



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

Report on the Thematic Inspection of Selling Practices of Licensed Corporations

October 2012



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Executive Summary

1. This report summarises the findings of the SFC thematic inspection on the selling practices of 10 licensed corporations (LCs). The LCs inspected were from a wide cross-section of the industry that is involved in the sale of investment products.
2. During the inspection, the SFC observed, among other things, varying degrees of inadequacies or deficiencies within these LCs in respect of:
 - (a) Management oversight, training and compliance monitoring;
 - (b) Suitability assessment process;
 - (c) Use of disclaimers and signing of declarations;
 - (d) Compliance with the new Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (**Code of Conduct**) requirements; and
 - (e) Eligibility verification of Professional Investors.
3. Some examples of good practices by LCs were observed during the course of the inspection and these are outlined in the report. However, these observations are not exhaustive and intermediaries should not regard them as being the only methods for complying with the relevant regulatory requirements.
4. Taking into account all relevant facts and circumstances, the SFC will take appropriate regulatory action against LCs found to have breached the Code of Conduct and other applicable requirements.
5. The SFC will also continue its efforts in assisting the industry to comply with the selling practices requirements through issuing advisory circulars or frequently asked questions (FAQs) which offer specific guidance in areas where there is a lower level of compliance.
6. From an investor protection perspective, the findings in this report may help educate investors on some common pitfalls regarding the selling processes of LCs. The SFC will continue its investor education efforts to raise the awareness of the investing public on issues such as the importance of understanding the suitability assessment process and asking for relevant information from LCs to protect their own interests.
7. The SFC will keep abreast of global developments in selling practices standards and regulations, and where appropriate, propose changes to keep Hong Kong on par with international standards.



Introduction

Selling practices requirements

1. Intermediaries that make investment recommendations or solicitations to clients are subject to the suitability obligations in the Code of Conduct as clarified by the “Questions and answers on suitability obligations of licensed and registered persons who are engaged in financial planning and wealth management business activities” issued in May 2007 (**Suitability FAQ**). Both of these documents should be read in conjunction with each other.
2. As explained in the Suitability FAQ, the Code of Conduct suitability obligations require intermediaries when making investment recommendations or solicitations to clients to:
 - (a) know their clients;
 - (b) understand the investment products they recommend to clients (product due diligence). Product due diligence should be conducted on a continuous basis at appropriate intervals having regard to the nature, features and risks of investment products offered;
 - (c) provide reasonably suitable recommendations by matching the risk return profile of each investment product sold to a client to the personal circumstances of that client;
 - (d) provide all relevant information to clients and help them make informed investment decisions;
 - (e) document and retain the rationale underlying each investment recommendation made to the client and provide a copy to each client; and
 - (f) employ competent staff and provide appropriate training (to ensure products are sold by staff who have sufficient understanding of the products).
3. The SFC has conducted routine and thematic inspections on selling practices, and from time to time, issued thematic inspection reports and circulars to provide guidance to intermediaries on how to comply with the selling practices requirements and to address emerging issues and market developments.

Objective and coverage of the inspections

4. The SFC has conducted a round of thematic inspections to monitor compliance by LCs with the regulatory requirements governing their conduct and selling practices relating to the sale of investment products including the new Code of Conduct requirements that were introduced following the publication of the SFC Consultation Conclusions on Proposals to Enhance Protection for the Investing Public. The objective is to gauge the compliance level of the industry in general and identify any areas of concern for formulating future policy and supervision initiatives.
5. This round of thematic inspections covered 10 LCs including independent financial advisers, wealth management affiliates of global financial institutions as well as stock brokers.



6. The investment products distributed or sold by these LCs ranged from plain vanilla investment funds and bonds, to more complex products such as accumulators and decumulators, over-the-counter options and other structured notes (e.g. with underlying equity, currency or commodity assets).
7. In these inspections, a top-down review combined with the sample testing of sales transactions was conducted on the firms' management supervisory system and controls to assess their effectiveness in ensuring the firms' compliance with the selling practices requirements set out in the Code of Conduct, Suitability FAQ and where relevant, the Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the SFC (**Management Supervision Guidelines**).



Findings

8. This part of the report details our findings and includes case examples illustrating various breaches, deficiencies and weaknesses. The findings are grouped into five sections as follows:
 - (a) Management oversight, training and compliance monitoring;
 - (b) Suitability assessment process;
 - (c) Use of disclaimers and signing of declarations;
 - (d) Compliance with the new Code of Conduct requirements; and
 - (e) Eligibility verification of Professional Investors.

