in illicit profits had the SEC not won an emergency court order within days of the News Corp. offer, freezing the account and stopping the money from being remitted overseas.

"Protecting the integrity of our markets in today's world of global trading and instant communications requires real-time enforcement across national borders," said the SEC's then Chairman.

"Insider trading on merger and acquisition information continues to be a top enforcement priority," said the then Director of the SEC's Division of Enforcement. "We hope this case sends a forceful reminder to corporate insiders that they need to exercise careful discretion when discussing important business matters outside the boardroom and executive suite."

Without admitting or denying the Commission's allegations, David Li, Michael Leung, K.K. Wong and Charlotte Wong consented to the entry of court orders enjoining them from violations of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. David Li was ordered to pay a USD8.1 million civil penalty. Michael Leung was ordered to pay USD8.1 million in disgorgement of profits plus pre-judgment interest and a USD8.1 million penalty. K.K. Wong was ordered to pay USD40,000 in disgorgement of profits plus pre-judgment interest and a USD40,000 civil penalty.

Case study 10 - Restoration orders against Tiger Asia & related parties to pay HKD45.3m to restore investors to their pre-transaction positions, May & Oct 2013

Scenario:

Tiger Asia Management LLC (Tiger Asia), a New York-based asset management company and two of its senior officers, Bill Sung Kook Hwang and Raymond Park (collectively the Tiger Asia parties) were ordered to pay HKD45.3 million to about 1,800 investors who traded with Tiger Asia in transactions involving shares of Bank of China Limited and China Construction Bank Corporation.

The court order followed admissions by the Tiger Asia parties in the SFC’s proceedings under section 213 of the Securities and Futures Ordinance (SFO) that they had contravened Hong Kong’s laws prohibiting insider dealing and false trading.

Separate proceedings on market misconduct were further sought in the Market Misconduct Tribunal (MMT) which determined that the Tiger Asia parties be banned from trading securities in Hong Kong without permission of the court for up to four years (the maximum period is five years) in Oct 2014.

The SFC's then Executive Director of Enforcement said, "Tiger Asia and Hwang abused the trust of the Hong Kong market, flouted Hong Kong’s laws and damaged the financial interests of thousands of investors who had no means of protecting themselves from such misconduct. They were wrong if they thought this could be done with impunity because they were situated beyond Hong Kong.”

“The SFC will track down and take action against wrongdoers wherever in the world they

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may lurk. In this case, we have recovered their illegal profits (around HKD45 million) for the benefit of the victims; the wrongdoers have been dealt with under US law and the MMT has rightly banned them from Hong Kong's markets for four years," he added.

*The restoration amount represents the difference between the actual price of the stocks sold by the parties and the stock value, taking into account the inside information known to the parties.

Price rigging

Price rigging is defined under sections 275 and 296 of the Securities and Futures Ordinance. It takes place when, in Hong Kong or elsewhere, a person:

(a) enters into or carries out, directly or indirectly, any transaction of sale or purchase of securities that does not involve a change in the beneficial ownership of those securities, which has the effect of maintaining, increasing, reducing, stabilising, or causing fluctuations in, the price of securities; or

(b) enters into or carries out, directly or indirectly, any fictitious or artificial transaction or device, with the intention that, or being reckless as to whether, it has the effect of maintaining, increasing, reducing, stabilising, or causing fluctuations in, the price of securities, or the price for dealings in futures contracts.

The transactions must be traded on a relevant recognised market or by means of authorised automated trading services or on a relevant overseas market. In other words, there are domestic and extra-territorial effects of the provision.

Other types of securities fraud, e.g. market manipulation

Stock market manipulation is defined under sections 278 and 299 of the Securities and Futures Ordinance. It takes place when, in Hong Kong or elsewhere, a person enters into or carries out, directly or indirectly, two or more transactions in the securities of a corporation that, by themselves or in conjunction with any other transaction, increase/reduce/maintain or stabilise, or are likely to increase/reduce/maintain or stabilise, the price of any securities, with the intention of inducing another person to purchase/sell or

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subscribe for, or to refrain from selling/purchasing, securities of the corporation or of a related corporation of the corporation.

2.5 Consumer protection laws

Consumer Council

The Consumer Council, established under the Consumer Council Ordinance, was set up in 1977. Under section 4 of the Consumer Council Ordinance, the functions of the Council are to protect and promote the interests of consumers of goods and services and purchasers, mortgagors and lessees of immovable property by, among others:

(a) collecting, receiving and disseminating information concerning goods, services and immovable property;

(b) receiving and examining complaints by and giving advice to consumers of goods and services and purchasers, mortgagors and lessees of immovable property;

(c) taking such action as it thinks justified by information in its possession, including tendering advice to the Government or to any public officer;

(d) encouraging business and professional associations to establish codes of practice to regulate the activities of their members.

Treat Customers Fairly Charter

Riding on the good practices promoted under the G20 High-Level Principles on Financial Consumer Protection promulgated in 2011, the HKMA has worked with the industry to develop the Treat Customers Fairly ("TCF") Charter as a catalyst for fostering a stronger risk culture towards the fair treatment of customers.

In 2013, all retail banks in Hong Kong signed up to the Charter to show their commitment to and full support of the TCF principles which promote consumer protection and education with a view to enhancing customer confidence and trust in banks for sustainable development of the banking industry. The Charter is primarily aimed at retail consumers and is designed to complement, not change, current law or regulation or the existing terms and conditions between banks and their customers.

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The Hong Kong Association of Banks (HKAB) showed its support by issuing a circular in the same year, encouraging member banks to adopt a flexible approach in relation to the charging of low-balance and dormant account fees. Today, many retail banks in Hong Kong do not charge dormant account fees and will exempt all vulnerable group customers from low-balance fees. Vulnerable group customers include senior citizens, minors, those receiving social welfare benefits and government subsidies, and those with physical or mental disabilities.

The five TCF principles are:

1. Banks should assess the risk appetite of customers prior to the offering of banking services;
2. Banks should provide clear explanations and the related terms and conditions of banking products to customers before, during and after the point of sale;
3. All promotional materials and information should be accurate and understandable;
4. Reasonable channels must be provided to customers in complaint & claims communication and redress seeking; banks must not impose unreasonable barriers on customers to switch banks;
5. Banks should engage with relevant parties, e.g. governments and regulatory bodies to promote financial literacy to the public and pay special attention to the banking services needs of vulnerable groups.

In 2017, the promotion of a strong corporate culture to ensure the fair treatment of customers was extended to the private wealth management industry when all member institutions of the Private Wealth Management Association committed to implement the Treat Customers Fairly Charter for Private Wealth Management Industry, which comprises broadly the same 5 TCF principles as the Charter for retail customers.

Personal Data (Privacy) Ordinance (PDPO)

The objective of the PDPO is to protect the privacy rights of individuals in relation to personal data. Examples of personal data protected by the Ordinance include names, phone numbers, addresses, identity card numbers, photos, medical reports and employment records.

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According to section 2(1) of the PDPO, "personal data" means "any data

(a) relating directly or indirectly to a living individual;

(b) from which it is practicable for the identity of the individual to be directly or indirectly ascertained; and

(c) in a form in which access to or processing of the data is practicable."

A bank is a data user who is liable as the principal for the wrongful acts of its authorised data processors, i.e. bank employees and service providers. Under the PDPO, a data user should comply with the six data protection principles.

Practical examples for banks have been extracted from the "Guidance Note on the Proper Handling of Customers' Personal Data for the Banking Industry, October 2014" published by the Office of the Privacy Commissioner for Personal Data, Hong Kong.

Data Protection Principles & practical examples

Principle 1 – Data Collection – Personal data should be collected in a lawful and fair way for a purpose directly related to the activity of the data user on a necessary basis.

Practical examples:

1. When collecting customers' personal data, banks should carefully consider the necessity of collecting each item of the information to be collected. For example, collection of a savings account customer's name and contact information is necessary for the provision of the account services to the customer, but collecting the customer's racial origin or religious affiliation would, in general, be excessive for such a purpose.
2. Where customers are required to supply their personal data, they should be provided with a Personal Information Collection Statement ("PICS") containing the following information:
   - a statement of the purposes for which customers' personal data will be used after collection;
   - classes of third parties to whom the personal data may be transferred;
   - whether it is obligatory or voluntary for customers to supply their personal data, and if obligatory, the consequences of the failure to supply the data;

- customer's rights of access to, and correction of, their personal data, and the name/job title and address of the officer responsible for handling any data access or correction request.

