SECURITIES AND FUTURES COMMISSION
證券及期貨事務監察委員會

Mystery Shopping Programme Findings

May 2011

Executive Summary

1. To complement its regulatory activities, the Securities and Futures Commission (the SFC) has engaged the Hong Kong Productivity Council[1] to carry out a mystery shopping exercise (the Exercise), which focuses on the selling practices of licensed corporations involving unlisted securities and futures investment products (Securities Products). The Exercise covers three key areas, namely know-your-client (KYC), explanation of product features and disclosure of risks, and suitability assessment.

2. The Exercise was carried out between July and November 2010. During the period, a total of 150 samples[2] were conducted on 10 selected licensed corporations (with 15 samples each). The SFC selected both investment advisory firms and brokerage firms that sell Securities Products to retail customers, including walk-in customers. A report (the Report) summarising the findings on the selling practices of these selected firms is enclosed (see Appendix).

3. The Exercise revealed that the selected firms generally complied with the KYC requirements, although in two instances, the practices of sales staff of a firm were found to have undermined the KYC process.

4. The Exercise has shown that there are gaps in the quality of explanation of features and disclosure of risks concerning the products recommended. Unsatisfactory practices were found in 16% of the cases where products were recommended to shoppers[3]. These included sales staff demonstrating insufficient understanding of the recommended products and the provision of insufficient or even inaccurate information to the shoppers. In this regard, licensed corporations must pay due regard to the needs of their clients and to help them make informed decisions by providing appropriate and accurate information to them.

5. There is also room for improvement in respect of the suitability assessments carried out by the selected firms. It was noted in some instances that the sales staff did not take into account all the relevant personal circumstances of the shoppers when making the recommendation. In addition, the sales staff generally did not sufficiently explain why the products were suitable for the shoppers having regard to their individual circumstances.

Key Findings

Know-Your-Client

6. Intermediaries are required under the Code of Conduct[4] to seek information from clients about their financial situation, investment experience and investment objectives. In order to better understand this client information, intermediaries are also required to collect from each client information about their investment knowledge, investment horizon and risk tolerance, etc[5].

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[1] This was a joint engagement with the Hong Kong Monetary Authority

[2] "Sample" in this paper refers to each instance where a "shopper" acts as a potential customer to gather information on the sales process of a licensed corporation

[3] "Shopper" in this paper refers to a person recruited by the service provider to act as a potential customer of the firm in question

[4] Paragraph 5.1 of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (Code of Conduct)

[5] Question 2 of the Questions and Answers on Suitability Obligations (Suitability FAQs) issued by the SFC on 8 May 2007

7. The findings of the Exercise revealed that while the selected firms generally complied with the KYC requirements, there was room for improvement in this area for some of them.

(i) Undermining KYC process

8. In two instances, sales staff from a firm were found to guide or hint to the shoppers to change their answers in the risk profile questionnaires so that a wider range of products could be recommended to them (see paragraph 25 of the Report). Deficient KYC and risk profile assessment would result in recommending unsuitable products to clients. While this happened in only one of the selected firms, the SFC would still like to highlight this practice. The SFC will not tolerate such a practice as it undermines the suitability regime. The licensed corporation concerned was required to take immediate measures including a review of its controls and procedures to ensure that the KYC process is properly conducted.

(ii) Failure to obtain certain key client information

9. In certain samples, some of the shoppers' attributes, in particular investment horizon (19% of the samples) and risk appetite (12% of the samples) were not collected beforehand (see paragraph 23 of the Report). Without obtaining the essential client information, it is questionable how the sales staff could assess whether the recommended products are suitable to the clients' specific circumstances.

(iii) Failure to properly address investors' enquiries

10. In another two cases, sales staff were not able to answer investors' enquiries when conducting the KYC process and assessing the risk profile of the shoppers (see paragraphs 26 and 27 of the Report). This casts doubt on whether the sales staff are familiar with the risk profile assessment methodology adopted by their firm or even appreciate the importance of the KYC procedure.

Explanation of product features and disclosure of risks

11. In order to ensure that investment recommendations to clients are reasonably suitable, intermediaries are required to help the client make informed decisions by giving the client a proper explanation of the basis of the investment recommendation, as well as the nature and extent of the risks the investment products bear. Intermediaries should always present balanced views about the investment products including drawing the client's attention to the disadvantages and downside risks.[6]

12. The Exercise has shown that more efforts should be made to improve the overall quality of explanation of features and disclosure of risks provided by the sales staff. The improper practices noted are summarised below.