Management oversight, training and compliance monitoring

9. The management of an intermediary has primary responsibility for the firm's operations including the development, implementation and on-going effectiveness of the firm's internal controls and the adherence thereto by the firm's staff. In particular, the policies and procedures should be established and maintained to ensure the firm's compliance with all applicable legal and regulatory requirements as well as with the firm's own internal policies and procedures.
10. Based on the instances of deficiencies and weaknesses observed during the SFC inspections, intermediaries should pay particular attention to the following common pitfalls:
 - (a) inadequate resources and procedures to supervise staff diligently;
 - (b) inadequate training for staff;
 - (c) ineffective compliance function and inadequate compliance monitoring procedures; and
 - (d) inadequate self examination of controls and procedures.

Supervisory resources and procedures

11. While appropriate management supervisory systems and controls may vary across intermediaries according to the differences in their scale and nature of business activities and management structure, it is important for all intermediaries to ensure that they have adequate supervisory resources and procedures to supervise staff diligently when making investment recommendations or solicitations to clients.
12. In the following case, the LC had over 70 sales staff serving over 1,000 clients but there was only one Responsible Officer (out of four in total) who directly supervised the selling activities undertaken by all the sales staff.



Case 1

The SFC found that transactions involving a risk mismatch (i.e. the risk rating of the investment product was higher than the risk profile of client) were not detected by the Head of Sales, a Responsible Officer of the LC, for further review to ensure suitability. The Head of Sales in question was solely responsible for directly supervising all the selling activities undertaken by over 70 sales staff of the LC. The detection failure was potentially attributable to the inability of a single supervisor to exercise effective supervision over a large number of sales staff.

13. Furthermore, it was noted that while the inspected LCs all had procedure manuals that provided guidance to staff on conducting investment advisory business and dealing with clients, certain key process areas were not covered in the manuals nor otherwise communicated clearly to staff as demonstrated by the following examples.

Case 2

Example A: No guidance was given to sales staff to document the rationale underlying the investment recommendations they made to clients, nor was there adequate supervision to ensure that the required documentation is being properly maintained by the sales staff.

Example B: There were no written guidelines on how to conduct suitability assessments based on the overall risks of the clients' portfolios of investments. While individual investment transactions handled by sales staff were subject to review and approval by supervisory staff, the management had not provided clear guidance to the supervisory staff on the approval criteria for individual investment transactions, nor were there compensatory measures in place, to ensure that the level of risk of every transaction was suitable to the client's portfolio.

Training for staff

14. Providing adequate and appropriate product training to staff and promoting staff awareness of relevant selling practices requirements would help foster a compliance culture and ensure that the firm's clients receive suitable investment advice.
15. The SFC noted that larger firms tended to provide more structured compliance and product training for their sales staff. While it may be possible for the management of smaller firms to train their sales staff in a less structured or formal manner via close day-to-day supervision, it is important for all intermediaries to ensure that adequate training is provided both initially and on an ongoing basis to sales staff and other staff members that is appropriate for the specific duties which they are required to perform.
16. Intermediaries should also establish a system to monitor the frequency and sufficiency of training and staff attendance to ensure that all sales staff have up-to-date knowledge.
17. The SFC inspection findings indicate that there was room for improvement in the training programme for sales staff in a number of cases. In one case, the lack of training had potentially led to an incorrect understanding by a sales staff of a product which he recommended to his clients as illustrated in the following example.



Case 3

In one case, the LC had not organised any product training for its sales staff on a fund it offered which was complex, had uncommon features, and bore high risks. It is important for a sales staff to be able to explain the product properly to the client and ensure that the product is suitable for the client. However, in the interview with the sales staff who had recommended the fund to his clients, the SFC found that he had advised his clients that the fund was a product with low liquidity risk when information disclosed in the prospectus of the fund shows that the product is not suitable to an investor who needs liquidity. This was probably due to his inadequate knowledge of the fund.

Case 4

Example A: New product training was not made compulsory for the sales staff responsible for distributing the product.

Example B: The attendance rate of the firm's weekly training, which included product updates and compliance updates, was below 40% and some sales staff did not attend any training throughout a 12-month period.

Example C: The LC was unable to demonstrate the adequacy of staff training as there was no record kept of the frequency and types of training provided and staff attendance.