As required by the Ordinance, banks send a copy of the PICS to their customers as an official notice on an annual basis.

Principle 2 – Accuracy & Retention – Practicable steps shall be taken to ensure personal data is accurate and not kept longer than necessary.

Practical examples:

1. Before sending a bank statement to a customer, it is important that the bank takes all practicable steps to ensure that the address of the customer is accurate and up-to-date. If delivered to the wrong address, the customer's financial data may be disclosed to unrelated third parties. Banks should therefore remind their customers regularly and provide them with a channel to notify them of any change in their contact information.
2. Banks should formulate policies and practices to specify the period of retention of customers' personal data.

Principle 3 – Data Use – Personal data must be used for the purpose for which the data is collected or a directly related purpose, unless the data subject's voluntary and explicit consent to use it for a new purpose is obtained.

Practical examples:

1. In general, unless prescribed consent has been obtained from the customer concerned, banks should not disclose the account data of a customer to his employer or family members.
2. An ex-staff member of Bank A should not use Bank A's customers' personal data for soliciting business in the form of loan transfers for his new employer, Bank B.
3. Bank staff should not without the bank's permission obtain a customer's prejudicial financial information from the bank's records and disclose it, for example, on the internet thereby causing psychological harm to the customer.

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Principle 4 – Data Security – A data user should take practicable steps to safeguard personal data against unauthorised or accidental access, processing, erasure, loss or use.

Practical examples:

1. Customers' data stored electronically in databases, computers or portable storage devices should be protected with adequate IT security measures and access control.
2. In engaging a marketing company to carry out a customer opinion survey, banks must ensure the safe handling and erasure after use by the marketing company of the data transferred to it to safeguard against unauthorised access or use of that data.

Principle 5 – Openness – A data user should make personal data policies and practices known to the public.

Practical example:

Banks should formulate and make available to the public their Privacy Policy Statements ("PPS") stating in detail the kinds of personal data held, the main purposes of using the personal data and their privacy policies and practices in place. The PPS may be displayed on the banks' websites.

Principle 6 – Data Access & Correction – A data subject should be given access to his/her personal data and allowed to make corrections if inaccurate.

Practical example:

A customer recently changed his nationality and notified the same to his bank. To ensure the bank has duly updated his nationality, he may make a request to the bank to be informed whether it holds information about his nationality in specific records, for example, his customer profile, and be supplied with a copy of such data within 40 days.

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Direct marketing

The PDPO was amended in 2012 to include a revised direct marketing regulatory framework (i.e. Part VIA which took effect on 1 April 2013). Thereafter, a bank must obtain the consent from a customer for the use of his/her personal data, or provision of his/her personal data to a third party for use in direct marketing. Contravention of this requirement is a criminal offence with a maximum fine of HKD500,000 and 3 years' imprisonment.

The customer has the option to 'opt-out' from such use or provision of his/her personal data by notifying the bank. Subsequent use, or provision for use without gain, of his/her personal data in direct marketing is also a criminal offence which carries a maximum fine of HKD500,000 and 3 years' imprisonment. Subsequent provision of his/her personal data for gain for use in direct marketing carries a heavier maximum fine of HKD1 million fine and 5 years' imprisonment.

For a more detailed discussion on direct marketing, please refer to the Privacy Commissioner's New Guidance on Direct Marketing on the website www.pcpd.org.hk.

Enforcement of Data Protection Principles

If a bank fails to comply with any of the Data Protection Principles, e.g. leaks customer data, the Office of the Privacy Commissioner for Personal Data (PCO) may issue an Enforcement Notice (EN) to the bank requiring it to remedy and, if appropriate, prevent recurrence of the contravention. If the bank contravenes the EN, this will constitute an offence which may result in a maximum fine of HKD50,000 and 2 years' imprisonment of the individual responsible for the contravention.

For sharing of best practice, useful case studies have been provided in the Privacy Commissioner's "Guidance on the Proper Handling of Customers' Personal Data for the Banking Industry" October 2014, and some of them have been extracted as below:

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Case study 11 – Bank documents sent to wrong and incomplete addresses

Scenario:

The complaint – A credit card customer provided her correspondence address in "Shek Tong Tsui" to a bank. Since there was no choice of "Shek Tong Tsui" in the pull down menu of the district field in the bank's system for inputting a customer's address, the bank's employee chose "Siu Lam" from the menu as the district for the address. The customer discovered the mistake when she received a letter (albeit wrongly addressed) from the bank. She then made a data correction request to the bank by using its amendment form. The customer did not receive any further credit card statements from the bank and later learnt from the bank that her statements had been sent to an address without flat and floor information because its employee failed to input the flat and floor information into the system when processing her data correction request. On both occasions, the bank's double-checking procedures failed to spot the mistakes.

Outcome:

The Privacy Commissioner found that the mistakes were made by the bank due to carelessness of its employees and failure of its checking procedures. The bank had breached Data Protection Principle 2 for failing to take all practicable steps to ensure the accuracy of the customer's address data. The Commissioner considered that by improving the bank's computer system and automated/manual checking procedures, similar mistakes could be avoided in future.

Case study 12 – Money changing

Scenario:

The complaint – The complainant went to a bank to change his HKD500 note into five HKD100 notes. Since he did not hold an account with the bank, the counter officer recorded the complainant's name and HKID Card Number according to the bank's policy.

Outcome:

The Privacy Commissioner took the view that there was no prima facie evidence to suggest that the money changing (for an amount less than HKD120,000) involved money laundering or terrorist financing activities, hence there was insufficient grounds to

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justify collection of the complainant's name and HKID Card Number in the circumstances. The bank subsequently ceased such practice.

Case study 13 – Disclosure of debtor's default in payment to third party

Scenario:
The complaint – A debt collection agent appointed by a bank made a dunning call to a school where the debtor was employed as a teacher. According to the call recipient who was the janitor of the school, the caller stated that he was calling to collect debt from the debtor and asked the janitor to urge the debtor to return the call.

Outcome:
The Privacy Commissioner was of the view that by stating the purpose of the call as recovery of debt, the fact that the debtor had defaulted on payment had been disclosed to a third party (i.e. the janitor in this case) and this was contrary to Data Protection Principle 3.

After intervention by the Commissioner, the bank issued a written guideline to its debt collection agents requiring their staff to leave only their names and contact numbers where the call recipient was not the debtor. In the event that the recipient enquires about the purpose of the call and the identity of the caller, the staff member should simply mention "for personal matters" and disclose the name of the caller's organisation only.

For the full content and more detailed information, please refer to the Privacy Commissioner's October 2014 Guidance Paper.

2.6 Equal opportunities

The Equal Opportunities Commission (EOC) in Hong Kong is an independent statutory body set up in 1996 with the responsibility for promoting equality and eliminating discrimination.

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The EOC has the duty to implement the Sex Discrimination Ordinance, the Disability Discrimination Ordinance, the Family Status Discrimination Ordinance, and the Race Discrimination Ordinance, collectively known as the anti-discrimination legislation in Hong Kong.

The Sex Discrimination Ordinance renders unlawful certain kinds of sex discrimination, discrimination on the grounds of marital status or pregnancy, and sexual harassment. Under the Disability Discrimination Ordinance, it is unlawful to vilify a person with a disability in public, or discriminate against or harass a person on the grounds of disability. The Family Status Discrimination Ordinance makes it unlawful to discriminate against a person on the grounds of family status. Under the Race Discrimination Ordinance, it is unlawful to discriminate against, harass or vilify a person on the grounds of his/her race.

The areas of activities for which a person may lodge a complaint under any of these anti-discrimination legislation include employment, education, the provision of goods, services or facilities, the disposal or management of premises, the eligibility to vote for or to be elected or appointed to advisory bodies, participation in clubs, and activities of the Government.

The EOC also issues guidelines and codes in relation to anti-discrimination such as the Code of Practice on Employment under each area of the anti-discrimination legislation, including the Sex Discrimination Ordinance, the Disability Discrimination Ordinance, the Family Status Discrimination Ordinance and the Race Discrimination Ordinance, the ‘Framework for Corporate Policy on Sexual Harassment’, etc. These codes and guidelines are issued for the purposes of elimination of discrimination and promotion of equal opportunities between persons.

