

STATEMENT OF DISCIPLINARY ACTION

The Disciplinary Action

1. The Securities and Futures Commission (**SFC**) has reprimanded Mega International Commercial Bank Co., Ltd. (**MICBC**)¹ and fined it HK\$7,000,000 pursuant to section 196 of the Securities and Futures Ordinance (**SFO**).
2. The disciplinary action is taken in respect of MICBC's internal control failures in relation to the sale of collective investment schemes (**CISs**).

Summary of facts

Background

3. The Hong Kong Monetary Authority (**HKMA**) conducted an onsite examination and subsequently an investigation on MICBC in respect of its CISs selling activities for the period between August 2014 and July 2015 (**Relevant Period**), and identified various irregularities in MICBC's selling practices. Following the investigation, the HKMA referred the case to the SFC.
4. Upon receiving the HKMA's referral, the SFC conducted an investigation under section 182 of the SFO into the conduct of MICBC. The SFC's investigation revealed that, in selling CISs to clients during the Relevant Period, MICBC had failed to implement adequate and effective systems and controls to:
 - (a) properly assess its clients' investment objective, risk tolerance level and knowledge of derivatives;
 - (b) ensure the investment recommendations and/or solicitations made to its clients were reasonably suitable in all the circumstances of each of its clients;
 - (c) conduct adequate product due diligence on certain funds;
 - (d) ensure all relevant factors were properly taken into account before assigning the funds risk ratings; and
 - (e) identify funds which constituted derivative products.

Client risk profiling

5. During the Relevant Period, MICBC required its salespersons to assess clients' risk tolerance level via a customer risk profiling questionnaire (**CRPQ**).
6. The CRPQ consisted of two sections:
 - (a) The first section required clients to provide general information such as their investment objectives, investment experience, annual income, and net worth. No scores were assigned to this section.

¹ MICBC is registered under the Securities and Futures Ordinance to carry on business in Type 1 (dealing in securities) regulated activity.

- (b) The second section contained 8 scoring questions for determining the clients' risk tolerance level. Clients were classified into 1 out of 4 risk tolerance levels (i.e. "Conservative", "Balanced", "Balanced Growth", and "Aggressive Growth") based on the total score attained by them in this section.
7. The design of the CRPQ was deficient:
- (a) Client information such as investment experience under the first section of the CRPQ did not carry any scores. There is no audit trail to show that such information was taken into account by the salespersons during the client risk profiling exercise or the sales process of each CIS transaction.
 - (b) Corporate clients were not required to answer the scoring questions under the second section of the CRPQ. Instead, they were asked to select their own risk tolerance level in the CRPQ.
 - (c) MICBC did not have any systems and controls to identify and assess conflicting answers in the CRPQ. Clients were allowed to select multiple investment objectives under the first section which might be conflicting with each other. There were also instances where clients had selected an investment objective that conflicted with their answers provided under the second section of the CRPQ.
 - (d) In a few cases, the risk tolerance level assigned to the clients was inconsistent with the clients' investment objective.

Failure to assess clients' knowledge of derivatives

8. According to MICBC, clients were required to complete a "*Derivatives Experience Profiling Form*" (**Derivatives Form**) during the know your client process.
9. The Derivatives Form contained several questions asking the clients to confirm whether they had: (a) executed 5 or more transactions in any derivative products in the past 3 years; (b) undergone training or attended courses on derivative products; (c) work experience related to derivative products; and/or (d) carried out activities related to derivatives in the capacity of a licensed or registered person.
10. Clients were deemed to have sufficient knowledge in derivatives if their answer to any of the above questions was affirmative. MICBC did not require its staff to make enquiry or gather relevant information about the clients' knowledge of derivatives in accordance with the requirement set out in the frequently asked questions issued by the SFC on 3 June 2011, which provides that:

"In assessing whether a client has knowledge of derivatives, intermediaries should make appropriate enquiries of or gather relevant information about the client during the know your client ("KYC") process so as to enable them to make the assessment instead of relying merely on the client's declaration that

he/she has knowledge of derivatives. A proper audit trail should also be maintained to demonstrate that they have made the assessment.”