Compliance function and compliance monitoring procedures

18. Intermediaries should have in place a compliance system that identifies, assesses, monitors, and responds to risks of non-compliance with relevant regulatory requirements as well as with their own internal policies and procedures. The SFC inspection findings indicate that the compliance functions and monitoring procedures of the inspected LCs were of variable effectiveness, and in some cases were lacking altogether. While it is understandable that smaller firms may not have dedicated compliance personnel, they should nevertheless establish and maintain effective supervisory procedures with close oversight by the management to ensure compliance with all applicable regulatory requirements.
19. In one case, the LC ceased to conduct regular compliance monitoring tests due to a lack of resources.
20. In the following examples, the LC had not put in place any compliance monitoring procedures to ensure that the sales staff had followed the firm's suitability policies and procedures when making investment recommendations to clients.

Case 5

Example A: There were no controls to ensure that all information required to be obtained from clients had been collected in accordance with the internal policies of the LC inspected. There were also instances where missing or inconsistent details in the client information forms had not been identified for follow-up action, revealing the inadequacy of the firm's compliance monitoring procedures.

Example B: There were no procedures in place to monitor non-compliance with the



internal policies requiring sales staff to obtain updated information regarding clients' profiles, and instances of non-compliance with such policies had not been identified for follow-up action.

Example C: Although the LC had an internal guideline to sales staff on the types of products suitable for clients with different risk profiles, the firm had not put in place any pre-trade or post-trade review to ensure that sales staff had followed the firm's suitability policies and procedures when making investment recommendations to clients.

21. It was not uncommon in smaller firms for the sales team heads responsible for sales performance to also act in the role of compliance officer to carry out certain compliance monitoring procedures. It is important for all intermediaries to put in place proper safeguards to mitigate the risks of potential conflicts of interest in such circumstances.

Case 6

A sales team head was allowed to approve his own transactions, and was delegated the authority to review and approve client orders submitted by his team members and earned commission generated from such transactions. While the firm may not be able to sufficiently segregate duties due to its small size, the above arrangements potentially impair the independence of the suitability review as there were no compensatory safeguards and mitigation procedures to address the potential conflicts of interest.

Self examination of controls and procedures

22. To ensure continuing compliance with the selling practices requirements, it is also important for intermediaries to regularly review the adequacy and effectiveness of their controls and procedures. In a circular issued by the SFC in February 2009, intermediaries were advised to conduct a formal self examination of the controls and procedures on suitability obligations and the management should review such self-examinations to ensure that established controls and procedures are operating effectively.
23. In terms of deficiencies found in this area, the SFC inspection findings indicate that some LCs had not carried out such self examinations, whilst other LCs did not properly document the self examination results, the review by the management and the follow-up actions taken.



Suitability assessment process

24. In order to meet their suitability obligations, it is important for intermediaries to have an effective process to assess whether the risk return profile of an investment product matches the personal circumstances of a client.
25. This section discusses deficiencies observed in relation to such processes including Know Your Client, product due diligence, suitability determination procedures, as well as documentation standards.

Know Your Client

26. Intermediaries should obtain from customers such information as is necessary to understand their personal circumstances so as to ensure that any investment advice or solicitation provided is suitable for customers and meets the customer's investment objectives after giving due consideration to his financial situation, investment experience, investment knowledge, investment horizon, risk tolerance (including risk of loss of capital) and capacity to make regular contributions and meet extra collateral requirements, where appropriate.
27. All LCs inspected used in-house designed forms or questionnaires to collect client information. For the purpose of assessing clients' risk tolerance, some LCs would adopt risk-profiling questionnaires while others would ask clients to simply pick a risk tolerance category from a number of given options. Below are some observed shortcomings and limitations of the process and/or questionnaires used for assessing clients' risk tolerance.

Case 7

An LC asked its clients to simply pick a risk tolerance category from a number of options given in the account opening form. However, there were neither explanations for the risks represented by each category nor descriptions outlining the common traits of individuals in the different risk tolerance categories. As a result, there was no certainty that the client and the LC had the same interpretation and thus understanding of the level of risk a particular category represented.

Case 8

Although the risk-profiling questionnaire developed by an LC asked a number of questions, the resulting risk tolerance category was effectively determined by the client's answer to one question relating to investment experience in different types of investment products. A client could obtain a high risk score from this question even if he had no experience in trading structured products and derivatives. This may result in the client being classified as a client with a higher risk tolerance but the client may not be aware of the heavy reliance being placed by the firm on just one answer and the associated risks.

Product due diligence

28. It is important that intermediaries have controls in place to ensure that their sales staff do not recommend products which they do not understand. They should obtain a thorough understanding of the products they sell by performing adequate product due diligence and maintaining an appropriate audit trail.