2.7 Bribery & corruption, acceptance of gifts & entertainment

The Independent Commission Against Corruption (ICAC) was established in 1974 with a view to fighting corruption using a three-pronged approach of law enforcement, prevention and education.

The main legislation regarding the prevention of bribery and corruption is the Prevention of Bribery Ordinance (POBO) (Cap201).

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Section 4 of the POBO deals with bribery of public servants. Any person who, without lawful authority or reasonable excuse, offers any advantage to a public servant as an inducement to or reward for that public servant performing or abstaining from performing any act in his capacity as a public servant, shall be guilty of an offence. The public servant who is the recipient of the bribe is also guilty.

Section 5 of the POBO deals with bribery for giving assistance, etc., in regard to public contracts. Any person who, without lawful authority or reasonable excuse, offers an advantage to a public servant as an inducement to or reward for that public servant giving assistance or using influence in matters relating to any contract with a public body shall be guilty of an offence. The public servant who is the recipient of the bribe is also guilty.

Section 8 of the POBO deals with bribery of public servants by persons having dealings with public bodies or the Government. It is an offence for any person to, without lawful authority or reasonable excuse, while having dealings of any kind with a government department/office of a public body, offer any advantage to any government officer employed in that department/office or public servant employed by that public body.

'Advantage' is defined under Section 2 of POBO to mean:

(a) any gift, loan, fee, reward or commission consisting of money or in kind;

(b) any office, employment or contract;

(c) any payment, release, discharge or liquidation of any loan, obligation or other liability;

(d) any other service, or favour (other than entertainment, which is defined as the provision of food or drink, for consumption on the occasion when it is provided, and of any other entertainment connected with, or provided at the same time as, such provisions);

(e) the exercise or forbearance from the exercise of any right or any power or duty; and

(f) any offer, undertaking or promise, whether conditional or unconditional, of any advantage within the meaning of any of the above mentioned items.

Section 9 of the POBO deals with corrupt transactions with agents in the private sector. Any agent who, without lawful authority or reasonable excuse, solicits or accepts any advantage as an inducement to or reward for his/her doing or forbearing to do any act or,

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showing or forbearing to show favour or disfavour to any person in relation to his/her principal's affairs, shall be guilty of an offence.

Any person who, without lawful authority or reasonable excuse, offers such advantage to any agent for the same purpose is also guilty.

Any agent who, with intent to deceive his principal, uses any receipt, account or other document which contains any statement which is misleading or false or defective in any material particular, and in respect of which the principal is interested, shall be guilty of an offence.

Furthermore, it is not a defence to claim that an advantage accepted or offered is customary in any professional, trade, vocation or calling. Thus, a bank employee cannot use custom as an excuse to accept any gift by any customer or supplier during festive occasions and he/she must seek approval from his/her employer before acceptance or as soon as reasonably possible after.

Please also refer to the paragraphs on Anti-bribery laws and relevant legal requirements in Chapter 1 section 2 and Appendix 3 for extracts of the POBO.

2.8 Prevention of financial crimes

Financial crimes are financial activities or conduct that involve criminal offences. Some of these have been discussed in earlier paragraphs. It can be divided into two broad categories.

First, fraud, deceit, insider dealings or other market misconduct are examples of criminal activities in financial transactions that at the same time generate wealth for the dishonest person engaging in those activities.

Second, money laundering and terrorist financing is another category where the person involved may or may not be dishonest but he/she deals with property that is obtained illegally or provides financial services to facilitate terrorist acts.

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Below are some common ways used by banks to prevent financial crime but they are by no means exhaustive:

- Senior management oversight and the regular review of corporate policies and procedures
  Senior management should ensure that risk management measures are imposed and a proper system is in place which can effectively address the risks identified. Customer due diligence procedures should be reviewed regularly.
- Controls that work efficiently and effectively
  Controls can be carried out by the Compliance Officer, Money Laundering Reporting Officer and the compliance function in the institution.
- Ongoing monitoring of transactions
  Ongoing monitoring of customers' transactions helps banks to understand customers' activities and know the customers better. Unusual or suspicious activities could be detected.
- Updating of the sanctions database
  For example, the UN Security Council regularly publishes and updates the Sanctions List, a name list of individual targeted sanctions. These are also published by notice in the Government Gazette pursuant to the United Nations (Anti-Terrorism Measures) Ordinance. Furthermore, the U.S. State Department designates individuals and entities from time to time known as Specially Designated Global Terrorists (SDGT). Financial institutions should regularly check and ensure their database is up-to-date and easily accessible to staff.
- Staff training to prevent and detect financial crime
  Under Chapter 9 of the HKMA Guideline on Anti-Money Laundering and Counter-Terrorist Financing, it is stated that staff training is an important element of an effective system to prevent and detect ML/TF activities. The effective implementation of even a well-designed internal control system can be compromised if staff using the system are not adequately trained. Also, staff should be trained in what they need to do to carry out their particular roles in the FI with respect to AML/CFT. This is particularly important before new staff members commence work.
- Cooperation with government and regulatory authorities and the sharing of good practices in the banking industry.

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With the flourishing of financial technology (FinTech) firms in recent years and the increasing popularity of their services, this also gives an opportunity for financial crimes to apply to the new business models. A recent example is the Ezubao online peer-to-peer lending scam, a Ponzi scheme in China resulting in a total loss of about RMB 60 billion by more than 900,000 investors.

The regulators are therefore facing new challenges in having to strike a delicate balance between cracking down the illicit behavior and protecting FinTech investors and promoting economic growth and financial innovation. In the opening keynote speech at the HKIB Annual Banking Conference 2017, Mr Norman T.L. Chan, Chief Executive of the HKMA, made the following remarks[18]:-

"(D) Banking Made Easy

Another component of the new Smart Banking era is our "Banking Made Easy" initiative. We will set up a new task force within the HKMA and work with the banking industry to identify and, where appropriate, modify or streamline those regulatory requirements or processes that may hinder technological innovations. We will seek to clarify regulatory expectations, review our own guidance and rules to make them more user friendly, thereby facilitating innovations in products and services for better customer experience. Remote onboarding of customers and account maintenance are two such examples in which the use of new technology may lower operating costs and improve customer experience. We will also initiate legislative changes in our anti-money laundering laws and regulations so that a more risk-sensitive approach to remote customer onboarding can be undertaken.

We and the Hong Kong Association of Banks are now studying how to use know-your-customer (KYC) utility to conduct customer due diligence processes more efficiently. The HKMA is also considering the introduction of multiple tiers of bank accounts so that the process required for opening accounts for the low risk banking services can be simplified. In addition to customer onboarding and account maintenance, Banking Made Easy would seek to facilitate the use of technology in the areas of online finance, online wealth management and robo advisers.

[18] Norman T.L. Chan, 29 September 2017, *A New Era of Smart Banking*, Opening Keynote Speech at HKIB Annual Banking Conference 2017, Available at: http://www.hkma.gov.hk/eng/key-information/speech-speakers/ntlchan/20170929-1.shtml

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(F) Cross-border Collaboration in Fintech

As an international banking and funding centre, Hong Kong must promote the use of FinTech in managing cross border financial flows. The HKMA is in close dialogue with several authorities in other jurisdictions to collaborate in this area. As the first step of strengthening our cooperation within the Guangdong-Hong Kong-Macao Bay Area, we are partnering with Shenzhen to promote FinTech and talent developments. We are also discussing with other centres in the Bay Area to strengthen collaboration in FinTech. More details will be announced later.

Separately, the HKMA is working with the banking industry to develop a Distributed Ledger Technology (DLT) platform for digital trade finance. We also hope to be able to announce soon the details of our collaboration with Singapore in linking up our respective trade platforms. This DLT initiative, if implemented, should bring significant benefits to financiers, importers and exporters by enhancing the transparency of cross-border trade finance processes, improving operational efficiency and reducing the risk of frauds. …"

No matter how up-to-date the law is in protecting the investors, regulation is only part of the solution. Echoing Baroness Onora O'Neill that "More fundamentally, I worry that overuse of regulation leads to the equation "Legal = Right[19]", Mr Arthur Yuen in a speech at the HKIB Annual Banking Conference 2017[20] argued that ultimately it is more important to promote sound corporate culture that supports prudent risk management. Corporate culture is a driver of behaviour. It is the bank's responsibility to drive behavioural change towards prudent risk taking, high ethical standards and treating customers fairly.

