# REPORT ON SELLING PRACTICES OF LICENSED INVESTMENT ADVISERS

## Executive Summary

As part of our statutory duty, the SFC has been monitoring cases of mis-selling of financial products to investors involving investment advisers in both Hong Kong and overseas. Two recent cases of mis-selling by SFC licensed investment advisers in Hong Kong highlight the need to enhance the level of awareness amongst these investment advisers of the conduct standard expected of them. In this report, unless stated otherwise, the reference to "IAs" shall be to SFC licensed investment advisers only.

In order to formulate an appropriate regulatory response, the SFC conducted a theme inspection on a good mix of 15 IAs, focusing on their selling practices and assessing their compliance with the relevant rules and regulations.

While the key regulatory requirements, in broad principles, have long been set out in the Code of Conduct[1], we note with concern that some of the IAs have over the years taken an increasingly liberal reading of these principles and moved away from compliance with these standards. Hence, the SFC wishes to remind all IAs that they should adhere closely to these standards.

Inspection findings and further action

(a) Apparent breaches of regulatory or statutory requirements:

Our inspection, together with our other investigations, have shown that most of the problematic regulatory issues identified could have been avoided if IAs had strictly observed the standards that are already set out in the existing Code of Conduct and the Internal Control Guidelines[2]. Deficiencies noted include (a) making investment recommendations without proper basis; and (b) not giving sufficient explanation or information to the clients for them to make informed decisions. One of the primary objectives of this report is to remind IAs to adhere closely to these regulatory requirements. This report also provides specific guidance on certain of these broad principle requirements.

We have also noted instances where investment products without SFC authorization were offered to the public and some of these cases are currently under investigation. The SFC takes a serious view on such misconduct, and will take enforcement action against any material breaches.

[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

As part of our continuing efforts to raise industry standards amongst IAs, we plan to conduct another theme inspection in 2006 to assess whether the levels of compliance have improved.

(b) Issues requiring further consideration:

We plan to further consider and, where appropriate, engage IAs to explore some of the issues arising from this report. These include (i) the feasibility and benefits of requiring IAs to disclose to clients the commission and rebates received from product providers (ii) possible measures to enhance investor protection, such as requiring them to take up professional indemnity insurance; and (iii) the disclosure of the exact nature of services provided to clients in a client agreement.

## Purpose

1. This report sets out the regulatory concerns over IAs in Hong Kong, by

(a) presenting the findings of our recent theme inspection on selling practices adopted by IAs;

(b) discussing some of the issues that arose out of our investigations and which we believe pose serious regulatory concerns; and

(c) clarifying some of the existing requirements.

The report also sets out related issues which the SFC plans to study further.

## Scope of this report

2. In Hong Kong, an investment advisory firm may be an IA, a bank or an insurance intermediary. The SFC's inspection and investigation initiatives have, so far, been limited to reviewing the selling practices of IAs, which are under the SFC's direct supervision.

## PART A - Introduction

3. In common with investors in the United Kingdom, United States and Australia, increasing numbers of investors in Hong Kong are investing in non-traditional investment products. In the past, Hong Kong investors mainly invested in property, shares and foreign currency. However, the low interest rate environment and stock market volatility in the last several years have encouraged many investors seeking better returns or planning for their retirement, to invest in a wide range of financial products. These include the traditional unit trusts and mutual funds, hedge funds and other collective investment schemes, structured products as well as insurance policies offering an investment element (investment-linked insurance policies). Over time, these financial products have become more complex, cutting across traditional boundaries between securities investment, banking and insurance. This trend

emphasizes the important role that IAs, licensed or otherwise, play in giving their clients suitable advice when selling financial products.

4. For some time, the SFC has been monitoring the issues of mis-selling by investment advisers in the UK, Australia and the US, and other initiatives taken by overseas regulators in combating similar issues. Two recent cases in Hong Kong have exposed particular areas of concern. The first is the Court case of Barber Asia Limited v. Susan Field ("Barber Asia"). The second is the SFC's disciplinary action against Towry Law (Asia) HK Limited ("Towry Law"). Cases like Barber Asia provide useful guidance in helping IAs understand their responsibilities to their clients. Please refer to **Appendix 1** for a brief summary of these two cases and **Appendix 2** for a detailed synopsis and breakdown of important lessons to be learnt from the Barber Asia case.