(i) Insufficient understanding of products

13. Some sales staff did not demonstrate sufficient understanding of the recommended products. They were not able to properly advise the shoppers of the underlying investments of the recommended funds, eg, the countries or types of shares that the funds invested in (see paragraphs 33 and 34 of the Report). Without truly understanding the features and risks of the products they recommend, it would be difficult for the sales staff to properly discharge their suitability obligations to clients.

[6] Question 5 of the Suitability FAQs

(ii) Providing insufficient information

14. Some sales staff failed to provide sufficient information about the recommended products to the shoppers, such as, the features and risks of the products, relevant fees and charges, and whether a secondary market was available for the recommended debt securities (see paragraph 35 of the Report). Failure to make full and fair disclosure of all material features of the recommended products would affect clients' understanding of the nature of the investments and the risks involved.

(iii) Providing inaccurate information

15. It was noted in some instances that the sales staff provided inaccurate information to the shoppers (see paragraphs 36 and 37 of the Report). For example, a sales consultant represented that investing in funds was a low risk form of investment and was even more secure than placing deposits with banks. In fact, the level of risks could vary from high to low depending on the characteristics and underlying investments of specific funds. It is incorrect to represent to the investor that investment in any funds would be more secure than placing deposits with banks. Clients rely on sales staff's advice when they invest. Sales staff have a duty to act in the best interest of the clients and should provide accurate information to them for making investment decisions.

16. During the Exercise, it was also noted that some sales staff provided a wrong interpretation of the SFC's requirements or practices (see paragraph 38 of the Report). For example, a sales consultant wrongly represented to the shopper that the SFC would categorise investment products into different risk groups. This would give a wrong impression to the clients that the SFC has endorsed the way that the firm categories its products.

Suitability assessment

17. Suitability involves matching the risk return profile of each recommended investment product with each client's personal circumstances. The facts and circumstances of each case differ and it is a matter for the sales staff to use their professional judgment to diligently assess whether the characteristics and risk exposures of each recommended product are actually suitable for the client concerned and are in the best interests of the client, taking into account the client's personal circumstances[7]. The following deficiencies in relation to suitability assessment were noted in the Exercise.

(i) Insufficient explanation of rationale behind recommendation

18. The sales staff generally did not sufficiently explain why the products were suitable for the shoppers having regard to their individual circumstances. Failure to provide a clear rationale for product recommendations would make it difficult for clients to assess whether the recommendations are suitable for them.

19. In some samples, the risk level of the recommended products was higher than the risk appetite of the shoppers but the sales staff did not explain why the recommended products were considered suitable for the shopper (see paragraph 41 of the Report).

[7] Question 4 of the Suitability FAQs

(ii) Recommending products to clients without proper regard to their specific circumstances

20. It was noted in some instances that the sales staff did not take into account all the relevant personal circumstances of the shopper when making the assessment (see paragraph 42 of the Report). In one case, the sales staff even advised the shopper that she could buy any investment product since she had experience in trading stocks. Such an advice is incorrect. Prior experience in trading of stocks does not mean that it is appropriate for the customer to invest in any type of investment product.

Good practices

21. Good selling practices by sales staff were also noted during the Exercise (see paragraphs 43 to 45 of the Report). For example, some sales staff advised the shoppers to diversify their investments, or to start investing in small amounts at different times so as to limit their risks. Other sales staff exercised extra care in dealing with elderly customers and young or inexperienced investors.

Responses

22. The SFC places great emphasis on industry's compliance with the selling practices requirements set out in the Code of Conduct, Internal Control Guidelines[8] and the Suitability FAQs. The results of the Exercise revealed that licensed corporations have gaps in complying with the regulatory requirements. Licensed corporations should critically review their systems and controls to ensure full compliance with the relevant regulatory requirements. In particular, the management of licensed corporations should exercise appropriate oversight over the selling practices of their sales staff.

23. For licensed corporations where major deficiencies were noted in the Exercise, the SFC has required the firms in question to take actions to address those deficiencies. The SFC will continue to monitor these firms and to ensure that they have put in place appropriate measures to address the issues noted. The SFC will not hesitate to take regulatory actions for repeated material breaches.