[19] Baroness Onora O'Neill, "What is banking for?", Remarks at the FRBNY Conference on "Reforming Culture and Behavior in the Financial Services Industry: Expanding the Dialogue," 20 October 2016 In: Arthur Yuen, Post-crisis reforms: Have we done enough?, Available at http://www.hkma.gov.hk/media/eng/doc/key-information/speeches/20170929e1a1.pdf

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3. Chapter Summary

The main regulators in the financial industry are the Hong Kong Monetary Authority, the Securities and Futures Commission, the Insurance Authority and the Mandatory Provident Fund Authority. Each of them has different functions and regulatory powers given by their governing legislation.

In delivering financial services, banks are required to observe laws in the areas of anti-money laundering and counter financing of terrorism, tax evasion and other types of financial crime, suitability obligations, insider trading and other types of market misconduct, customer data privacy, consumer protection, equal opportunities, and anti-bribery and corruption.

The HKMA requires banking institutions to conduct customer due diligence (CDD) and maintain proper records to ensure proper implementation of controls to prevent money laundering and terrorist financing. Banks are required to take reasonable CCD measures to verify the customer's identity at the time of account opening and on an on-going basis.

In Hong Kong, the major legislation on AML and CFT are the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance (AMLO); the Drug Trafficking (Recovery of Proceeds) Ordinance (DTROP); the Organized and Serious Crimes Ordinance (OSCO); and the United Nations (Anti-Terrorism Measures) Ordinance (UNATMO).

When financial products are sold to customers, financial institutions are subject to 'suitability obligations', which require them to ensure that the products are suitable for the customers. The bank should, "when making a recommendation or solicitation, ensure the suitability of the recommendation or solicitation for that client is reasonable in all the circumstances." Banks must comply with the "know your client" ("KYC") requirement to seek information from their customers about their financial situation, investment experience and investment objectives for the purpose of assessing their risk tolerance.

Market misconduct under the SFO includes insider trading, false trading, price rigging, market manipulation, and disclosure of information about prohibited transactions.

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The objective of the Personal Data (Privacy) Ordinance is to protect the privacy rights of individuals in relation to personal data. Banks handling data should follow the Six Data Protection Principles in relation to handling personal data: the Data Collection Principle, Accuracy & Retention Principle, Data Use Principle, Data Security Principle, Openness Principle, and Data Access & Correction Principle.

The HKMA has worked with the industry to develop the Treat Customers Fairly ("TCF") Charter, which acts as a catalyst for fostering a stronger risk culture towards the fair treatment of customers. Retail banks in Hong Kong have signed up to the TCF Charter to show their commitment to and full support of the TCF principles, which promote consumer protection and education with a view to enhancing customer confidence and trust in banks for sustainable development of the banking industry.

The Equal Opportunities Commission has the duty to implement the Sex Discrimination Ordinance, the Disability Discrimination Ordinance, the Family Status Discrimination Ordinance, and the Race Discrimination Ordinance, collectively known as the anti-discrimination legislation in Hong Kong.

The main legislation regarding the prevention of bribery and corruption is the Prevention of Bribery Ordinance.

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5. Review Questions

1. The main legislation governing the insurance industry is the:

   A. Insurance Ordinance
   B. Insurance Companies Ordinance
   C. Insurance Amendment Ordinance
   D. Insurance Intermediaries Ordinance

2. Which of the following is not a main function of the Hong Kong Monetary Authority?

   A. Achieving monetary stability in Hong Kong.
   B. Regulating and supervising the banking business.
   C. Development of the status of Hong Kong as an international trading centre.
   D. Responsible for the investment management of the Exchange Fund.

3. Which of the following descriptions of the Hong Kong Securities and Futures Commission (SFC) is INCORRECT?

   A. The SFC is a public company to regulate Hong Kong's securities and futures markets.
   B. The SFC's regulatory powers are mainly derived from the Securities and Futures Ordinance.
   C. The SFC is responsible for the licensing of intermediaries engaged in the provision of investment services.
   D. The SFC is responsible for supervising intermediaries engaged in the provision of investment services.

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4. When financial or investment products such as stocks and shares are sold to retail customers, financial institutions are subject to 'suitability obligations', which require them to ensure that the products are suitable for the customers. This is a requirement under:

   A. The Code of Banking Practice
   B. The Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission
   C. The Supervisory Policy Manual
   D. The Code of Conduct and Practice

5. Which of the following is NOT one of the 6 data protection principles under the Personal Data (Privacy) Ordinance?

   A. Accuracy & Retention Principle
   B. Data Use Principle
   C. Data Security Principle
   D. Closeness Principle

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Answers:

Question 1: A

Question 2: C

Question 3: A

Question 4: B

Question 5: D

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Chapter 4

CORPORATE GOVERNANCE AND INTERNAL CONTROL

Learning outcomes:

Upon completion of this chapter, learners will be able to:

- Understand the importance of corporate governance in banks.
- Be familiar with the organisational structure of banks and its relationship with corporate governance.
- Explain the approaches to internal control and auditing, and be aware of the issues which may arise.
- Describe the relationship between CG6 "Competence and Ethical Behaviour" and the Enhanced Competency Framework (ECF).

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Chapter 4 Terminology

AI	Authorised Institution
ALCO	Asset and Liability Committee
ECF	Enhanced Competency Framework
HKIB	The Hong Kong Institute of Bankers
HKMA	Hong Kong Monetary Authority
HKSI	Hong Kong Securities and Investment Institute
INED	Independent Non-executive Directors
MA	HKMA, Hong Kong Monetary Authority
PWM	private wealth management
PWMA	Private Wealth Management Association
QF	Qualification Framework
SBU	corporation's strategic business units
TMA	Treasury Markets Association

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1. Corporate Governance

1.1 Introduction

In order for a company to be considered ethical, all employees must behave ethically as a whole. In some cases, the board of directors of a company may behave very ethically but some employees may not, putting the company at risk. A handful of bad apples can ruin the whole company, no matter how stellar the others are. To mitigate this type of risk, internal controls are necessary in the following two areas:

- Compliance – a company should ensure its employees comply with all applicable laws and regulations. Non-compliance may have undesirable results such as fines, revocation of business licences or litigation, and reputational damage.
- Corporate governance – internal controls help to keep business decisions and practices in line with the company's objectives and strategies. Controls can be especially useful in helping corporations achieve their corporate social responsibility goals.

Corporate governance, as discussed earlier, is essential in building ethical organisations. Clear job responsibilities, appropriate checks and balances, internal controls, compliance procedures and internal auditing are all effective in preventing employees from committing fraudulent or unethical acts.

Corporate governance became a hot topic after Michael Jensen and William Meckling proposed the 'agency theory' in 1976 in their paper 'A Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure'. The Theory states that company ownership and management are segregated in capitalist societies: shareholders are the principals who own the company, while managers are the agents employed by the principals to maximise their interests. Agents tend to know the company better, and may abuse its resources for their own benefit, at the expense of the principals. When such a situation occurs, the company bears an 'agency cost', reflected in:

- a lower share price
- a lower bond price (i.e. a higher borrowing cost)
- the cost of external and internal audits.

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To tackle the agency problem, corporations can consider the following options:

- nominating independent directors who can monitor the company on behalf of ordinary shareholders
- developing remuneration packages for the agents that align their interests with those of the shareholders
- strengthening internal control and external auditing procedures.

In the early 2000s, the collapse of two giant corporations in the USA, Enron and Worldcom, made corporate governance a serious concern in the capital market: both collapses were associated with internal fraud by senior management. To restore public confidence in the stock market, the Sarbanes-Oxley Act was passed in 2002. The Act requires that senior executives, such as the CEO and CFO, must certify and approve the integrity of their financial reports, and that corporations adopt higher standards on reporting their financial transactions, including off-balance-sheet transactions, pro-forma figures and stock transactions of corporate officers. If senior executives manipulate, change or destroy the financial records of their companies, it is regarded as a criminal act.