Suitability assessment process

11. During the Relevant Period, MICBC implemented, among other things, the following measures to ensure suitability of products recommended to clients:
 - (a) Salespersons were required to match a client’s risk tolerance level with the product’s risk rating to determine whether there was a risk mismatch. In the event of a risk mismatch, salespersons were required to inform the client of the mismatch and warn the client of the relevant investment risk. The client was required to sign an Investment Risk Acknowledgement Form to acknowledge the risk mismatch and provide reasons for entering into the risk mismatch trade. The trading documents would be passed to the Head of Wealth Management for approval after the back office had confirmed the transaction with the client over a tape-recorded call.
 - (b) From 1 October 2014, salespersons were further required to perform the following assessments (**Additional Assessments**) and document the results in a product checklist (**Checklist**):
 - (i) whether the client was a vulnerable customer²;
 - (ii) any tenor mismatch, i.e. a mismatch between the product tenor and the client’s investment horizon;
 - (iii) whether the transaction would give rise to an investment objective mismatch, i.e. a client with an investment objective of “capital preservation” placing an instruction to invest in investment funds, or a client with an investment objective of “income” placing an instruction to invest in equity funds; and
 - (iv) whether the client’s total investment in the same type of product equalled to or exceeded 50% of the client’s net worth or asset under MICBC’s management, whichever is higher (**Over-concentrated transactions**).
 - (c) Salespersons were required to document their rationale for recommending the product to the client.
12. However, the SFC found that:
 - (a) The Additional Assessments were not applied to fund switching transactions and subscriptions for regular savings funds (also known as monthly income plans, **MIP**) during the Relevant Period.
 - (b) MICBC did not require salespersons to document the rationale underlying their investment recommendations made to the clients in respect of fund switching transactions.

² Under MICBC’s policy, vulnerable customers included customers: (i) over the age of 65; (ii) with low level of education (junior high school or below) and/or (iii) with major disabilities.

- (c) The concentration assessment as described in paragraph 11(b)(iv) above was performed only when the client indicated in the CRPQ that his/her investment amount accounted for 35% or more of his/her total assets.
- (d) Among a total of 523 fund transactions conducted during the Relevant Period after 1 October 2014, there were 233 Over-concentrated transactions. No Checklist was completed for 156 Over-concentrated transactions involving fund switching or MIP subscriptions. For the remaining 77 Over-concentrated transactions where a Checklist had been completed, 42 (55%) were not identified as an Over-concentrated transaction in the relevant Checklists.
- (e) Funds which could be redeemed freely at any time by the clients' requests were considered by MICBC to be suitable for any investment horizon. Although the investment objective of certain funds was stated in the product fact sheets to be "long term capital growth", they were sold to clients who had selected the shortest period (i.e. less than 3 years) as their investment horizon in the CRPQ³. There is no record to show that the salespersons had considered the funds' investment objective in performing the suitability assessment and documented the reasons as to why such funds were considered to be suitable for the clients having regard to the clients' investment horizon.
- (f) There was no guideline on the handling and approval of transactions with multiple mismatches/exceptions in different aspects, including the clients' risk tolerance level, investment objective, investment horizon and/or asset concentration level (**Multiple Mismatches transactions**)⁴.
- (g) The executive officer of MICBC was not required to document any justification for approving the mismatch transactions (including Multiple Mismatches transactions).
- (h) Whilst salespersons were required to document the reasons as to why a particular mismatch transaction should proceed, a sample review of the Multiple Mismatches transactions showed that most of the explanations provided were overly general and failed to sufficiently justify why the intended transactions were considered to be suitable for the clients despite the risk mismatch and high asset concentration risk. In some cases, the salesperson input "the client specifically requested for the relevant product" as one of the reasons for recommending the mismatch product to the client when the transaction was in fact not initiated by the client.

³ The client's investment horizon was determined by his/her answer to a question in the CRPQ which asked when the client would expect to withdraw a major portion of his/her investment. There were 3 answer options to the question: (a) "in more than 5 years"; (b) "between the next 3 to 5 years"; and (c) "within the next 3 years".

⁴ As stated in the circular issued by the HKMA dated 30 July 2014: "[Authorized Institutions] should put in place adequate controls and provide appropriate level of supervision in respect of mismatched transactions or exceptions such as high asset concentration, and risk/ objective/ tenor mismatch. There should be more stringent controls over transactions having serious or multiple mismatches or exceptions. The level of controls and supervision should reflect the seriousness of mismatch or exception involved in the transactions."