5. These recent cases raise concerns on whether the conduct standard amongst IAs is satisfactory. As part of our statutory duty, the SFC is tasked with identifying potential problems before they become widespread. Against this background, the SFC conducted a theme inspection on selected IAs in 2004. The theme inspection aimed at providing the SFC with an indication of the state of the industry to assist the SFC to formulate the appropriate regulatory responses where necessary.

## PART B - Theme Inspection

6. In 2004, the SFC inspected 15 IAs that sell financial products to the public and assessed their compliance with the SFO, the Code of Conduct and the Internal Control Guidelines. This represents approximately 10% of the number of IAs that are currently engaged in this business. This report merely summarizes the findings of this theme inspection and some other investigations. While the SFC draws no inference that these findings would be found in the remaining 90% of IAs, the SFC believes that it is duty bound to alert the industry as to these findings, and to remind all that the Code of Conduct requirements should be vigorously adhered to.

### Profiles of selected IAs

7. The SFC selected a good mix of IA firms in order to better gauge the range of prevailing market practices. The 15 IAs selected for the theme inspection include:

   (a) those that only offer investment advisory business as well as those that offer investment advisory, discretionary management and other types of advisory business;

   (b) those that are not affiliated with any company and those that are members of local or overseas financial services conglomerates;

   (c) those that serve different types of clientele (e.g. local Chinese clients, expatriate clients or both);

(d) those that employ varying number of sales staff (e.g. ranging from a few sales staff to over 50 sales staff);

(e) those that serve varying number of clients (e.g. those with less than 50 advisory clients to those with over 1,000 clients); and

(f) those with varying amounts of shareholders' funds (e.g. ranging from less than HK$1 million to over HK$10 million).

**Clarification of existing requirements**

8. Our inspection and investigations have identified a number of areas concerning IA selling practices that require improvement. Starting with this report, the SFC plans to generate awareness regarding the conduct issues and problems that have been noted, and clarify the existing requirements applicable to IAs. Where we have come across unacceptable or undesirable conduct by IAs, we provide examples of what we believe should be improved.

9. IAs should critically review their existing systems and practices in the light of this report and enhance them where necessary. While we recognize that the market is very competitive, with banks and insurance intermediaries all seeking greater share in the lucrative investment advisory business, we believe that it is all the more important for IAs to adhere closely to high conduct standards to build up trust among their clients. Indeed, clients' trust is the vital element that underpins the entire investment advisory/ financial planning industry.

10. The standard of conduct upon which we assessed the selected IAs was based on the high-level principles set out in the Code of Conduct. The following requirements are of particular relevance to IAs:

(a) to act in their clients' best interests;

(b) to give suitable advice;

(c) to avoid conflicts of interest; and

(d) to employ competent staff and other resources and procedures for ensuring compliance with relevant law, etc.

IAs are advised to consider their own circumstances when developing their own systems and controls for meeting our expectations.

**Main conduct issues and clarification of existing requirements**

11. A range of issues have been identified in the theme inspections. These can be grouped into three main categories: (a) integrity and professionalism, (b) reasonable suitability of recommendations and (c) compliance matters. For a quick overview, these issues are summarized in Table 1 below:

**Table 1 – Summary of key conduct issues and clarification of existing requirements**

| Issues | | Clarification of Existing Requirements | Paragraph |
|---|---|---|---|
| **I. INTEGRITY AND PROFESSIONALISM** | | | |
| I.1 | Acting in the clients' best interests | IAs should always act with integrity and in the best interests of their clients. Under no circumstances should IAs place their own interests ahead of their clients. | 12-13 |
| I.2 | Avoiding conflicts of interest | IAs should, where there is an actual or potential conflict of interest, disclose that conflict of interest to their clients and take all reasonable steps to ensure that their clients are treated fairly, before giving any advice. | 14-16 |
| **II. REASONABLE RECOMMENDATIONS** | | | |
| II.1 | "Know your clients" | IAs should always know their clients before giving advice. | 21-24 |
| II.2 | Product due diligence | IAs should exercise due care in selecting appropriate products for selling to their clients. | 25-29 |
| II.3 | Making reasonable recommendations | IAs should make recommendations that are reasonably suitable given their clients' specific circumstances and prepare financial plans that set out the reasons and basis for recommendations made. | 30-33 |
| II.4 | Helping clients make informed decisions | IAs should explain the basis of recommendations to their clients to help them make informed decisions and there should be adequate disclosure of the risks associated with the products recommended. | 34-35 |
| II.5 | Competency | IA staff should have an adequate level of knowledge and skill to provide good advice. | 36-38 |

| III. COMPLIANCE MATTERS | | | |
|---|---|---|---|
| III.1 | Clients agreements | IAs should enter into client agreements with all their clients, setting out clearly the terms, obligations and scope of the services. | 42-46 |
| III.2 | Waivers and disclaimers | IAs should not include waivers and disclaimers that are unreasonable or place undue reliance on them for protection. | 47 |
| III.3 | Management supervision | Senior management should be responsible for ensuring proper standards of conduct and compliance with all applicable rules and regulations, such as the SFO, the Code of Conduct and the Internal Control Guidelines. | 48-50 |
| III.4 | Selling of unauthorized products | It is an offence to sell unauthorized financial products to the public. | 51-53 |

## I. INTEGRITY AND PROFESSIONALISM

### I.1 Acting in the clients' best interests

12. The best way to build clients' trust and confidence lies in the integrity and professionalism of IAs. The overarching principle governing an SFC licensed person's conduct is that he/it treats clients honestly and fairly, ensures suitability of products recommended, helps clients make informed decisions by making appropriate disclosures and above all, acts in their best interests.

13. Clients entrust the planning, preservation and growth of wealth (sometimes their lifetime savings) to IAs and rely on the IAs' integrity and professional investment advice to meet their own financial goals. One of the complaints levelled against IAs is that some IAs have exploited their clients' trust. An IA commits serious misconduct if it fails to advise clients when it should have been aware of fundamental problems in the products that it sells.

### I.2 Avoiding conflicts of interest

14. The current way in which IAs are remunerated in Hong Kong presents potential conflicts of interest. Our inspection confirmed that there are three ways in which IAs are normally paid for their services.

(a) For commission-based services (most common way), IAs receive commission from the product providers for each investment product sold/invested in by clients.

The commission rebate is usually derived from the investment amounts that clients pay to product providers. If clients keep their investments, IAs may receive further payment (known as trail commission) from product providers. In addition to such 'hard' commission, we were advised that some IAs or their sales staff receive soft dollar benefits (e.g. free air flight ticket and meal coupons) from product providers.

(b) For portfolio-based services, IAs charge management fees based on the total value of investments under management.

(c) Under the category of fees for service, clients are required to pay IAs whether or not they accept the advice or recommendations.

15. While some IAs disclose to clients that they receive commission rebates from product providers, the current market practice is that IAs usually do not disclose to clients the quantum of their remuneration or soft dollar benefits which they receive from product providers.

16. During the inspection, we noted that a number of IA firms and/or their staff tended to sell more financial products that reward IAs with higher commission rebates. While this should not of itself lead to the conclusion that these firms or their staff have put their interests ahead of their clients, it does however raise conflicts of interest issues, potential or otherwise, as can be seen in paragraph 39.

17. Regarding soft dollar benefits, the Code of Conduct does not presently require IA firms and/or their staff (who do not exercise investment discretions on their clients' behalf) to seek written consent from their clients when receiving soft dollar benefits or to disclose such receipt on a regular basis.