24. The SFC will also take into account the findings of the Exercise when updating our supervisory regime regarding selling practices. The mystery shopping exercise will be used as one of our regulatory tools from time to time to assess industry's compliance with the relevant requirements. Areas where shortcomings are identified in the Exercise will be subject to greater scrutiny during our inspection visits.

[8] Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the SFC

REPORT ON MYSTERY SHOPPING PROGRAMME FOR THE SALE OF UNLISTED SECURITIES AND FUTURES INVESTMENT PRODUCTS IN HONG KONG

SECURITIES SECTOR

April 2011

Table of Contents

1. EXECUTIVE SUMMARY

1. A service provider[1] has been engaged to carry out a mystery shopping exercise. This report summarizes the findings of the exercise which focuses on selling practices involving unlisted securities and futures investment products ("Securities Products").

2. The exercise was carried out between July and November 2010. During this period, a total of 150 samples[2] were conducted on 10 selected licensed corporations (with 15 samples each).

3. The mystery shopping exercise revealed that the selected firms generally complied with the Know-Your-Client ("KYC") requirements although in two instances, the practices of sales consultants of a firm were found to have undermined the KYC process. Deficiencies were also noted in other areas such as explanation of product features to customers, disclosure of risks and suitability assessments. The major findings of this report are summarized in the following paragraphs:

<u>Know-Your-Client</u>

4. Sales consultants from the selected firms collected shopper[3] information through a mix of verbal discussion and the use of risk profile questionnaires. The information obtained generally included the shopper's investment objectives, financial situation and investment experience. However, in some samples, the sales consultants failed to collect relevant information such as the shopper's investment horizon and risk appetite during the KYC process.

5. Two sales consultants from the same firm were found to have guided or hinted to shoppers to change their answers in the risk profile questionnaire so that a wider range of investment products could be recommended to them.

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[1] All references to service provider in this report refer to us – Hong Kong Productivity Council

[2] "Sample" in this report refers to each instance where a "shopper" acts as a potential customer to gather information on the sales process of a licensed corporation

[3] "Shopper" in this report refers to a person recruited by the service provider to act as a potential customer of the firm in question

Explanation of product features and disclosure of risks by sales consultants

6. Shoppers were generally recommended by the selected firms to invest in mutual funds (mainly those with the underlying investment being equities or bonds).

7. Most sales consultants provided shoppers with a general description of the features and risks of the products recommended. However, in 16% of the samples where recommendations were made to shoppers, it was noted that the sales consultants:
   (a) provided inaccurate or insufficient information about the features and/or risks of the products to the shoppers;
   (b) did not demonstrate sufficient understanding of the products being recommended to the shoppers; or
   (c) provided inaccurate descriptions regarding the requirements or practices of the Securities and Futures Commission ("SFC").

Suitability assessment

8. In the majority of samples, (95% or 142 out of 150 samples), the sales consultants ended up recommending specific products to shoppers. In the remaining 8 samples involving 3 firms, the sales consultants declined to recommend any products to shoppers after carrying out the KYC procedures. They advised the shoppers that no products matched their risk profiles.

9. When making a suitability assessment and considering investment products to recommend, firms are required to take into account the customer's personal circumstances. In this regard, it was noted in some samples that the sales consultants did not take into account all the relevant personal circumstances of the shopper (e.g. investment horizon and risk appetite) when making a suitability assessment.

10. Good selling practices by sales consultants were also noted during this exercise. Some sales consultants advised the shoppers to diversify their investments, or to start investing in small amounts at different times so as to limit their risks. Other sales consultants exercised extra care in handling elderly customers and young or inexperienced investors.

2. PROGRAMME INTRODUCTION

2.1 BACKGROUND AND OBJECTIVE

11. In respective reports sent to the Financial Secretary in December 2008 on "Issues raised by the Lehmans Minibonds crisis", both the SFC and the Hong Kong Monetary Authority ("HKMA") (described together as the "Regulators") recommended the introduction of a Mystery Shopping Programme ("MSP"). These recommendations were made with the intent of enhancing the existing regulatory framework by providing an additional supervisory tool to oversee the practices of regulated entities selling investment products in Hong Kong.

12. The Regulators have jointly engaged a service provider to assist them in implementing the MSP covering the sale of unlisted securities and futures investment products ("Securities Products") in Hong Kong.

13. The MSP complements the Regulators' regulatory activities by helping to assess whether sales consultants are complying with the Regulators' rules and regulations when selling Securities Products to investors in Hong Kong.