Product due diligence

13. The SFC's investigation also revealed various deficiencies in the product due diligence (**PDD**) performed by MICBC during the Relevant Period:
- (a) MICBC offered a total of 292 fund classes, among which 174 had been selling by its head office in Taiwan (**HO Funds**). MICBC relied on the PDD performed by its head office on the HO Funds. Apart from checking whether the HO Funds were authorized by the SFC, MICBC did not conduct any independent assessment on the adequacy and quality of the PDD performed by its head office having regard to the regulatory requirements in Hong Kong⁵.
 - (b) MICBC adopted a product risk rating methodology whereby a risk rating would be assigned to each of the funds distributed by it. However, MICBC only considered a limited number of factors during the risk rating exercise. Relevant factors such as price volatility, market segment and certain product features which might directly or indirectly impact on the risk return profiles of the funds were not taken into account in the risk rating exercise.
 - (c) MICBC did not establish any policies or procedures for assessing and identifying funds which might constitute derivative products⁶.

The SFC's concerns

14. The conduct of MICBC as set out above constitutes a breach of:
- (a) General Principle 2 (Diligence) of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (**Code of Conduct**), which requires a registered person to act with due skill, care and diligence, in the best interests of its clients and the integrity of the market;
 - (b) General Principle 3 (Capabilities) and paragraph 4.3 (Internal control, financial and operational resources) of the Code of Conduct, which require a registered person to employ effectively the resources and procedures which are needed for the proper performance of its business activities and have internal control procedures which can be reasonably expected to protect its operations and its clients from financial loss arising from professional misconduct or omissions;
 - (c) paragraph 5.1(a) (Know your client: in general) of the Code of Conduct, which requires a registered person to take all reasonable steps to establish the true and full identity of each of its clients, and of each

⁵ The HKMA's circular dated 30 July 2014 provides that, "[w]hile [Authorized Institutions] may take into account due diligence work of group company or head/ regional office as appropriate, they should establish proper policies and procedures to ensure that adequate product due diligence is performed taking into consideration the local regulatory requirements and other local circumstances to assess whether the investment product is suitable for target customers."

⁶ The SFC's circular dated 23 April 2012 provides that, in determining whether a fund is a derivative product, an intermediary should, where appropriate, seek written explanations from the product issuer of the rationale for a fund's classification provided to it. The intermediary should then be in a position to, having regard to all the information available, including explanations from the product issuer, determine whether the fund is a derivative product.

client's financial situation, investment experience, and investment objectives;

- (d) paragraph 5.1A (Know your client: investor characterization) of the Code of Conduct, which requires a registered person to assess a client's knowledge of derivatives and characterize the client based on such knowledge;
- (e) paragraph 3.4 (Advice to clients: due skill, care and diligence) of the Code of Conduct, which requires a registered person to act diligently and carefully in providing advice to a client and ensure that its advice and recommendations are based on thorough analysis and take into account available alternatives, and paragraph 5.2 of the Code of Conduct (Know your client: reasonable advice) which requires a registered person to ensure the suitability of its recommendation or solicitation for the client is reasonable in all the circumstances having regard to information about the client of which it is or should be aware through the exercise of due diligence; and
- (f) General Principle 7 (Compliance) and paragraph 12.1 (Compliance: in general) of the Code of Conduct, which require a registered person to comply with, and implement and maintain measures appropriate to ensure compliance with, relevant regulatory requirements.

Conclusion

- 15. Having considered all relevant circumstances, the SFC is of the opinion that it is in the interest of the investing public and in the public interest to resolve the above concerns with MICBC, and take the disciplinary action set out in paragraph 1.
- 16. In deciding the disciplinary sanctions, the SFC has taken into account that:
 - (a) MICBC took remedial actions to strengthen its suitability framework;
 - (b) MICBC engaged an independent reviewer to validate whether the findings raised by the HKMA during the onsite examination are fully addressed and whether its control mechanisms operate effectively in accordance with its internal policies and procedures, and undertook to submit the validation review report to the SFC and the HKMA as soon as it is available;
 - (c) there is no evidence that MICBC's failures resulted in losses borne by its clients;
 - (d) MICBC cooperated with the SFC in resolving its concerns; and
 - (e) MICBC has no previous disciplinary record with the SFC.