29. The SFC found that some LCs did not conduct product due diligence on SFC authorized funds. They only reviewed the reputation, track record and financial standing of the fund houses, but did not focus on the features and risks of the individual products sold by these fund houses. These LCs had a misconception that no product due diligence work on SFC authorized funds was necessary.
30. Some of the LCs inspected did not conduct any product due diligence themselves but merely relying on the information available on a fund platform. Given the product information provided by the fund platform was limited, these LCs would unlikely have a sufficient understanding of the investment products.
31. As part of the product due diligence process, many LCs assign risk ratings to approved products after evaluating the product's key risks in order to facilitate the suitability determination process. The SFC found that some LCs simply adopted the risk rating of funds published by an independent research company which classified risks of funds based mainly on the three-year annualised volatility, without taking into account the due diligence work performed by the LCs themselves. While intermediaries may take into account any relevant information they deem appropriate in conducting their own product due diligence, they should arrive at their own risk assessment of the product.
32. The SFC found that in a number of cases, there was inadequate documentation of the due diligence work performed. This is a fundamental requirement towards demonstrating whether the LCs have properly discharged their suitability obligations. For all products that are offered to clients, intermediaries should document, amongst others, the verification work done and enquiries made about the investment products and in what aspects are they considered suitable for different risk categories of investors.

Suitability determination

33. When conducting a suitability assessment, intermediaries should make reference to all the circumstances of the particular client. The SFC inspection revealed some cases whereby the LCs failed to assess all aspects of the products and client circumstances before recommending products to their clients.

Case 9

A sales staff had recommended an unauthorized fund which was complex and had high risks (such as liquidity risk) to his clients which included some elderly individuals and retirees. The sales staff failed to demonstrate that he had assessed all relevant aspects of his clients' circumstances (such as the investment horizon) before recommending the fund to them. In addition, the sales staff was unable to show that he had an adequate understanding of the fund. It is therefore questionable whether he could have explained the product properly to clients. The sales staff also failed to present a balanced view of the fund to clients by emphasising only the good points of the fund but not its disadvantages and downside risks.

Case 10

An LC sold to retail customers an unauthorized fund whose target investors are specified in the fund manager's due diligence questionnaire to be institutional investors, such as banks and asset managers. The LC was unable to demonstrate



how it ensured suitability of its recommendations for its retail investors, including an elderly person.

34. In the following example, the LC adopted a rudimentary methodology in determining what products were suitable for different risk categories of investors.

Case 11

The LC generally treated bonds which were above investment grade as suitable for all its clients. It also treated funds with a risk rating of 3 or below (ratings were on a scale of 1-5 with 5 being the highest risk) as suitable for all clients.

Every investment product has its own unique features, structure and risks. It is inappropriate for intermediaries to assume that a particular type of product is suitable for all clients without matching the risk return profile of each recommended investment product with each client's personal circumstances. For example, a bond with uncommon features and / or complex structure such as perpetual bond, subordinated bond and convertible bond is most unlikely to be suitable for all clients. Intermediaries should pay particular attention to ensure that the special features and risks of such product are properly explained to and understood by the client and meet the client's investment objective, risk tolerance and other personal factors.

35. Assessing the level of concentration risk is also a necessary part of the suitability determination. However, the SFC found that not all LCs inspected would require sales staff to assess the concentration risk taking into account the client's net worth. Some LCs provided no written guidelines to sales staff on how the concentration risk assessment should be performed. Shortcomings in the LCs' concentration risks assessment methodology were found as follows.

Case 12

An LC would calculate the amount of the proposed investment as a percentage of the client's net worth, and if this percentage is lower than a specified threshold, the exposure would be considered acceptable even when the risk rating of the product was higher than the client's risk profile. However, the LC failed to demonstrate that it had given due consideration to the risk ratings of any investment products already held in the client's portfolio. The LC thus ran the risk that the client might have invested most of his assets in high risk products, and even a small degree of exposure to any proposed high risk investment may well be unsuitable for the client.

Documentation standards and keeping of records

36. Maintaining adequate documentation on the rationale underlying the investment recommendations made to clients is another area where there is room for improvement. In this regard, the SFC found that some LCs had only kept scanty documentation which was not sufficient to explain how the recommendations were considered suitable having regard to the clients' personal circumstances.



Case 13

A client, who had a “balanced” risk appetite, was recommended by the LC to invest in a fund which was rated “aggressive” (investing in derivatives such as futures). The documentation maintained by the sales staff indicated that such investment recommendation was made because the client wanted to have a “more diversified and safer portfolio.”