2.2 SELECTION OF TARGET FIRMS

14. A total of 150 samples were conducted on 10 selected licensed corporations (with 15 samples each). The firms selected included both investment advisory firms and brokerage firms. The firms selected by the SFC are those that sell Securities Products to retail customers, including walk-in customers.

2.3 FIELDWORK ARRANGEMENT

15. The fieldwork was carried out between July and November 2010.

2.4 METHODOLOGY

16. The MSP focused on 3 key areas, namely KYC procedures, explanation of product features and disclosure of risks, and suitability assessment.

17. Shoppers acting as potential customers were used throughout the MSP

exercise to visit and assess the selected firms. The shoppers used their real personal particulars (including name, age and address). The service provider provided training to shoppers on product information, securities regulation, selling practices of licensed firms, and how to complete the shopper questionnaire.

18. A shopper questionnaire was designed by the Regulators to document the shoppers' experiences during their visits to selected firms. Each shopper was required to complete and submit the questionnaire to the service provider after their visit.

19. Specific instructions were provided to the shoppers on how to approach the firms and act during the customer interview. In this regard, the shoppers were asked to express interest in Securities Products and have face-to-face meetings with the firms' sales consultants. However, the shoppers were not required to make any actual investments. The shoppers would record what happened during the meetings, complete the questionnaires and collect any materials provided by the sales consultants.

20. During the mystery shopping exercise, the service provider carried out quality control tests and checked all completed questionnaires against the relevant records to ensure the completeness and accuracy of the questionnaires.

2.5 PROFILES OF SHOPPERS

21. The MSP covered shoppers with different attributes, for example:

(a) Age: young adult, middle aged or the elderly;

(b) Risk appetite: high, medium or low;

(c) Financial net worth: ranging from low net worth (less than HKD 500,000) to high net worth (more than HKD 2,000,000);

(d) Educational background: primary, secondary or tertiary education level; and

(e) Investment experience: from no investment experience to more than 5 years of investment experience.

3. FINDINGS

3.1 KNOW-YOUR-CLIENT ("KYC")

General Observations

22. Out of 150 samples, 80 samples (53%) of the shoppers' personal information was collected through verbal discussion only, and in 70 samples (47%) the shoppers' personal information was obtained by the sales consultants via the firm's standard risk profile questionnaire and through verbal discussion with the shoppers.

23. It was observed that in most samples, the sales consultants collected information regarding shoppers' investment objectives, investment experience and financial situation during the KYC process. However, in certain samples, some of the shoppers' attributes were not collected (particularly investment horizon (19%) and risk appetite (12%)) before the sales consultants recommended products to the shoppers.

Figure 1: No. of samples where certain customer information was NOT collected by sales consultants

	Investment objective	Investment horizon	Financial situation	Investment experience	Risk appetite
No. of samples	14	28	7	4	18
Base total	150	150	150	150	150
%	9%	19%	5%	3%	12%

Other Observations

24. Key information about shoppers was obtained during the KYC process, but improper practices were noted in some samples. The major deficiencies noted are described below.

<u>Guiding shoppers to make changes to the answers of questionnaires</u>

25. 2 sales consultants from the same firm (see below) guided or hinted to the shoppers to change their answers in the risk profile questionnaires so that a wider range of investment products could be recommended to them.

> **Example 1**: After introducing some funds to the shopper, the sales consultant requested the shopper to mark her risk appetite in the firm's standard risk profile questionnaire. The shopper originally chose a risk level of "5" (Medium High) out of a total of 9 risk tolerance levels. However, the sales consultant indicated that she would be unable to invest in most of the funds if she chose level "5". The sales consultant suggested the shopper to choose "7" (Very High) and even "8" (Speculative) given the shopper had invested in stocks. The shopper read the descriptions in the questionnaire and noted that level "8" was for speculative investors who would invest in products such as warrants. The shopper told the sales consultant that she had not invested in warrants. The sales consultant then concluded that the shopper should choose "7" without explaining how he arrived at this rating.

> **Example 2**: The shopper completed a risk profile questionnaire indicating her risk tolerance level was 5 ("Medium High"). The sales consultant advised her to select a higher risk level because the shopper might want to maintain a high-risk account in the future. The shopper then changed her original risk tolerance level to 6 ("High"). When the sales consultant noticed that the shopper had selected capital protection as one of the investment objectives, he suggested the shopper not to choose that option. The sales consultant had incorrectly represented to the shopper that only by not choosing this option would the licensed corporation comply with the SFC regulations.