18. The SFC intends to further study the issues involved before consulting the IAs regarding the disclosure of commission rebates (including soft dollar rebates) received by IAs from product providers when selling financial products, for the following reasons:

(a) Such disclosure can address the conflicts of interest issue and enhance client confidence.

(b) Generally speaking, unless a client consents, an IA should not keep secret pecuniary benefits or otherwise (i.e. profits) from their clients from the selling of financial products to these clients.

(c) Hong Kong may be lagging behind international standards in this regard (such disclosure is mandatory in countries such as Australia and the UK).

## II. REASONABLE RECOMMENDATIONS

19. In order to ensure that investment recommendations and advice to clients are reasonably suitable, an IA should

    (a) know the client's financial situation, investment experience and investment objectives (II.1);

    (b) conduct adequate due diligence on the products and their providers to assess the risks (II.2);

    (c) make recommendations that are reasonably suitable given the client's specific circumstances (II.3);

    (d) 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 (II.4); and

    (e) employ competent staff and provide appropriate training (II.5).

20. We have investigated a number of cases in which clients have complained that the nature of and the risks associated with a financial product were not adequately explained to them. We have determined that some of these complaints are valid and reveal serious shortcomings in the performance of certain IAs. In particular, we have found that on occasions, the risks associated with products have been misrepresented, so that clients are led to believe they are investing in a lower risk product when, if properly described, the product is higher risk and therefore not suitable for conservative investors. As a point of reference, we have provided (in paragraph 39) three cases in which the basis of investment recommendation appears questionable given the clients' specific circumstances.

### II.1 "Know your clients"

21. There is a positive obligation on IAs under paragraph 5.1 of the Code of Conduct to seek sufficient information from a client about his financial situation, investment experience and investment objectives and risk tolerance.

22. Moreover, it is in the interests of both the IA and the client that a full and accurate record of the client's circumstances and objectives is kept by the IA in the event of a dispute at a later date. However, we note that some of the IAs inspected had not collected and recorded sufficient information on their clients to meet the standards set out in the Code of Conduct or the Internal Control Guidelines. Some IAs claimed that they did not provide any investment advice to "execution-only" clients, i.e. these clients only wanted their IAs to execute orders without requiring any professional advice from them.

23. The Barber Asia case shows that disputes may arise between an IA and a client as to whether an IA has merely assisted a client in investing in a product chosen by the client or has provided advice which is relied upon by the client in deciding what product to buy. Therefore, the facts and circumstances in

each specific case should be taken into account in determining whether investment advice was actually provided by IAs and/or relied upon by their clients.

24. We wish to remind IAs that "Know your client" obligations and anti-money laundering obligations apply to all types of clients though these obligations could be reduced when dealing with "execution-only" clients.

## II.2 Product due diligence

25. General Principle 2 of the Code of the Conduct states that "in conducting its business activities, a licensed or registered person should act with due skill, care and diligence, in the best interests of its clients and the integrity of the market".

26. In the present context, this principle requires IAs to conduct adequate due diligence on products before recommending them to clients. Due diligence involves an IA developing a thorough understanding of the structure of a product, how it works, the nature and level of risk it bears and the experience and reputation of the product provider. Factors to be taken into account include size of funds, licensing/authorization status, service level of product providers, track record of fund managers and other service providers, past performance, and volatility, etc. If an IA recommends a product which even he himself does not understand, the IA cannot be acting with due skill and care towards his clients.

27. Product due diligence is of particular importance when the product concerned is a financial product which is not authorised by the SFC. An IA is advised to document its criteria for screening unauthorized products before including them in its approved product lists and the actual work done in this connection. Expectations about the work done in performing product due diligence, both at the time of making the initial recommendation and subsequently on an ongoing basis, are substantially higher where the IA concerned is closely associated with the unauthorized product itself, such as being involved in the design and development of the product.

28. Despite the requirements of General Principle 2 of the Code of Conduct, a good number of those inspected and the majority of those who were the subject of investigations either did not conduct much product due diligence on unauthorized funds or did not document the work done or both. In one investigation case, no due diligence was carried out and in another, clearly insufficient work was done on the nature of the product, the product provider and the risks the product bore. In both cases, investors suffered significant losses.