It was unclear from the documentation as to why the recommended product would amount to a safer portfolio for the client. In this case, the sales staff should have documented, amongst others, an explanation of why the recommended product or strategy is considered appropriate in light of the client’s personal circumstances and existing portfolio holdings.

37. The SFC also found some cases where the sales staff had kept his own notes regarding the client’s circumstances and / or subsequent changes, but did not keep a copy of such relevant information as part of the LCs’ records. Proper record keeping policies and procedures should be established to prevent possible loss of client information.



Use of disclaimers and signing of declarations

38. The SFC found that some LCs inspected had inserted exemption clauses or disclaimers in client agreements, or asked clients to sign declarations or acknowledgements. This section discusses the issues or deficiencies observed in the practices adopted by the LCs in this regard.
39. The SFC found that the client agreements or account opening documentation of some LCs contained clauses which restricted the purposes and effect of certain investor protection measures under the Code of Conduct as demonstrated in the following examples.

Case 14

In one example, the LC stated in the client agreement that it would not be obligated to forward to clients any notices or documents received in respect of any investments held on behalf of its clients. In another example, the LC stated in its agreement that it is the client's duty to obtain a copy of the offering documents of investment funds before submitting the fund subscription applications.

These clauses would adversely affect the interests of the clients.

Case 15

An LC had inserted a client declaration section in the risk profiling form. When clients signed on the form confirming the risk profiling results, they at the same time acknowledged and agreed that the LC had no responsibility for reviewing / assessing whether particular products and investment choices were suitable for them.

Where an intermediary has made a recommendation or solicitation to a client, the intermediary should ensure the suitability of the recommendation or solicitation for that client is reasonable in all the circumstances. The LC's intention to exclude the effect of this obligation so far as its contractual obligations to the client were concerned was manifest by inserting such a disclaimer in the customer documentation.

40. In the following case, the LC would request clients to sign an acknowledgement or declaration on a transaction basis confirming that they had not received any investment advice from the LC when clients wished to transact in investment products rated high risk by the LC.

Case 16

Where a client wished to transact in investment products rated high risk by the LC, the client would be required to sign a declaration to the effect that the product was purchased according to his own will, and the LC had not made / provided the client with any recommendation or solicitation.

Where a recommendation or solicitation was in fact provided to a client, the obligation of the intermediary to comply with the requirement to ensure suitability of the transaction cannot be limited by asking the client to sign such a declaration.



Case 17

An LC required its clients to sign a declaration on a transaction basis and they were given only two options: confirm to have received investment advice from the LC or not to have received any investment advice from the LC. However, if the latter option was taken, the client would also be confirming, without allowing for different circumstances, the following matters: he made the investment decision at his own volition; he had read and understood all relevant product literature; and he was competent to judge the suitability of the product in light of his own investment objectives, risk tolerance level, etc.

The design of such declaration form appears to be faulty as the second option in the form relates to a multiple question to which the client is only allowed to provide one single affirmative answer and which may not properly reflect the reality of the relationship between the LC and the client.

41. Any insertion of clauses in client agreements with the intention to restrict clients' ability to make any contractual claims relating to protections under the Code of Conduct may be contrary to General Principle 1 of the Code of Conduct in which intermediaries are required to act "honestly, fairly, and in the best interests of clients and the integrity of the market." Intermediaries should also ensure that their clients understand properly any declarations that they are asked to sign and are willing to accept the implications and consequences.
42. The SFC will further evaluate these inspection findings in respect of the use of disclaimers and declarations contained in client agreements which potentially distort the true relationship between the LC and the client in order to limit potential liability for advice given to the client, and propose an appropriate regulatory response separately.



Compliance with the new Code of Conduct requirements

43. As a means to enhance intermediary conduct and selling practices relating to the sale of investment products, new requirements concerning the sale of investment products under the Code of Conduct were introduced in phases and were fully implemented by September 2011.
44. This section discusses how some LCs failed to implement these new requirements properly and clarifies the misconceptions held by some LCs.

Pre-sale disclosure of monetary benefits

45. In order to address potential conflicts of interest issues, new disclosure requirements require intermediaries to deliver some sales related information, including monetary and non-monetary benefits, to the client prior to or at the point of sale to enhance transparency.
46. It was found that some LCs held the mistaken belief that only disclosure of the charges paid by clients was required, but not the rebates received by the firm from the product providers. Some other LCs when disclosing the rebate earned on a particular transaction gave only a figure representing the highest possible rate of rebates that the product providers might pay to the firms among all products distributed, but not the actual rate of rebate (rounded up to the nearest 1%) earned on the particular transaction as required by the Code of Conduct.

