Frequently Asked Questions on Compliance with Suitability Obligations by Licensed or Registered Persons (FAQs)

Licensed or registered persons are required to observe suitability obligations under paragraph 5.2 of the Code of Conduct which states that:

“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.”

These FAQs set out some practical considerations that licensed or registered persons should take into account when they seek to comply with the standards of conduct expected of them under the existing Code of Conduct and Internal Control Guidelines as supplemented by circulars and FAQs issued by the SFC from time to time (hereinafter referred to as the Codes). Given that the FAQs are relevant to any licensed or registered person making a recommendation or solicitation to clients, references to a “recommendation” in the FAQs also include references to a “solicitation” made by licensed or registered persons where suitability obligations under paragraph 5.2 of the Code of Conduct are triggered, and references to “recommend” should be construed accordingly.

The statements below are general statements and licensed or registered persons should consider their own circumstances and review their existing systems and practices in the light of the FAQs. Where necessary, licensed or registered persons should enhance their own systems and controls to meet the standards set out in the Codes.

Owing to significant differences that exist in the nature, features and risks of investment products and the personal circumstances of investors, the FAQs are neither intended to be, nor should be construed as, an exhaustive list of all factors that licensed or registered persons should consider in the conduct of their business.

Licensed or registered persons should note that, in addition to the requirements in the Codes, the SFC will take into account compliance with guidance in the FAQs to determine whether a licensed or registered person is fit and proper to carry on the relevant regulated activities in Hong Kong.

Apart from the following guidance in the FAQs, licensed or registered persons are urged to consider taking all necessary action in their particular circumstances to ensure compliance with the Codes. Where appropriate, licensed or registered persons should seek independent advice before taking action on matters to which the answers may be relevant or if they have doubt about how the Codes apply to them.

1. **What are the suitability obligations expected of licensed or registered persons?**

   Licensed or registered persons should:

   a) know their clients;

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1 Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission
2 Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the Securities and Futures Commission
3 These cover both exchange traded products and non-exchange traded products. For the purpose of these FAQs, non-exchange traded products include products sold over the counter and products which may be listed but the trading of which is executed outside an exchange.
b) understand the investment products they recommend to clients (Product due diligence);
c) provide reasonably suitable recommendations by matching the risk return profile of each investment product with the personal circumstances of each client to whom it is recommended;
d) provide all relevant material information to clients and help them make informed investment decisions;
e) employ competent staff\(^4\) and provide appropriate training; and
f) document and retain the reasons for each investment recommendation made to each client.

2. **What are the “know your client” requirements”?**

There are positive obligations on licensed or registered persons under the “know your client” (KYC) requirement of paragraph 5.1 of the Code of Conduct to seek information from clients about their financial situation, investment experience and investment objectives, irrespective of whether a solicitation or recommendation is to be made. Examples include information about:

a) Annual income, liquid assets or net worth in order to assess the client’s financial situation;
b) The types of investment products in which the client has invested and the period over which investment in such products has occurred in order to assess the client’s investment experience; and
c) The purposes of investment, such as income generation or capital preservation, in order to assess the client’s investment objectives.

In order to better understand this client information for the purpose of the suitability assessments, licensed or registered persons should collect from each client information that includes the client’s 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.

Where licensed or registered persons have used reasonable efforts to obtain information from clients, the licensed or registered persons may rely on the information provided by the clients in discharging the KYC requirement unless they are aware or should reasonably be aware that such information is inaccurate or out of date.

If conflicting information or incomplete information is provided by a client, the licensed or registered persons should alert the client and seek clarification from the client before performing the suitability assessments.

Licensed or registered persons should make an assessment of the client’s attitude towards risk, his expectations and so on based on the information disclosed by a client. However, if disclosure by the client is limited and as a result the licensed or registered persons are unable to make that assessment properly, the licensed or registered persons should, as a minimum, explain to the client the inherent limitations of the recommendations made as a result of the lack of information. Furthermore, the licensed or registered persons should explain to the client the assumptions, if any, they made in relation to such recommendations.

\(^4\) This also includes appointment of agents, consultants, contractors and similar arrangements
Each client’s information should be properly documented and where appropriate, updated on a continuous basis.

3. **How should licensed or registered persons assess clients’ attitude towards risk?**

There may be different ways for licensed or registered persons to assess a client’s attitude towards risk for the purpose of suitability assessments. For example, they may have verbal discussions with their clients and supplement the discussions by questionnaires with a risk-scoring mechanism. If licensed or registered persons use a risk-scoring questionnaire to support their assessment, they should pay particular attention to the design of the questions and the underlying scoring mechanism. For example, questions and the list of possible answers to each of them, together with the risk-scoring mechanism, should be properly designed to accurately reflect the personal circumstances of a client, and to avoid producing skewed results towards high risk tolerance. Further, licensed or registered persons should not ask a client to answer the questions in a particular way so as to produce a risk tolerance level that is commensurate with the risk of a product it is recommending to the client.