29. Product providers for unauthorized products are largely free to describe their products in any way they deem appropriate in the offering documents. The rationale that underpins this regime is that these products are not offered to retail investors, who may not have the wherewithal to understand or tolerate the risks involved. While investment risks were mentioned in some of the offering documents of unauthorized products that we reviewed, these risks were presented in a way that was difficult to read and understand (both in

terms of language and layout), particularly for lay investors. Where IAs seek to recommend such unauthorized products to clients, they should ensure that they do not offer these products to the public and that clients understand the risks of investing in these products. As to the issue regarding improper sales of unauthorized funds, this is dealt with separately in paragraphs 51 to 53 of this report.

## II.3 Proper basis of recommendations

30. Under paragraph 5.2 of the Code of Conduct, IAs should make investment recommendations and advice to clients that are reasonably suitable given a client's specific circumstances. In addition, paragraph VII(3) of the Internal Control Guidelines state that IAs should document the reasons for the recommendations and advice given to clients.

31. After the IA has assessed the client's current financial situation, the IA would start developing a written financial plan based on the client's lifestyle aims and objectives. Generally, the IA develops this plan based on the information provided by the client such as the client's risk preference, expected rates of return, investment horizon and other factors. However, in some cases encountered during our inspection, the details of how such factors had led to the particular strategies being chosen were found to be lacking. In other words, it was difficult to understand (and justify) how the recommended strategies or investments would achieve the client's investment objectives or in what way they could be considered suitable based on the information given by the client.

32. We have found that some IAs appeared to only recommend "in-house" products or only one product. One IA even went as far as to advise its clients to sell or liquidate all of their existing investments and use the proceeds to invest in these products. There was no explanation or basis to indicate why the "in-house" products should be considered to be more suitable to clients. Furthermore, it was not evident that the IA had considered the inevitable transaction costs for restructuring clients' existing investment portfolios.

33. In summary, any recommendation to clients must be suitable, taking into account information and recommendations (including assumptions and parameters), which should be recorded in writing and kept on the IAs' client files.

## II.4 Helping clients make informed decisions

34. IAs are obliged to help clients make informed decisions by giving clients a proper explanation of the basis of the investment recommendation, the nature of the product recommended and the nature and extent of the risks it bears. In our view, it is not enough for an IA to hand over documents saying "read these, they explain the product and its risk". Instead of just focussing on the good points of a financial product, the IA should always present a balanced view, drawing clients' attention also to the disadvantages and risks as well. Our investigations have shown that in some cases, documents given to clients do not adequately explain the risks inherent in products. The onus is on the IA

to ensure that it provides a full explanation to clients. It is also not enough for the IA to rely on brochures and offering documents as being self-explanatory. Frequently, they are not, and clients have every right to expect IAs to explain the contents to them.

35. The level of risk could vary from high to low depending on characteristics and features of specific products. In some financial plans, there were, at best, vague summary explanations (and in some cases, none at all) of the specific risks associated with the unique features of particular products being recommended. Based on such limited disclosure of information by IAs, we are concerned whether clients are able to make informed decisions, particularly in relation to complex products.

## II.5 Competency

36. The IA business is essentially a skill and talent business. The sales staff of IAs must have an adequate level of knowledge and skill and be able to effectively apply that knowledge and skill towards providing quality advice and services to clients. Such skills come with education, perceptive ability, experience and knowledge of the latest trends and financial products. In view of rapid changes in business environment, IAs and their sales staff must have a continuing commitment to learn, improve and keep abreast of the latest developments in the industry.

37. As competency is a prerequisite for IAs to effectively discharge their duty to investors, it is important that all IAs employ competent staff and provide appropriate training. Owing to the small size of some IAs' operations, they do not provide focused and structured training programs for their staff. They normally arrange for product providers to deliver presentations to their staff and/or provide on-the-job training through sharing sessions and individual coaching.