Case 18

The LC received 2.5%, 3.5% or 4.5% commission rebate from the product issuers depending on the specific product in question, and incorrectly made a uniform disclosure of commission rebate (e.g. up to 5% of investment amount) for all products distributed. The rate of rebate (rounded up to the nearest 1%) earned on the particular transaction should be disclosed on a transaction basis.

The purpose of the disclosure is to increase transparency of the rewards or benefits received by the distributor for selling individual products, thereby facilitating an investor to compare the rewards or benefits that the intermediary would receive for distributing each of the recommended products, among other factors, in order to make an informed investment decision. Therefore, disclosing only the highest uniform rate across all products would diminish the usefulness of disclosure about the rewards received by the distributor for individual products.

47. In addition, the SFC found that some LCs had not disclosed the trading profit to be made from back-to-back transactions in accordance with paragraph 8.3A(a) of the Code of Conduct. The SFC would like to remind intermediaries that whenever they, after receiving a purchase order from an investor, purchase an investment product from a third party and then sell the same investment product to the investor and make a trading profit without taking any market risk, the trading profit should be disclosed to the investor. The rationale for such disclosure requirement had been explained in the



consultation paper¹ and consultation conclusions² published in September 2009 and May 2010 respectively.

Investor characterization

48. The investors' knowledge in investment products is a crucial factor in determining whether an investment product is suitable for a client. As investment products with embedded derivative elements are generally difficult for investors to understand, intermediaries are now required to assess a client's knowledge of derivatives and characterize the client based on his knowledge of derivatives.
49. Most LCs had implemented measures to assess a client's knowledge of derivatives and characterize a client based on his knowledge of derivatives, and to assess whether an investment product is a derivative product for the purpose of the Code of Conduct.
50. The SFC found that some LCs relied solely on client's declaration that he has attended training or has prior working experience or trading experience relating to derivative knowledge. Intermediaries are expected to make appropriate enquiries of or gather relevant information about the client during the Know Your Client process so as to enable them to carry out a proper assessment instead of merely relying on the client's declaration.
51. In assessing whether investment products are derivatives, LCs in general had treated structured products (e.g. equity-linked notes, accumulators, etc.) as derivatives, but some LCs had not implemented procedures to assess if a fund is a derivative product for purpose of paragraph 5.1A of the Code of Conduct.

Case 19

An LC incorrectly assumed that only structured products, but not funds (whether or not embedded with derivatives), would be considered as derivative products. Hence, it did not implement any measures in determining whether any particular fund is a derivative product.

The function derivatives play in the structure of the fund, the duration, and the extent of derivatives being used by the fund will affect whether or not an investor who wishes to invest in that fund would need to have an understanding of derivatives in order to make an informed investment decision.

¹ Consultation Paper on Proposals to Enhance Protection for the Investing Public issued by the SFC in September 2009.

² Consultation Conclusions on the Proposals to Enhance Protection for the Investing Public issued by the SFC in May 2010.



Eligibility verification of Professional Investors

52. Under the Securities and Futures (Professional Investor) Rules (**PI Rules**), high net worth investors who meet the requisite portfolio threshold can be treated as Professional Investors (**PIs**). If an investor is a PI, certain legal restrictions do not apply. In addition, the term PI is also referred to in the Code of Conduct which sets out the specific actions that an intermediary is required to take when the intermediary wishes to waive certain Code of Conduct requirements for a high net worth client classified as a PI under the PI Rules. If a client is both a PI under the PI Rules and assessed to be a PI under the Code of Conduct, certain Code of Conduct requirements can be waived including the requirement to ensure the suitability of a recommendation or solicitation made to the client.
53. This section discusses the inadequacies and deficiencies observed in the LCs' assessment of the eligibility of their PI customers.
54. The PI Rules prescribe certain methods by which intermediaries can be satisfied that a client meets the requisite portfolio threshold. Intermediaries can rely on a certificate issued by an auditor or a certified public accountant of the client or one or more custodian statements issued to the client within 12 months before the relevant date showing that the client has the requisite portfolio amount.
55. The SFC found that some LCs, when ascertaining whether a client is a PI (i.e. being able to meet the requisite portfolio threshold of HK\$8 million), had misconceptions about what assets held by a client could be counted.

Case 20

Example A: An LC incorrectly counted the value of residential property of a client in ascertaining whether the client met the requisite portfolio threshold. Residential property does not fall within the definition of a portfolio.