Failure to properly address shopper's enquiry

26. In one sample, the shopper was assessed as an "aggressive" customer after completion of the firm's risk profile questionnaire, but the shopper queried why she was assessed as such and advised that she would only accept a medium risk rating. The sales consultant responded that the assessment was to comply with SFC's regulatory requirements and if she were graded at a low risk level, she may not be able to invest even in equity funds. What the sales consultant should have done is to properly explain the risk profiling method or approach to the shopper and advise her regarding the options available if she did not agree to the final risk rating.

27. In another sample, the sales consultant did not properly address the shopper's enquiry when conducting the risk profile assessment. The shopper asked if the firm's risk profiling questionnaire was effective. Instead of explaining the basis adopted by the firm in developing its questionnaire, the sales consultant simply mentioned that the risk profile questionnaire had been reviewed by the Regulator.

3.2 EXPLANATION OF PRODUCT FEATURES AND DISCLOSURE OF RISKS

General Observations

28. In the majority of samples, (95% or 142 out of 150 samples), the sales consultants ended up recommending specific products to shoppers. In the remaining 8 samples involving 3 firms, the sales consultants declined to recommend any Securities Products to the shoppers after they performed the KYC procedures. They advised the shoppers that no products matched their risk profiles.

29. Shoppers were generally recommended by the selected firms to invest in mutual funds (mainly those with the underlying investment being equities or bonds). In 5 samples involving 3 firms, the sales consultants also recommended corporate bonds to the shoppers. In one sample, an ELN was also recommended to the shopper.

30. Regarding mutual funds / unit trusts products that were recommended, the sales consultants usually mentioned the funds' basic information (e.g. the region of investment and the nature of the underlying assets), their historical performance and the relevant fees and charges. However, in some samples, the sales consultants did not provide sufficient or accurate information about the features and/or risks associated with the products to the shoppers.

31. For corporate bonds that were recommended, the sales consultants provided shoppers with basic information regarding the products but some did not mention whether there was a secondary market available for the recommended bonds or say anything about the credit risk of the issuers.

Other Observations

32. In 16% of the samples where recommendations were made to the shoppers, it was noted that the sales consultants did not properly explain the features and/or risks of the products to the shoppers. The following observations highlight the deficiencies noted.

Insufficient understanding of the recommended products

33. In some samples, the sales consultants did not demonstrate sufficient understanding of the recommended products or the fund factsheets. For example, when a shopper asked about the meaning of an "Indian Subcontinent Fund (印度次大陸基金)", the sales consultant did not appear familiar with the underlying investments and replied that the fund invested in second-tier stocks but not large-cap stocks. In fact, the Indian subcontinent generally refers to the countries of India, Pakistan, Bangladesh and Sri Lanka, and according to the fund factsheet, the fund also had investments in large cap stocks.

34. In another sample, a sales consultant wrongly advised that the fund in question only invested in H shares but not A shares. The shopper noted from the factsheet that the fund did in fact invest in A shares and pointed out the error to the sales consultant.

Insufficient disclosure about Securities Products

35. Some sales consultants did not provide sufficient information about the recommended products to the shoppers, such as the features and risks of the product, relevant fees and charges and whether a secondary market was available (for debt securities). For example:

(a) A sales consultant did not provide a clear explanation of the leverage nature of a fund.

(b) Some sales consultants did not explain the fund details to the shopper.

(c) In a sample where corporate bonds were recommended, certain key features about corporate bonds such as the issuer's credit risk and whether a secondary market was available were not disclosed to the shopper.

(d) Some sales consultants did not sufficiently explain the disadvantages and downside risks of the recommended products and/or did not disclose information about product fees and charges to the shopper when recommending the product (see below for examples).

Example 3: The sales consultant constructed 2 investment portfolios for the shopper (aged about 50 with moderate risk appetite, targeted for capital growth and with experience in securities trading). Graphs of yearly performance relative to market index were presented to the shopper as illustration which indicated a negative 3-year return against 3-year volatility for the recommended portfolios. The shopper enquired why the portfolios had a negative return and whether she would make a loss if she invested in this portfolio. The sales consultant did not directly address the shopper's query but responded that those negative returns were just some numbers for the shopper's reference and she could ignore them. In fact, the sales consultant failed to disclose the downside risks of the investment to the shopper.