38. All IAs should supplement product-specific training with more general training on market issues such as the latest market trends, relevant macro issues and presentation/communication skills. This broader spectrum of training is necessary so that IAs can give advice in good context. In this respect, the SFC is committed to work with the industry to provide higher standards of training for the industry.

## II.6 Examples of cases where there is apparently no proper basis for the recommendation made

39. We have identified a few cases in which the basis of the advice appears questionable given the clients' specific circumstances:

**Example 1: An unsophisticated investor was sold a complicated investment product**

An unconventional unauthorized fund was sold to an investor with very limited investment experience. The amount of investment accounted for nearly one-half of the investor's total net worth and there was no apparent

reason why this unconventional fund was considered appropriate for this investor. While the client had signed a pro-forma statement declaring that it was he who had requested to invest in the product and that he fully understood the offering document, there might be ground for skepticism bearing in mind that:

(a) the offering document was a highly complex technical document; and

(b) by concluding the transaction, the sales staff earned a commission rebate that was double the amount that he would otherwise have earned from recommending other products to the client.

**Example 2: An unsophisticated investor was advised to gear up his investment**

An investor in the lower income bracket and only a few years away from retirement age was advised to invest more than 50% of his total net worth in a particular fund and pay the balance of his investment by bank borrowings (at almost 3 times gearing). The bank obtained security on the investment to secure repayment of the bank's debt. The obvious concern was that the investor might not have sufficient resources to meet the necessary financial obligations. Given that this particular fund happened to offer high commission rebate to the sales staff, there was again this issue of perceived conflict of interest.

In the past, some investors who had highly geared investment portfolios were required by their banks to repay their loans, in whole or in part, when their investments declined in value. When they could not meet the banks' demand for payment, these investors were obliged to liquidate their investments and suffered substantial losses in the circumstances.

**Example 3: Elderly investor was advised to invest in product with long lock-in period**

An elderly investor was sold an investment product with a long lock-in period. Whilst there was no problem with the product itself, it was questionable why the long lock-in period was considered suitable for an investor who was 90 years old.

40. Unsuitable recommendations can result in substantial financial loss for clients. Negligence claims can also arise from inadequate risk disclosure and/or failure to conduct product due diligence. These claims can easily involve amounts that an IA can ill afford to pay given that under the current Securities and Futures (Financial Resources) Rules, an IA is typically only required to maintain a small amount of regulatory capital (i.e. liquid capital of not less than HK$100,000). This level of regulatory capital has been set with a view to ensure that IAs have the minimum financial resources to operate their business as a going concern and not with a view to provide a financial buffer to compensate clients for potential losses incurred as a result of unreasonable recommendations. As demonstrated by the cases of Towry Law and Barber

Asia, IAs could be asked to pay very substantial claims that they might not be able to honor.

41. There is thus merit in IAs buying professional indemnity insurance. In other countries such as Australia, IAs are required to take out professional indemnity insurance. The SFC will further examine this issue, and consult the market on what would be appropriate measures to take.

## III. COMPLIANCE MATTERS

### III.1 Client agreements

42. As mentioned above, we are concerned with the way some IAs have been treating their so-called "execution-only" clients, especially where there are no client agreements or any other types of record to confirm that client transactions have indeed been carried out on such a basis.

43. In other cases, clients have provided written statements confirming that they themselves made the investment decisions and only asked IAs to execute transactions on their behalf. By signing such statements, clients who have received and relied on advice from IAs may be agreeing to waive their rights and protection. The SFC will step up investor education to raise the awareness of investors in this regard.

44. Under paragraph 6.1 of the Code of Conduct, an IA is required to establish and define its relationship with clients by way of a client agreement before providing services to clients. Under paragraph 6.4 of the Code of Conduct, a client agreement should properly reflect the services to be provided. The inspection highlighted some unacceptable situations in which there were no client agreements for certain categories of clients (an example would be the "execution-only" clients). Even where there were client agreements, they did not clearly explain or document the services to be provided to clients, nor did they clearly define the responsibilities and obligations of the respective parties. There were generally insufficient details as to whether the services provided to the client were confined to a one-off trade execution (e.g. the acquisition of a financial product), or whether the IA would be providing continuous advice (i.e. it performs ongoing review and monitoring after the initial sale). We intend to seek the industry's view on the best way to communicate this differentiation to investors.