Example B: An LC erroneously included the portfolio of an account jointly held by the client and his parent in ascertaining whether the client met the requisite portfolio requirement. While a portfolio jointly held by the client and his associate (only the spouse or any child of the individual) can be counted, a portfolio held jointly with other people cannot be counted.

Example C: An LC included the portfolio of an account solely held by a person whom the LC erroneously thought was the associate of the client in ascertaining whether the client met the requisite portfolio requirement. As mentioned above, a portfolio jointly held by the client and his associate can be counted, but not the portfolio held in a sole account of the client's associate, let alone the portfolio of a person who is not the associate of the client.

56. Subsequent to the coming into effect of the Securities and Futures Professional Investor)(Amendment) Rules 2011 on 16 December 2011 and in addition to the methods mentioned in paragraph 54 above, intermediaries may use methods that are appropriate in the circumstances to satisfy themselves that a client meets the requisite portfolio threshold at the relevant date to qualify as a PI. Intermediaries are expected to keep proper records of their assessment process so as to demonstrate that they have exercised professional judgement and have reached a reasonable conclusion that their clients meet the relevant threshold.



57. Prior to waiving certain requirements under the Code of Conduct, an intermediary should, amongst others, assess and be reasonably satisfied that the client is knowledgeable and has sufficient expertise and investment experience in relevant products and markets. Such assessment should be in writing. Records of all relevant information and documents obtained in the assessment should be kept so as to demonstrate the basis of assessment.
58. Some LCs that were inspected merely relied on the information collected from clients through standard assessment forms without assessing whether the information collected was consistent with other information known about the client as demonstrated in the following example.

Case 21

An LC relied on a client's responses in a standard PI assessment form to assess a client's knowledge, expertise and investment experience in relevant products and markets. It was only subsequently discovered that the responses provided regarding the client's knowledge, expertise and investment experience were inaccurate, which had, in the absence of compensating measures, resulted in the LC reaching a wrong conclusion as to the products and / or markets in which the client could be classified as a PI. The assessment form had not been filled in by the client himself. This was possible as the LC allowed clients to return the completed assessment form without the need for the LC's staff to walk the client through or discuss with the client the questions and answers to the assessment form.

Intermediaries should conduct an assessment regarding the client's knowledge, expertise, investment experience and his awareness of risks in relevant products and markets. Where a standard assessment form is used to assist information gathering from clients, intermediaries should also assess whether the answers provided by the client in the form are consistent with the information gathered through discussions with the client and the Know Your Client process. The assessment should be in writing and records of all relevant information and documents obtained in the assessment should be kept to demonstrate the basis of the assessment.

59. In addition to conducting the assessment mentioned above, an intermediary should provide a written explanation to the client explaining the risks and consequences of being treated as a PI (i.e. that the intermediary is entitled to waivers of certain Code of Conduct requirements including the waiver of the requirement to ensure the suitability of a recommendation or solicitation). The written explanation should also inform the client that he has a right to withdraw from being treated as a PI. The intermediary should also obtain a written and signed declaration from the client that the consequences of being treated as a PI and the right to withdraw from being so treated have been explained to him and that the client consents to being treated as a PI.
60. In this regard, the SFC found that some LCs provided unclear written explanations to PI clients such that the clients did not know whether the LCs were entitled to waive relevant regulatory requirements when selling products to them.



Case 22

When a client signed on the application form to be classified as a PI by which the client also agreed to be treated as a PI with its attendant risks and consequences, it was unclear as to whether the client was to be treated as a PI under the law only (where certain legal restrictions under the SFO would not apply) or also as a PI under the Code of Conduct (where certain requirements in the Code of Conduct, such as the requirement to ensure the suitability of a recommendation or solicitation for the client, would not apply). The same issue arose in the notifications the client received informing the client of his PI status. This might be very confusing for the client and could potentially affect the client's legal rights.

Intermediaries should ensure that any documentation provided to clients in relation to the classification of the client as a PI should accurately and clearly convey the relevant risks and consequences of being classified as a PI and in which products and/or markets the intermediary intends to treat the client as a PI under the Code of Conduct.

61. The standard and methods that should be taken into account in establishing the portfolio levels of PIs are laid down in the PI Rules. The assessment that an intermediary is required to go through and the relevant procedures that it should undertake when the intermediary wishes to waive certain Code of Conduct requirements are also clearly explained in the Code of Conduct. Further guidance has also been provided in the circular³ and consultation conclusions⁴ issued by the SFC. Intermediaries should refer to the relevant rules and guidance in the process of performing eligibility verification of their clients' PI status.

