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

SFC
證監會

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