45. With respect to clients to whom an IA has been continuously providing advice:

(a) for those who have signed client agreements, the IA should review the client agreements and ensure that the scope of services it provides and the instructions given by clients are properly recorded;

(b) for those who have not signed client agreements, the IA should enter into written agreements with clients in order to confirm and clarify any business arrangements between them.

46. In relation to "execution-only" clients, clear explanation of the limited scope of the services provided by the IA and of its obligations to clients could serve to minimise any subsequent misunderstanding and disputes with clients. The Barber Asia case offers an example as to how such an issue may arise.

### III.2 Waivers and disclaimers

47. Some client agreements and related supplementary statements contained extensive disclaimer clauses seeking to limit or waive certain liabilities of IAs. We note with concern that some of these disclaimers seem to have been included to prevent clients from pursuing their rights against IAs. According to the Control of Exemption Clauses Ordinance (Cap. 71), liability for negligence or for any breach of contract cannot be excluded or restricted in standard terms and conditions unless the relevant clause satisfies the requirement of reasonableness. Hence, the use of waivers and disclaimers of liability may not be lawful depending on the circumstances of each case and IAs should not unduly rely on these waivers and disclaimers to shield them from possible claims for damages.

### III.3 Management supervision

48. Only in a minority of those firms inspected did we find IAs:

(a) with computer-assisted systems in place that helped senior management track, monitor and control the selling activities of their sales staff; or

(b) with procedures to review specific suitability issues, such as expiry of investments beyond normal retirement age and payment of premium amounts which exceed a certain percentage of a client's monthly income.

49. IAs should implement appropriate systems, controls and procedures to ensure that they are in the position to serve their clients efficiently and fairly. In this regard, IAs, especially the larger-sized firms, may wish to consider using technology to assist their senior management in managing and controlling their selling activities.

50. Senior management are reminded that they bear primary responsibility under General Principle 9 of the Code of Conduct for maintaining appropriate standards of conduct and adherence to proper procedures. In considering any disciplinary action against IAs, the SFC will pay particular attention to the roles played by individuals holding supervisory and managerial posts.

### III.4 Selling of unauthorized funds

51. Under section 103 of the SFO, it is an offence (subject to specified carve-outs) to issue to the public advertisements, invitations or documents relating to collective investments unless they have been authorized by the SFC. For example, only SFC authorized funds can be offered to the public, unless an exemption applies. The above notwithstanding, we have noted in both our

inspection and investigations that some IAs had sold unauthorized funds to their newly signed up clients. In most of these cases, the IAs concerned had required their clients to confirm in writing that (a) they had requested to invest in the relevant unauthorized funds; or (b) they should be treated as professional investors for the purposes of investing in unauthorized funds. Yet, in the latter case, based on information in the IAs' records, it was not apparent that these clients satisfied the asset test and the knowledge and experience requirements under the relevant law and the Code of Conduct to qualify as professional investors.

52. Given that some of these unauthorized funds have been sold to investors on a large scale, the SFC is skeptical whether IAs that obtain clients' written confirmation stating their intention to invest in unauthorized funds would alter the fact that the IAs are, in reality, selling unauthorized funds to the public and hence would contravene section 103 of the SFO.

53. The SFC is investigating these incidents. Should any breaches be substantiated, the SFC will not hesitate to take enforcement action against the IAs concerned. IAs are urged to review their marketing practice of selling unauthorized funds and take appropriate remedial measures as soon as possible.

## PART C - Way Forward

54. Our theme inspection and investigations have identified specific issues that need to be addressed by IAs. The SFC aims to do its part in assisting the promotion of good practices in the industry by implementing the following measures:

*Specific guidelines and reminder*

(a) This report serves to remind IAs to adhere closely to the requirements in the SFO, the Code of Conduct and the Internal Control Guidelines and provides specific guidance in explaining practical application of high-level requirements. IAs following this guidance should be in a better position to provide Hong Kong investors with access to quality, affordable financial products, based on good advice and appropriate disclosure. They should have regard to the SFC's recommended Sales Practice Checklist in **Appendix 3**.