4. **How should licensed or registered persons conduct due diligence on investment products?**

Licensed or registered persons should not recommend investment products which they do not understand. They should conduct due diligence work in selecting appropriate investment products for each client.

When conducting product due diligence, apart from understanding the nature and extent of risks of the investment products, licensed or registered persons may need to consider market and industry risks, economic and political environments, regulatory restrictions and any other factors which may directly or indirectly impact on risk return profiles and growth prospects of investments depending on the nature of the investment products.

Licensed or registered persons should conduct their own product due diligence and arrive at their own assessment of the products by taking into account all relevant information that is appropriate and reasonably available for a fair and balanced assessment. The risk ratings published by independent research companies or credit ratings assigned by credit rating agencies are only one of the factors to be considered in conducting product due diligence.

Licensed or registered persons may adopt a proportionate approach in conducting product due diligence and documenting the due diligence work by having regard to the nature and extent of risks of the investment products.

a) **Non-exchange traded products**

- Due diligence involves licensed or registered persons developing a thorough understanding of non-exchange traded products, for example, the structure of investment products, how they work, the nature of underlying investments, the level of risks they bear, the experience, financial condition and reputation of product issuers, guarantors (if any) and service providers, fees and charges, the relative performance and liquidity of investment products, lock-in periods, termination conditions, valuation and unit pricing, and safe custody arrangements.
Licensed or registered persons should make their own enquiries and obtain full explanations from product issuers about the risks inherent in the investment products, where appropriate. It is not advisable for licensed or registered persons to rely on prospectuses, offering circulars or marketing materials as necessarily being self-sufficient and self-explanatory.

Licensed or registered persons should document verification work and enquiries which they have made about the products, the criteria for selecting the products and in what aspects they are considered suitable for different risk categories of investors, and the approvals they obtain from senior management for recommending the products.

**b) Exchange traded products**

- Licensed or registered persons should have a thorough understanding of the investment products that they recommend to their clients. In the case of exchange traded products, this includes an understanding of the risks and features of different types of exchange traded products. Some types of exchange traded products (e.g., derivative warrants, callable bull/bear contracts and leveraged and inverse products) may have a higher level of risk than others.

- The level of product due diligence and the documentation of the due diligence work can be proportionate to the complexity, opaqueness, risk and liquidity of the different types of exchange traded products.

Licensed or registered persons should ensure that product due diligence is conducted on a continuous basis at appropriate intervals having regard to the nature, features and risks of investment products.

**5. How may licensed or registered persons provide recommendations that are reasonably suitable for clients?**

Suitability involves licensed or registered persons matching the risk return profile of each recommended investment product with each client’s personal circumstances. Therefore, licensed or registered persons should use their professional judgement to assess diligently whether the characteristics and risk exposures of each recommended investment product (including transaction costs, effect of gearing and foreign currency risks, where appropriate) are actually suitable for the client and are in the best interests of the client, taking into account the client’s investment objectives, investment horizon, investment knowledge and experience, risk tolerance, and financial situation, etc. Licensed or registered persons should take into account all the relevant circumstances of a client when performing the suitability assessments. Hence, for licensed or registered persons that have assigned risk ratings to products, merely mechanically matching a product’s risk rating with a client’s risk tolerance level assessed by the licensed or registered persons may not be sufficient to discharge their obligation.

Licensed or registered persons should give due consideration to all relevant circumstances specific to a client, including concentration risk, when assessing the suitability of a product to the client. They are expected to assess concentration risk based on available information about the client (e.g., investment portfolio held with the licensed or registered persons and information about the client’s financial situation). In assessing concentration risk, licensed or registered persons should take into
account all relevant factors, particularly the risk profile and nature of a product and a client's risk tolerance level and financial situation.

Where licensed or registered persons recommend investment products to their clients, as part of the suitability assessments, they should consider the overall effect of their recommended investment products on their clients' portfolios. For example, for a client with low or medium risk profile, a proportion of high risk products in his portfolio may not be unsuitable so long as this is commensurate with the risk return profile of the portfolio and the licensed or registered persons are able to satisfy itself that any investment products recommended are likely to meet the investment objectives and other personal circumstances of the client.

Where licensed or registered persons or their related companies will receive commission rebates or other benefits for transacting in particular investment products for clients, the licensed or registered persons must not take such commission rebates or other benefits as the primary basis for recommending particular investment products to clients. Also, where the licensed or registered persons only recommend investment products which are issued by their related companies, they should disclose this limited availability of products to each client.