Ethical issues in corporate governance

Corporate governance plays an important role in encouraging ethical and social responsibility. The following are some examples of how this can be done:

- putting systems in place to ensure employees comply with relevant laws and regulations;
- creating clear codes of conduct for employees to guide them regarding good business practices;
- expecting senior executives to balance profit and corporate social responsibility;
- expecting senior executives to behave ethically in running the company;
- expecting senior executives to consider environmental issues when conducting business.

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1.2 Structure of banks

1.2.1 Organisational structure

Board of directors and senior management

There is no legal requirement for a particular organisational structure for banks. The structure differs from bank to bank. Typically, the brain of the bank is the board of directors. Assisting the board are the Board Committees, such as the Executive Committee, Audit Committee, Risk Committee, Remuneration Committee and Nomination Committee and each plays a specific supervisory role (see Specialised Committees below).

The board of directors delegate part of their management functions, especially the day-to-day operations, to the senior management team. The latter could be composed of, for example, the Chief Executive Officer, General Manager, Head of Commercial Banking, Head of Retail Banking, Head of Wealth Management, Head of Human Resources, Chief Operating Officer, Chief Risk Officer, Chief Information Officer and Chief Financial Officer. Some of them are also Executive Directors.

Functional management

Banks usually adopt a functional organisational structure and divide their operations into functional areas, such as finance, marketing operations and administration, or by product types such as trade finance, leasing, retail or corporate lending and credit cards. Management is conducted through clear lines of authority, ultimately reporting to the head in the hierarchy. Functional management requires collaboration between departments in order to meet the overall objectives and missions of the bank. One of the key factors in successful collaboration is effective communication. If the functional areas are working in 'silos' and restricting communication with other departments, this inhibits cooperation and teamwork within the organisation as a whole. To promote better communication and synergy, many banks in Hong Kong supplement traditional functional management with strategic approach management.

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Strategic management

Strategic management is the process of defining a company's mission, vision and objectives, developing policies and plans to achieve these objectives, then allocating resources to implement the policies and plans. This type of management involves ongoing evaluation and control of the business. It assesses a situation, sets goals and strategies, then reassesses those strategies regularly to determine how well they have been implemented and whether anything needs to be changed.

Strategic management is the highest of the levels of management in a corporation as it defines the corporate value, culture, goals and missions. Under this broad corporate strategy are: Business strategies; Operational strategies and Functional strategies.

Business strategies are the aggregated strategies of each of the corporation's strategic business units (SBUs) – profit centres that have their own budgets and make decisions about new products, hiring and prices. Strategies regarding focus, differentiation and cost leadership must be developed by each SBU in order to achieve a competitive advantage and success.

Operational strategies fall under the SBU's business strategies and relate to their day-to-day operational activities. Each SBU operates within a budget set by the company's senior management.

Functional strategies can include strategies on marketing, product development, human resources, finance, legal issues and information technology. These strategies have a short- and medium-term focus on a department's functional responsibility. As the department has to accomplish its part in meeting the overall corporate objectives, its strategies are derived to a certain extent from the broader corporate strategies.

Front, middle and back offices

Banks may divide their activities into front offices, middle offices and back offices.

Front offices are the business units generating revenue for the banks. They may include:

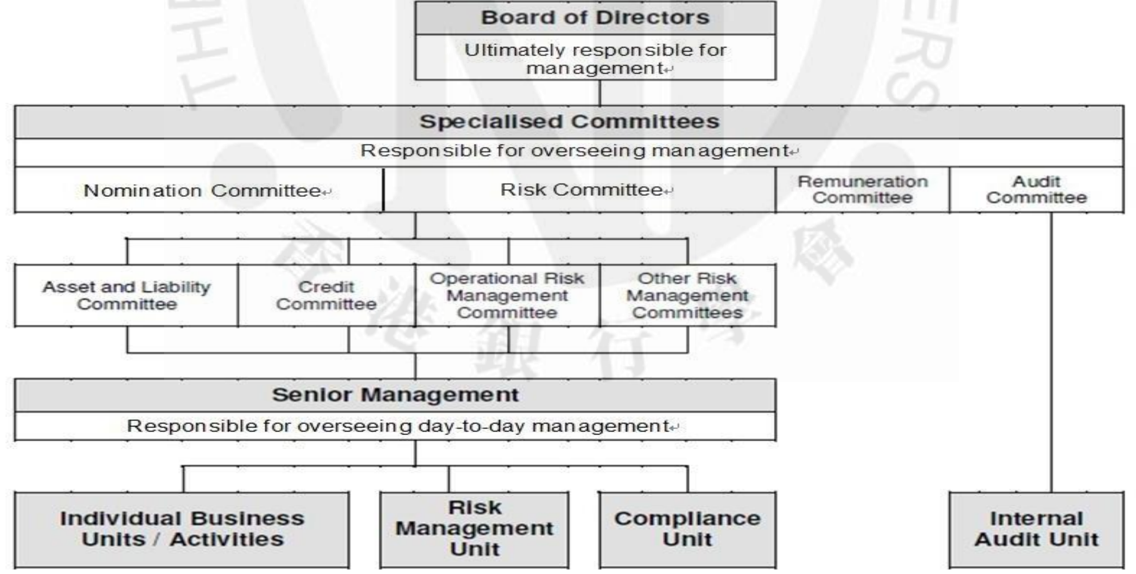
- A marketing team, selling products and services;

- A wealth management team providing clients with investment services;
- Branch offices for distributing services and products: taking deposits, accepting loan applications, selling insurance and investment products and so on;
- A team of traders and dealers who quote bid/ask prices to clients for investment transactions and may also take positions on behalf of the bank in order to earn trading profits;
- A brokerage service, earning commissions from clients' investment transactions.

Middle offices support the operation of the front offices and they may include:

- A risk management team, monitoring the risks incurred by the bank's business units and advising them on how to manage and mitigate them;
- A financial control team, analysing the bank's cash flows and carrying out capital and performance planning;
- A compliance team, aiming to ensure that all business units comply with relevant laws and regulations.

Back offices support all other offices, and include teams dealing with accounting, settlement, information technology, operations, human resources and so on.



A typical management system [1]

[1] Adopted from Supervisory Policy Manual, IC-1,Risk Management Framework" (under consultation), HKMA, Page 7. Retrieved on 6 October 2017 at http://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/supervisory-policy-manual/IC-1.pdf

1.2.2 The board

In a company with a strong corporate governance culture, the board of directors has the highest authority. The board must have oversight on all the company's policies, and ensure that they are implemented professionally. As the board is ultimately responsible for all business decisions, it should also ensure that the company is managed by competent staff.

The HKMA has issued guidelines on the corporate governance of banks in Hong Kong. Table 1 below describes some of the responsibilities of the board of directors listed in those guidelines. Full details of the responsibilities of directors can be found in the module CG-1 'Corporate Governance of Locally Incorporated Authorized Institutions' of the Supervisory Policy Manual issued by the HKMA. Where the authorised institution is also a listed company in Hong Kong, it has to consider Appendix 14 of the Listing Rules - Corporate Governance Code and Corporate Governance Report.

TABLE 1 The responsibilities of the board of directors according to the HKMA (Source: HKMA, Supervisory Policy Manual, CG-1 'Corporate Governance of Locally Incorporated Authorized Institutions' Section 2 - Responsibilities of the board)

2.1.1 The board of an AI[2] is ultimately responsible for the operations and financial soundness of the AI. In discharging its responsibilities, the board should be actively engaged in the affairs of the AI and cognizant of material changes in the AI's business and the external environment in which the AI operates. Decisions of the board should be taken in a timely manner, having regard to the legitimate interests of shareholders, depositors and other relevant stakeholders.

2.1.2 Individual members of the board should act bona fide in the interest of the AI, and on an informed and prudent basis, in accordance with applicable laws, regulations and supervisory standards.

2.2.1 The key responsibilities of the board of an AI include

(i) setting and overseeing the objectives of the AI and the strategies for achieving those objectives;

[2] 'AI' refers to banking institutions authorised by the HKMA

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(ii) establishing and overseeing risk governance;
(iii) appointment and oversight of senior management;
(iv) setting corporate values and standards;
(v) overseeing the remuneration policy;
(vi) ensuring a suitable and transparent corporate structure;
(vii) ensuring effective audit functions; and
(viii) ensuring an appropriate degree of transparency in respect of the structure, operation and risk management of the institution."