Example 4: The shopper (aged 20-30 with high risk appetite and some investment experience) enquired about the fees and charges and the sales consultant advised that the upfront fee was generally around 3% but it would vary among different funds. The sales consultant also mentioned that once the shopper had decided on which funds to invest in, they would check the details for him; but at that point in time the shopper only had to decide which funds/areas he wanted to invest in. The sales consultant failed to provide relevant information regarding the fees and charges of each fund to the shopper.

During the selling process, the sales consultant only described the market risk of the funds to the shopper. At the conclusion of their meeting, the shopper was asked to sign a risk declaration form acknowledging that all investments bear risks as read out by the sales consultant, which included credit risk, market risk, foreign exchange risk (use USD or EURO to calculate prices) and liquidity risk (cannot turn investments into cash quickly). The sales consultant then stated that he had already mentioned the risks of the products.

The sales consultant should not merely read out to the customer a list of the different types of risks inherent to investment products but should provide proper explanations on the nature and extent of the risks of the products that have been recommended.

Provision of inaccurate information about Securities Products

36. Some sales consultants provided inaccurate information about the recommended products to the shoppers. For example:

    (a) A sales consultant wrongly advised the shopper that one of his recommended funds was an eligible investment under the HKSAR Capital Investment Entrant Scheme when in fact it was not.

    (b) Another sales consultant suggested that investing in funds was a low risk form of investment and was even more secure than placing deposits with banks.

    (c) In some samples where the shoppers were recommended to invest in investment products provided by insurance companies, the sales consultants had not clearly explained to the shoppers that the recommended product was an investment-linked assurance scheme i.e. an insurance policy.

37. Some sales consultants failed to properly explain the features, disadvantages and downside risks of the Securities Products to the shoppers (see below for examples).

Example 5: A shopper (a 74-year old retired woman with low risk appetite, having about HK$1M in fixed deposits) accompanied by her daughter was recommended to invest in a life insurance policy and a portfolio of funds. The sales consultant briefly mentioned about the products' names and their historical performance but did not elaborate on details of the specific markets and types of stocks that the recommended products invested in.

In addition, one of the recommended funds was a fund primarily invested in futures and options which according to this fund's prospectus would be subject to key risk factors including leverage, counterparty and liquidity risks and substantial losses may be suffered. However, the sales consultant did not tell the shopper about these risk factors. He even told the shopper that this fund was one which could avoid risk ("避險基金") and would be more secure. The shopper's daughter sought clarification and enquired if the sales consultant's explanation of "avoiding risk" ("避險") meant that investors could avoid risks when they invested in this fund during market turmoil. The sales consultant replied in the positive.

When the shopper's daughter further questioned how the fund could avoid risks, the sales consultant simply responded that it was due to the fund manager's capability, but did not explain the fund's investment or risk management strategies to the shopper.

Example 6: When explaining the risks involved in "traditional mutual funds" to a shopper (aged 20-30 with some investment experience and a high risk appetite), the sales consultant said that the shopper would not lose all of his investment by investing in funds because the risks involved were minimal. In explaining the downside risks of the funds, the sales consultant advised that if the shopper invested in 5 funds on a long-term basis, even if only 2 funds could perform well, he could still make a profit.

The sales consultant incorrectly informed the shopper that the upward movement in some of the funds would always be more than enough to cover the downward movement of the other funds.

Provision of inaccurate information about the SFC's requirements or practices

38. Some sales consultants provided inaccurate information about the SFC's requirements or practices. For example, the sales consultants in 2 samples had wrongly claimed that the SFC would categorise investment products into different risk groups, and one of them also incorrectly represented to the investor that the SFC, when considering whether a licensed corporation has properly complied with the suitability obligation, would only match the risk rating of the product with the investor's risk appetite without considering the amount invested having regard to the investor's total net worth (i.e. concentration risk).

3.3 SUITABILITY ASSESSMENT

Observations

39. In general, the sales consultants usually gave brief explanations of why the recommended products were suitable for the shoppers, but they did not sufficiently elaborate on why the products were suitable for the shoppers having regard to their individual circumstances.

40. As mentioned in Section 3.1, in some samples, the risk assessment result might not properly reflect the shopper's risk profile due to the shopper being guided or hinted to change her answer in the risk profile questionnaire and the shopper disagreeing with the final assessment result which stated that she had a higher risk profile. This might potentially result in unsuitable products being recommended to shoppers.