³ The circular on the "Guidance to Licensed Corporations and Registered Institutions in relation to Investor Characterization and Professional Investors Requirements" issued by the SFC on 28 May 2010

⁴ Consultation Conclusions on the Evidential Requirements under the Securities and Futures (Professional Investor) Rules issued by the SFC in February 2011



Concluding Remarks

62. In this round of thematic inspections, the SFC noted that all LCs had established procedures to implement relevant requirements governing their selling practices.
63. However, implementation deficiencies were found. There is also room for improvement in the management supervision framework to ensure compliance with selling practices requirements. Taking into account all relevant facts and circumstances, the SFC will take appropriate regulatory action against LCs found to have breached the Code of Conduct and other applicable requirements.
64. The SFC will continue to use a range of supervisory tools to monitor compliance by LCs with the selling practices requirements.
65. The SFC will also continue to provide guidance to intermediaries (e.g. issuing FAQs, circulars) concerning compliance with the Code of Conduct, the Management Supervision Guidelines and the Suitability FAQ in areas where a lower level of compliance is found.
66. The SFC will further evaluate the inspection findings in respect of the use of disclaimers and declarations contained in client agreements which potentially distort the true relationship between the LC and the client in order to limit potential liability for advice given to the client, and propose an appropriate regulatory response separately.
67. The SFC will continue with its investor education campaign to raise awareness amongst the investing public of the importance of understanding the suitability assessment process and asking for the right information to protect their own interests.



Appendix

Examples of good practices adopted by certain licensed corporations

During the course of our inspections, the SFC noted some good practices and internal controls being adopted by certain LCs in providing advisory services. The examples listed below are not exhaustive nor should intermediaries treat them as the only methods of meeting regulatory requirements. Intermediaries should always take into account their own particular circumstances when adopting these examples.

Training for staff

1. Some LCs have established a formal assessment procedure (such as quizzes) to test the understanding of their staff on the training received.
2. Refresher training was provided to staff periodically to remind staff about regulatory requirements, reinforce basic principles and concepts, and provide updates on regulatory changes and developments.

Compliance monitoring procedures

3. An LC established an elaborate compliance monitoring program which comprise of:
 - (a) employing a checklist to check if all necessary information has been obtained by the sales staff and the suitability assessment has been properly carried out by the sales staff as part of a systematic process for performing compliance monitoring to ensure effectiveness;
 - (b) staff performing these compliance checks report directly to the Compliance Department and senior management regarding any exceptions or issues identified; and
 - (c) establishing a penalty system for breaches of policies and procedures (e.g. warning letters to sales staff) to impress on staff that non-compliant behaviour will not be tolerated.
4. Some LCs promoted good compliance culture by taking into account a number of performance indicators (e.g. whether the sales staff had breached any policies and procedures or were the subject of any client complaints) in the determination of the amount of discretionary bonus paid to the sales staff.

Know Your Client

5. In order to ensure that the clients agree with the risk profile assessment and classification, some LCs requested clients to sign and acknowledge the risk profiling results and provide a copy of the signed document to clients.
6. An LC sent an annual confirmation letter to clients to confirm their risk profile. Clients are required to contact designated sales staff to conduct the risk profiling exercise again should there be any changes in their risk appetite or investment objectives, and/or if they do not agree with the assessed risk tolerance level.



Product due diligence

7. As part of an LC's product due diligence process, the LC set out in detail what aspects of the products it considered to be suitable for different risk categories of investors and provided clear guidance to its sales staff. For example, for a high risk structured product, the guideline states that such a product would only be suitable for clients with a high risk tolerance level and who has a specific view regarding the market of the underlying asset (e.g. the client believes that the underlying currency accumulated will appreciate or trade sideways over time); it also states the investment horizon of the clients (e.g. a six-month to one-year investment horizon). Apart from providing training to sales staff, the LC prepared presentation materials that assist sales staff to provide effective and consistent explanations to clients regarding the product.

Additional controls for certain customer groups

8. An LC put in place additional controls when selling investment products to certain customer groups such as elderly people and those with relatively low level of education. Sales staff will arrange a meeting with such customer to explain to him the general risks of investing in investment products. A non-sales staff would also attend the meeting to ensure that the explanation is properly given to the customer. Moreover, the customer is encouraged to invite a relative or friend to attend the meeting to help ensure that the customer understands the general risks of investing in investment products.