Many countries require listed companies to have at least two or three independent directors who are credible and capable business executives, as independent and non-executive directors who can provide effective checks and balances on the powers of executive directors. They can also make sure the company has appropriate business objectives and will balance profit and corporate social responsibility appropriately. In December 2016, the HKMA issued a circular providing guidance on the empowerment of Independent Non-Executive Directors (INEDs) in the banking industry in Hong Kong. This covers the role of INEDs, the practices of locally-incorporated authorised institutions with regard to INEDs, and measures recommended to be taken by authorised institutions to ensure there are sufficient suitably qualified people willing to serve as INEDs on their boards.

For details, see:
https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2016/20161214e1.pdf

1.2.3 Specialised committees

The board of directors may delegate some of their roles and functions to specialised committees. CG1 'Corporate Governance of Locally Incorporated Authorized Institutions' of the HKMA's Supervisory Policy Manual states the objectives, composition and qualification requirements of these specialised committees. The relevant sections of CG1 (draft version 3[3]) have been extracted below.

[3] Version 3 of Module CG1 was issued on 30.08.2016 and at the time of writing, it is still under consultation with the industry.

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5.1 Objectives and practices

The board is ultimately responsible for the conduct of an AI's affairs. The oversight of certain major functional areas can be delegated to specialized committees, such as the nomination committee, audit committee, risk committee and remuneration committee. These committees have clear objectives and terms of reference, authorities, responsibilities, membership, tenure limit and working procedures. Each specialized committee should be provided with sufficient resources to perform its duties.

The specialized committees have an optimal mix of skills and experience from members. There should be a sufficient number of Independent Non-executive Directors (INED) and be chaired by an INED. There should be a regular and transparent communication mechanism between the board and the specialized committees and between committee and committee to ensure continuous and robust dialogue, information sharing, consistency and compatibility in actions and minimise any potential for gaps.

Each specialized committee should maintain appropriate records of its decisions and they should report regularly (at least quarterly) to the board on its decisions and recommendations.

Specific requirements

5.2 Nomination Committee

The board of each licensed bank and any other AI which may be designated by the MA under §3S or §3U of the Banking (Capital) Rules as systemically important should establish a nomination committee. The majority of the nomination committee members (including the chair) should be INEDs.

The key objectives of the nomination committee include the following:

- identifying individuals suitably qualified to become members of the board or of senior management, and selecting, or making recommendations to the board on the selection of, individuals nominated for directorships and senior management positions; and
- making recommendations to the board on the appointment or re-appointment of directors and succession planning for directors, in particular the chair and the chief executive.

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The nomination committee may also undertake board performance evaluation to assist the board in reviewing the efficiency and effectiveness of the functioning of the board. The nomination committee should ensure objectivity and independence in the selection process for board members and senior management.

5.3 Audit Committee

An audit committee should be made up of non-executive directors, the majority including the chair are INEDs. The chair should be an INED with an accounting or financial background. To ensure independence, the chair of the audit committee should not also be the chair of the board or of any other committee.

The audit committee as a whole should have adequate experience in audit practices, financial reporting and accounting and should possess a collective balance of skills and expertise which is commensurate with the complexity of an AI and its business and risk profile in order to ensure it is in a position to discharge its responsibilities effectively. Where necessary, it should have access to external expert advice at the AI’s expense. See IC-2 for the responsibilities of the audit committee.

5.4 Risk Committee

The risk committee should be distinct from the audit committee. The risk committee should be chaired by an INED with an accounting or financial background or expertise in risk management. The chair of the risk committee should not be the same person as the chair of the board or of any other committee. The majority of the members of the risk management committee should be INEDs.

The risk committee should interact regularly with, and oversee, the chief risk officer. The committee should also receive regular risk reports from, the AI’s risk management function and chief risk officer.

See IC-1 for the responsibilities of the risk committee.

5.5 Remuneration Committee

The remuneration committee should be chaired by an INED. The other committee members should be INEDs or, where executive directors are to be members of the committee, the committee should comprise a majority of INEDs.

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The remuneration committee should assist the board in discharging its responsibility for the design and operation of the AI's remuneration system, and make recommendations in respect of remuneration policy and practices to the board.

The remuneration committee should:

(i) make recommendations to the board in respect of the remuneration packages for the bank's senior management and Key Personnel in cases where the approval authority for such remuneration packages rests solely with the board;

(ii) ensure that remuneration is appropriate and consistent with the AI's culture, long-term business and risk appetite, performance and control environment as well as with any legal or regulatory requirements; and

(iii) work closely with the risk committee in evaluating incentives created by the remuneration system.

Other commonly used specialised committees

Executive Committee

The Executive Committee usually handles matters which require the board's review, but which arise between full board meetings and is used most commonly in large banking institutions. It can relieve the full board of detailed review of information and operational activities. Generally, all major functions of the AI will be subject to review and approval by this Committee, and the work of the other board committees will be coordinated by it.

Credit Committee

The Credit Committee ensures that the AI's lending policies are adequate and lending activities are conducted in accordance with established policies and relevant laws and regulations. It also serves the vital role of monitoring loan portfolio quality and ensures that management follows adequate procedures to identify problems early, recognise adverse trends, take appropriate corrective actions and maintain adequate provisions for loan losses. It should pay particular attention to the procedures for monitoring compliance with statutory lending limits.

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Asset and Liability Committee ("ALCO")

The ALCO is an important feature in the effective management of the assets and liabilities of an AI. The most fundamental function of the ALCO is to oversee the AI's operations relating to interest rate risk and liquidity risk and in particular to ensure that the AI has adequate funds to meet its obligations. Other functions of the ALCO will be dependent on the AI's size and assets/liabilities mix. It is essential to have a balanced representation in the ALCO covering both the assets and liabilities sides of the balance sheet. The ALCO is therefore composed of the senior staff of the AI including usually the chief executive, the chief financial officer, the treasurer, the chief risk officer, and the officer in charge of deposit-taking. Other members such as division heads of corporate and retail banking may also be found in the ALCOs of larger banks.

Corporate Governance Committee

The Corporate Governance Committee helps ensure that an AI devotes sufficient attention, time and resources to compliance. It should develop and regularly review the AI's compliance with legal, regulatory and corporate governance standards and make recommendations to the board. The committee should have a majority of INEDs as its members, and at least one member should be an executive director or non-executive director with sufficient knowledge of the AI's day-to-day operations.

Ethics and Compliance Committee

The Ethics and Compliance Committee helps ensure that an AI has the appropriate means for promoting proper decision-making, due consideration of the risks to the AI's reputation, and compliance with laws, regulations and internal rules.

1.3 Stakeholders in corporate governance

Traditionally, shareholders were regarded as the primary stakeholders in corporate governance. The Stakeholder Theory of Edward Freeman proposed that stakeholders comprise investors, employers, suppliers and customers as their interests are closely aligned with those of the corporation. In 1981, A.L. Mendelow proposed a way to analyse how much 'power' and 'interest' each of a corporation's stakeholders have to influence its objectives and strategies, i.e. 'Influence' = 'power' x 'interest'. Hence corporations

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may pay more attention to those stakeholders who have significant interest and significant power—the equivalent of strong influence.

Nowadays, the concept of stakeholders extends to many other parties, including employees, bondholders, creditors, suppliers, customers and potential clients, professional associations & trade groups, governments & regulators, and society as a whole. No one can underestimate the influence of any one of the stakeholders.

The Lehman Brothers' incident in Hong Kong is a good example to show the power of bank customers whose demonstrations and petitions placed enormous pressure on the government, bank regulators, and related banks that had sold Lehman Brothers' high-risk products.

If a company is poorly managed or collapses, all stakeholders will become victims. Shareholders and bondholders will definitely lose; suppliers will be unable to collect their account receivables; employees will lose their jobs; and customers will receive low-quality products or services, if they receive them at all. Governments will lose tax revenue and may have to bail out a company on the brink of collapse where this will have a significant impact on the economy.

1.4 Implications of CG6 and ECF

Under CG6 "Competence and Ethical Behaviour" of the HKMA's Supervisory Policy Manual, Authorised Institutions (AIs) should engage and deploy personnel with sufficient skills, knowledge, experience and soundness of judgement for the discharge of the particular duties and responsibilities allocated to them. The board of directors (the board) of an AI is ultimately responsible for ensuring that the AI's business is conducted with integrity, prudence and the appropriate degree of professional competence. The senior management of an AI should ensure that appropriate policies and procedures are put in place, among others, to assess the competence of new staff; to monitor and assess whether the knowledge, skills and performance of staff members remain appropriate to ensure their competence on an ongoing basis; and to provide relevant staff training to ensure continuing competence.