41. In some samples, the risk level of the recommended products was higher than the risk appetite of the shopper but the sales consultant did not explain why the recommended products were considered suitable for the shopper (see below for an example of such a situation).

> **Example 7:** A middle-aged housewife with a few years' experience in investing in stocks and bonds, was recommended to invest in products having higher risk (mutual funds in emerging markets and natural resources market) than her preferred risk appetite ("low to medium"). The sales consultant was aware of the mismatch between the shopper's risk appetite and the risk profile of the products.
>
> The sales consultant pointed out to the shopper that the recommended portfolio was riskier than shopper's past investment and stressed that the funds were selected because of their big upward potential, but he did not explain why they were suitable for the shopper.

42. Some sales consultants had not taken into account the personal circumstances of the shoppers when making investment recommendations. For example,

(a) It was not explained why corporate bonds issued by some PRC property development and construction companies would be suitable for a retiree with a medium risk appetite.

(b) A shopper informed the sales consultant that she did not want her money to be locked-in after the sales consultant recommended her to invest in funds via an investment platform with a lock-in period of 5 years. However, the sales consultant did not propose other investment alternatives. He simply ignored the shopper's liquidity needs and told her that there was no way to work around the issue because that was how the investment platform worked.

(c) A sales consultant (see example below) claimed that the shopper had the necessary experience for buying investment products but whether this was, in fact, the sample was questionable.

Example 8: The shopper (a housewife with some investment experience and medium risk appetite) enquired whether some investment products would not be available to her, based on her personal circumstances. The sales consultant explained that the shopper could buy any investment products since she had experience in trading of stocks which attracted the highest risk rating.

Prior experience in trading of stocks does not mean that it is appropriate for the customer to invest in any type of investment product.

4. GOOD PRACTICES

43. Good selling practices by sales consultants were also noted during this exercise. In some samples, it was noted that the sales consultants had advised the shoppers to diversify their investments or not to invest a significant amount into any single fund product or products with high volatility. Some shoppers were also advised to start investing in small amounts at different times so as to limit their risks.

44. In other samples, the sales consultants reminded shoppers of various issues regarding their individual circumstances:

    (a) A shopper without any investment experience was reminded of the SFC's quote to "learn before you invest" and was advised to attend some courses.

    (b) A few young shoppers were advised to invite family members to come along to assist in reviewing the investment plan or strategies. A sales consultant advised a young shopper that she should not invest in an investment product if she was not familiar with its nature.

    (c) Some shoppers who were assessed as aggressive investors were reminded by sales consultants to watch out for the risks involved even though the risk profile assessment indicated that they could assume high risks.

45. A few sales consultants also exercised extra care in advising elderly or retired shoppers, advising them on one or more of the following points:

    (a) A more conservative risk appetite should be adopted and investments should not be made in high risk products.

    (b) Principal protection should be set as the major investment objective.

    (c) Ensure that there was no short term liquidity needs before making the investment, so as to avoid unnecessary financial pressure on oneself.

    (d) Investment ideas should be shared with family members before reaching a final decision on whether to invest.

5. WAY FORWARD

46. The SFC has already set out the requirements governing selling practices in the Code of Conduct[4], Internal Control Guidelines[5] and the Suitability FAQs[6]. It should consider reminding licensed firms in the securities sector to put in place proper controls and procedures to ensure compliance with the relevant regulatory requirements regarding the selling of investment products to investors in Hong Kong.

47. In particular, firms should be reminded to provide their customers with enough relevant information to make informed investment decisions. Such information would include providing customers with an accurate explanation of product features and risks. Firms should also carry out proper suitability assessments and provide regular training to their sales staff so as to equip them with regularly updated and complete information about the Securities Products they sell and the relevant regulatory guidelines and requirements. Furthermore, firms should perform effective monitoring of the sales process.

48. Regarding the examples and areas of potential non-compliance that have been highlighted in this report, the SFC may wish to follow up these with the licensed firms concerned and require the firms in question to take appropriate action to address the issues noted.

49. The SFC is advised to take into account the experiences and observations gained in this exercise when designing similar mystery shopping programmes in the future.

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[4] Code of Conduct for Persons Licensed by or Registered with the SFC

[5] Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the SFC

[6] Questions and Answers on Suitability Obligations