Lastly, licensed or registered persons should exercise extra care when making recommendations to elderly or unsophisticated clients or those who may not be able to make independent investment decisions on complex investment products and rely on the licensed or registered persons for recommendation, particularly when these clients invest in investment products with long maturity periods and those which will attract hefty penalty charges upon early redemption or withdrawal.

6. **How can licensed or registered persons help clients make informed decisions?**

Licensed or registered persons should, where available, provide each client with recommended investment products' up-to-date prospectuses or offering circulars and other up-to-date documents relevant to the investments.

Licensed or registered persons should help each client make informed decisions by giving the client proper explanations of why recommended investment products are suitable for the client and the nature and extent of risks the investment products bear. In addition to explaining the good points of the investment products, licensed or registered persons should always present balanced views, drawing the client's attention to the disadvantages and downside risks as well. Licensed or registered persons should use simple and plain language, and in a language that the client can readily understand. The explanations must be fair and not misleading.

Each client should be given sufficient time to digest, consider and evaluate the information and recommendations provided by licensed or registered persons and be given sufficient opportunity to raise queries with the licensed or registered persons. Under no circumstances should licensed or registered persons use high-pressure or unfair techniques to force or entice any client to make hasty investment decisions.

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5 In respect of non-exchange traded products, licensed or registered persons are expected to at least provide up-to-date product offering documents or offering circulars. For exchange traded products, a good practice would be to inform the client where up-to-date documents or information could be accessed such as a hyperlink to the offering documents in relation to the IPO of a stock.
7. What are the documentation standards expected of licensed or registered persons?

Licensed or registered persons should maintain records documenting the rationale underlying investment recommendations made to the client and provide a copy of the rationale for the recommendations to the client upon his or her request6.

To demonstrate compliance with regulatory requirements, licensed or registered persons should document and record contemporaneously the information given to each client, including any material queries raised by the client and the responses given by the licensed or registered persons. In addition, licensed or registered persons should keep sufficient documentation on all client transactions including orders placed to product providers.

Licensed or registered persons may choose to fulfill the documentation requirement by maintaining a written record or an audio record having regard to their mode of operations. 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.

8. Would licensed or registered persons who use computer models to generate investment recommendations be subject to suitability obligations?

Licensed or registered persons are also subject to the suitability obligations set out in Question 1 above when they assist clients to make investment decisions by using computer models to generate investment recommendations which make reference to specific client information input into the computer.

Licensed or registered persons should ensure that such computer models take into account all relevant information about each client, use objective criteria to generate investment recommendations which match the client's personal circumstances against suitable investment products and operate in a manner that is not biased.

9. In terms of the nature and scope of services, what is expected of licensed or registered persons in client agreements?

Licensed or registered persons should establish and define their relationships with each client by way of a client agreement before providing services to the client. The client agreement should define rights, obligations and responsibilities of each party and properly reflect the nature and scope of the services to be provided.

For those licensed or registered persons who provide continuous services to clients, they should review each of their client agreements on an ongoing basis to ensure that the nature and scope of the services they provide to each client is properly updated and recorded.

6 Licensed or registered persons that adopt a portfolio-based approach in assessing suitability when providing services to Private Banking Customers (PB Customers) are reminded to follow the requirements set out in the Circular on Compliance with Suitability Obligations issued by the SFC on 17 July 2012 for the purpose of compliance with the requirement of providing the rationale of recommendations to their PB Customers under this Question.
10. **What is senior management of licensed or registered persons expected to do?**

Governing bodies of licensed or registered persons (including senior management) should maintain a good corporate governance structure, with clear lines of responsibility and authority, by which licensed or registered persons’ activities are properly directed, managed and controlled in order to serve the best interests of clients.

Senior management is responsible for ensuring that licensed or registered persons comply with all applicable laws, rules and codes. It should review, assess and be satisfied that the licensed or registered persons have adequate systems and controls to promptly identify issues and matters that may be detrimental to a client’s interest (eg, cases in which investment recommendations may have been made merely to meet sales targets or may be driven by financial or other incentives).

In addition, the senior management should recruit staff who are fit and proper and have an adequate level of knowledge and skills to provide recommendations to clients. Licensed or registered persons should also provide regular and appropriate training to their staff and ensure that they keep abreast of developments in the industry.

On an ongoing basis, senior management should ensure that transactions and related documents are reviewed by qualified and competent personnel. Sampled selection of transactions and related documents should be risk-based and cover investments in complex investment products by elderly or unsophisticated clients or those who may not be able to make independent investment decisions concerning such investment products.

Client complaints should be promptly investigated in accordance with a properly documented procedure and appropriate remedial measures should be taken without undue delay.

The escalation policies and procedures of licensed or registered persons should be such that senior management is kept informed on a timely basis of all issues and matters that may call into question compliance with applicable laws, rules and codes and protection of client interests.