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The HKMA has launched an Enhanced Competency Framework (ECF) which is a non-statutory framework to support talent development, raise professional core competence and enhance ongoing professional development of banking staff in Hong Kong.

The ECF generally covers areas that are central to the safety and soundness of the banking sector. Currently the following areas have been identified: Anti-Money Laundering and Counter-Financing of Terrorism; Cybersecurity; Credit Risk Management; Private Wealth Management; Retail Wealth Management; Risk Management and Compliance; and Treasury Management. Individual modules are rolled out on a gradual basis.[4] For example, on 24 June 2014, with the general support from the industry, the ECF for private wealth management (PWM) practitioners was launched. This was developed as a result of the work of a Task Force led by the HKMA and comprised members from the Private Wealth Management Association (PWMA), The Hong Kong Institute of Bankers (HKIB), the Hong Kong Securities and Investment Institute (HKSI), and the Treasury Markets Association (TMA).

Paragraph 2.5 of CG6 Competence and Ethical Behaviour[5] of the HKMA's Supervisory Policy Manual provides that when developing policies and training plans to ensure staff competence, AIs are strongly encouraged to refer to the ECF, where applicable and available as a benchmark. For areas other than those covered under the ECF, AIs may make reference to other benchmarks as they deem appropriate, such as the Qualification Framework (QF) established by the Government of the Hong Kong Special Administrative Region.

Paragraph 3.1 continues to state that AIs should implement a control process to assess the competence of their staff. Where applicable, AIs are strongly encouraged to adopt the ECF as a benchmark. An initial assessment should be made upon the staff member assuming a particular post (whether following initial recruitment or internal transfer) in the light of both the role to be performed and the level of supervision and support to be provided to the individual concerned. The initial assessment process is likely to vary depending upon the

[4] Extracted from FN5 of Version 2 of the CG-6 Competence and Ethical Behaviour of the HKMA's Supervisory Policy Manual
[5] Version 2 of the CG-6 Competence and Ethical Behaviour of the HKMA's Supervisory Policy Manual was issued on 08.12.2017.
https://www.hkma.gov.hk/eng/key-functions/international-financial-centre/soft-infrastructure/enhanced-competency-framework/

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seniority of the employees concerned and the job functions or activities proposed to be allocated to them. Thereafter, the competence of employees should be monitored on an ongoing basis.

In future, when AIs develop and document corresponding competence criteria covering the skills, knowledge and professional qualifications required for individual posts within the AI, qualifications, such as the ECF certification, which are based on occupational standards will be considered. AIs are also expected to facilitate the undertaking by relevant staff of the continuous professional training courses or activities required under the ECF or by the TMA and other comparable professional bodies.

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2. Internal Controls

Internal controls are essential for risk management and building ethical corporations, as they ensure compliance with laws and effective corporate governance.

A manager of an authorized institution, as defined under section 2 of the Banking Ordinance, should be principally responsible for the conduct of the affairs or business of the institution and this includes, among others, maintaining systems of control of an authorized institution, including those systems intended to manage the risks of the institution, and the conduct of internal audits or inspections of the institution's affairs or business (Schedule 14 of the Banking Ordinance).

According to the HKMA Supervisory Policy Manual IC-1 “Risk Management Framework”, sound internal control relies on effective risk governance, i.e. strategic planning with risk management controls built on a bank’s risk appetite. Complementary to an effective governance and internal control system, a bank should also implement good integrity management through, for example, ethical leadership, education, training, probity requirements for business partners, reliable reporting channels, clear internal investigation procedures and compliance with the Code of Conduct.

An effective risk governance framework broadly consists of the following major functions currently established by banking:

1. Internal control
2. Compliance
3. Internal audit
4. Risk management

We shall discuss these functions in turn in the following sections.

2.1 Elements of internal control systems

A sound internal control system is part of an effective risk management framework. It should be fully supported by the board and senior management. The internal audit function should also regularly evaluate its effectiveness on an ongoing basis.

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Under Module SA-1 “Risk-based Supervisory Approach” of the HKMA Supervisory Policy Manual, the following factors should be considered in evaluating the adequacy of the internal control environment:

- the appropriateness of the system of internal controls in relation to the type and level of risks posed by the nature and scope of the AI's business activities and products;
- whether the AI's organisational structure establishes adequately clear lines of authority and responsibility for monitoring compliance with policies, procedures and limits;
- whether reporting lines provide for sufficient independence of the control functions from the business areas, as well as adequate segregation of duties throughout the organisation (such as those relating to trading, custodial and back-office operations or loan origination, marketing and processing);
- whether the official organisational structure reflects actual operating practices;
- the reliability, accuracy and timeliness of all financial, operational and regulatory reports;
- the adequacy of procedures for ensuring compliance with applicable laws, regulations, and internal policies and procedures;
- the effectiveness, independence and objectivity of internal audit or other control and review procedures in providing adequate coverage of the AI’s operations;
- whether internal controls and information systems are adequately tested and reviewed;
- whether the coverage, procedures, findings and management responses to audits are adequately documented; and
- whether identified material weaknesses are given appropriate and timely high-level attention, and management’s actions to correct material deficiencies are objectively verified and reviewed. (Paragraph 3.5.3 of the SA-1 Risk-based Supervisory Approach)

2.2 Attributes of an effective control system

Module IC-1 “Risk Management Framework” of the HKMA Supervisory Policy Manual further explains that an AI’s internal control system should, at a minimum, cover the following:

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- high level controls, including clear delegation of authority, written policies and procedures, separation of critical functions (e.g. marketing, risk management, accounting, settlement, audit and compliance);
- controls relating to major functional areas, including retail banking, corporate banking, institutional banking, private banking and treasury. Such controls should include segregation of duties, authorisation and approval, limit monitoring, physical access controls, etc.;
- controls relating to financial accounting (e.g. reconciliation of nostro accounts and review of suspense accounts), annual budgeting, management reporting and compilation of prudential returns to the regulators;
- controls relating to information technology;
- controls relating to outsourced activities, where applicable;
- controls relating to compliance with statutory and regulatory requirements (including but not limited to those relating to anti-money laundering and counter-terrorist financing.)

(Paragraph 6.1.3 of the HKMA Supervisory Policy Manual IC-1 "Risk Management Framework").

For further details, please read Module IC-1 "Risk Management Framework" of the Supervisory Policy Manual.

2.3 Risk management

To enable effective risk management, financial institutions should have in place a robust risk governance framework, whereby:

- responsibilities of the board and senior management, and among different functions of the institution, are well defined;
- escalation and notification procedures, as well as disciplinary actions for excessive risk-taking, are provided for; and
- responsibilities among different functions are defined in such a way that there are three lines of defence (detailed below) which are independent from each other.

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Effective risk management requires a strong risk culture in promoting risk awareness and encouraging open communication and challenge with regard to risk-taking across all levels of staff and management. Any obstacles that impede the sharing of information should be avoided, for example, incompatible IT systems or competition among business lines.

For more detailed information, please refer to the HKMA Supervisory Policy Manual IC-1 "Risk Management Framework".

Three Lines of Defense Figure 1

Governing Body / Audit Comittee
Senior Management
1st Line of Defence
2nd Line of Defence
3rd Line of Defence
Management Controls
Internal Control Measures
Financial Controller
Security
Risk Management
Quality
Inspection
Compliance
Internal Audit
External Audit
Regulator
[6]

First Line

The first line of defence is provided by the business units where risks are taken. They are responsible and accountable for the proper identification, assessment, management and reporting of risk exposures on an ongoing basis, having regard to the institution's risk appetite, policies, procedures and controls. Examples of the business units include front offices such as the Retail and Corporate Banking Departments and the Commercial Lending Department, as well as back office operations such as remittance units, loan operations, etc.

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[6]IAAA. (2013 January). THE THREE LINES OF DEFENSE IN EFFECTIVE RISK MANAGEMENT AND CONTROL. Retrieved 2020, from https://na.theiia.org/standards-guidance/Public%20Documents/PP%20The%20Three%20Lines%20of%20Defense%20in%20Effective%20Risk%20Management%20and%20Control.pdf

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Second Line

The second line of defence is provided by the independent and effective risk management and compliance functions. The risk management function oversees the financial institution's risk-taking activities and undertakes risk assessments independently from the business line, while the compliance function monitors compliance with laws, regulations, corporate governance rules and internal policies. Examples are the Credit Risk Management Department and Compliance Department.

Third Line

The third line of defence is provided by an independent and effective internal audit function giving assurance on the effectiveness of the financial institution's risk management framework including the first and second lines of defence.[7]

2.4 Compliance

Following past financial crises, in particular the 2008 incidents mentioned in the previous chapter, banks have reviewed, revamped and strengthened their compliance functions.

In the past, many banks' legal and compliance functions were structured in one department and as one function. Relevant authorities, with hindsight to better the protection of customers and investors, advised financial institutions to separate the legal function from the compliance function. Nowadays, many international banks have independent central compliance units taking care of and ensuring proper compliance with legislation, rules and regulations, internal policies and procedures.

According to the HKMA Supervisory Manual Policy IC-1 (Risk Management Framework), the primary role of a financial institution's compliance function is to ensure compliance with

[7] A fourth line of defence has been suggested to include external auditors and supervisory bodies, Arndorfer I and Minto, A, (2015) The "four lines of defence model" for financial institutions, Occasional Paper No 11, Bank for International Settlements

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the statutory provisions, regulatory requirements and codes of practice or conduct applicable to its banking or other regulated activities, and the institution's internal policies and procedures. The work of the compliance function should be subject to periodic reviews by the internal audit function.

Major responsibilities of a compliance function include identifying, assessing and monitoring compliance risk, advising senior management and staff on the statutory, regulatory and other compliance requirements and ensuring compliance, establishing compliance procedures and guidelines and ensuring they are effective, providing compliance-related advice and training to staff, and establishing a compliance programme that sets out its planned activities.

An effective compliance function should:

- have adequate resources and be staffed by an appropriate number of competent staff who are sufficiently independent of the business and operating units;
- be given appropriate standing and authority within the AI. It should report directly to a designated committee of the board (e.g. the Audit Committee) or senior management, and have the right to report matters to the board directly as necessary;
- be able to carry out its duties on its own initiative in all business and operating units of the AI in which compliance risk exists, with unfettered access to any records or files necessary to enable it to conduct its work.

2.5 Internal audit

Internal audits are periodic independent checks on whether internal policies and procedures are being properly implemented, and whether laws and regulations as well as internal policies and procedures are being complied with to reduce risk.

According to the HKMA Supervisory Policy Manual IC-2 (Internal Audit Function), an effective internal audit function is accountable to the board of directors (through the board's Audit Committee) and assists the board and senior management in managing effective internal control systems by providing independent assessments and assurance on the financial institution's internal control systems.

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An internal audit ensures risk management mechanisms are in place effectively, financial and management information is reliable and accurate with timely regulatory reporting, and effective information systems are in place. Independent assessments should also be made to ensure the efficiency of operations through testing of both transactions and the functioning of specific internal control procedures and the effectiveness of related systems.

The scope and frequency recommended for internal audits vary, but should be adjusted and increased depending on the circumstances, e.g. significant weaknesses/risks are found, major changes are planned or new products are introduced.

To carry out an effective internal audit, auditors should:

- have the authority to choose which departments, business products or activities are to be audited;
- have authority to access relevant records, documents and systems;
- be given appropriate independence and status so as to ensure that senior management react to and act upon their recommendations;
- be given sufficient resources and staff with the necessary training, expertise and experience to carry out auditing functions;
- be able to assess the risk management functions;
- follow up on remedial plans and/or actions recommended to be taken by the audited units by a specified time line.

For more detailed information, please refer to the HKMA Supervisory Policy Manual IC-2 "Internal audit function."

2.6 Costs & benefits of internal control

A sound internal control system is an important element in the risk management framework and it is costly. The expenses used in internal control are more direct and visible. However, a properly structured and effective internal control system has a number of benefits, which are mostly indirect. It should:

- help to promote effective and efficient operation (for example, there will be fewer errors);

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- provide reliable financial information (and thus more accurate information is provided to investors for decision-making);
- safeguard assets and maintain the faith of investors and customers;
- minimise the operating risk of loss from irregularities, fraud and errors (and with fewer complaints from customers, increase customer satisfaction and preserve the institution's reputation);
- ensure effective risk management systems (and improve overall corporate governance); and
- ensure compliance with relevant laws, regulations and internal policies (and hence minimise the legal, regulatory and reputation risk and the cost of litigation.) (Paragraph 6.1.2 of Module IC-1 "Risk Management Framework" of the HKMA Supervisory Policy Manual).

Many past scandals in the banking sector such as rogue trader scandals were related to weaknesses in internal controls. A single loophole in internal control procedures can allow a bank to collapse, such as the fall of Barings in 1995, and the huge losses incurred by Société Générale in 2008 and UBS in 2011.

However, some argue that the cost of implementing internal control should not exceed its expected benefit. Whether an internal control system is appropriate or not also depends on the type and level of risks of the business activities of the AIs. Normally, a company assesses the probability of different risk events and their potential impact. Events that happen frequently or have a large impact should be subject to stronger internal control procedures which are inevitably more costly.

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3. Chapter Summary

Corporate governance helps build ethical organisations, by clarifying job responsibilities and using checks and balances, internal controls and internal audits.

Corporations should consider the interests of all their stakeholders, including employees, shareholders, bondholders, creditors, suppliers, customers and governments.

The board of directors of an authorised institution plays an important role in ensuring sound corporate governance. The board should ensure the establishment of policies, procedures and controls to manage the risks with which a bank is faced.

Assisting the board are the Board Committees, such as the Executive Committee, Audit Committee, Risk Committee, Remuneration Committee and Nomination Committee, and each plays specific supervisory roles.

A company's board is composed of executive, non-executive and independent directors. A board of directors that upholds corporate & social responsibility will pay senior executives remuneration based on a balanced scorecard assessment.

Internal controls are essential for building ethical corporations, as they ensure compliance with laws and regulations and effective corporate governance. They are an essential part of the risk management framework.

Sound internal controls have clear objectives and written procedures, and effective risk management, with compliance and internal audit functions in place. A sound internal control system is costly but will bring a number of intangible benefits to the institutions.

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5. Review Questions

1. Which of the following is an example of the role of middle offices?

   A. Branch offices for distributing services and products.
   B. An investment trading team of traders and dealers who quote bid/ask prices to clients for investment transactions.
   C. A brokerage service, earning commissions from clients' investment transactions.
   D. A risk management team, monitoring the risks incurred by the bank's business units and advising them on how to manage and mitigate it.

2. Which of the following is a key objective of the nomination committee?

   A. Identifying individuals suitably qualified to become members of the board.
   B. Making recommendations to the board on the removal of directors.
   C. Assist the board in discharging its responsibility for the design and operation of the AI's remuneration system.
   D. Making recommendations in respect of remuneration policy and practices to the board.

3. The Enhanced Competency Framework (ECF) is a qualification or competence benchmark for:

   A. Accountants
   B. Banking practitioners
   C. Financial advisors
   D. All money brokers

4. Which of the following is an example of the third line of defence?

   A. Provided by staff and managers working in the revenue generating units.
   B. Provided by the independent risk management function.
   C. Provided by the independent internal audit team.
   D. Provided by the independent external audit team.

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5. Which of the following is NOT a benefit of an effective internal control?

   A. Annual profit growth
   B. Minimise the operating risk
   C. Ensure effective risk management systems
   D. Ensure compliance with relevant laws

Answers:

Question 1: D

Question 2: A

Question 3: B

Question 4: C

Question 5: A

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6. Further Reading

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PROFESSIONAL ETHICS AND COMPLIANCE

About the Study Guide

This Study Guide provides a solid background and comprehensive overview of the various facets of the banking service sectors, including its system structure, the codes, regulations and ordinances binding practitioners in this sector, the different operations and areas as well as the risk management aspects. Major areas of professional ethics and issues faced by individuals and corporations today, as well as its relevance in the context of corporate governance will also be explored. Such element of professional ethical issues pertaining to the different facets of understanding is very essential to the current banking environment in Hong Kong and in the world.

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