*Engaging IAs to find solutions*

(b) The SFC will study the issues identified in this report as require further consideration. Thereafter, it is the SFC's intention to engage IAs on possible measures to enhance investor protection and transparency in industry practice, such as:

(i) disclosure to potential clients on how IAs earn their remuneration and disclosure of the quantum of commission/

rebates (as well as soft dollar benefits) received from the product providers ;

(ii) requiring IAs to take up professional indemnity insurance; and

(iii) informing the client of the exact nature of services to be provided to the client.

*Follow-up theme inspection*

(c) We will carry out another IA theme inspection in 2006 to assess whether the levels of compliance with the SFO, the Code of Conduct, the Internal Control Guidelines and the guidance provided herein have improved.

*Disciplinary action*

(d) We will take action against IAs that are involved in serious breaches of the relevant law such as selling unauthorized financial products to the public. A number of cases already under investigation are likely to be publicized in due course. The SFC will draw the industry's attention to any specific failings that are established.

*Investor education*

(e) The SFC will continue with its efforts to help investors know their rights, responsibilities and risks when seeking advice from IAs.

**Appendix 1**

**Two recent enforcement actions against licensed investment advisers ("IAs")**

**(i) Barber Asia Limited v. Susan Field**

1. The Barber Asia case is significant because it is the first time in Hong Kong that an investor has successfully sued an IA for negligent investment advice. In **Appendix 2**, we summarize the facts of this case and the lessons to be learned from it. Barber Asia was found liable to Ms. Field for damages of approximately £220,000 together with interest and costs. The principal of Barber Asia, Mr. Andrew Barber, is currently the subject of SFC disciplinary proceedings which have reached the Securities and Futures Appeal Tribunal ("SFAT").

**(ii) Towry Law (Asia) HK Limited**

2. The SFC instituted disciplinary proceedings against Towry Law in August 2004. The SFC alleged, inter alia, that Towry Law:

   (a) conducted insufficient due diligence into two hedge funds before recommending them to clients. These funds were subsequently liquidated;

   (b) sold the two funds to clients whose investment objectives and risk tolerance did not match with the risk profiles of the two funds;

   (c) failed to conduct proper enquiries into circumstances surrounding the two funds which indicated problems with the funds; and

   (d) failed to advise clients when it became clear that the funds had problems.

3. Without admission of liability, Towry Law agreed to make ex-gratia payments of approximately US$37.7 million to 1,216 affected clients. As a result, the SFC decided that it was in the public interest to settle its disciplinary proceedings by severely reprimanding Towry Law.

**Appendix 2**

**Lessons to be learnt from the "Susan Field v Barber Asia Limited" case**

1. The following is a synopsis of the court case of *Susan Field v Barber Asia Limited*. Some lessons could be learnt from this mis-selling case.

2. Ms Susan Field was an inexperienced investor and first met Mr Andrew Barber, the responsible officer of Barber Asia Limited, in June 1997. Ms Field did not enter into an investment advisory agreement with Barber Asia, nor pay any fees to him. From the outset Ms Field made it clear to Mr Barber that she wanted to invest her savings, which represented many years of hard work, in a conservative way and did not want to lose any of her savings. Based on Mr Barber's advice, she initially invested substantially the whole of her savings of approximately US$300,000 into an investment-linked assurance scheme in March 1998. She trusted and relied implicitly on the advice that she was given, without questioning. That said, she did not enter into an investment advisory agreement with Barber Asia, nor pay any fees to Mr Barber.

3. Several months later, Mr Barber advised Ms Field to enter into a scheme that involved gearing – using Ms Field's initial investment as collateral for a loan to finance acquisition of a further investment, which would also be pledged as security for the loan. Whilst the investments securing the loan were in Sterling, the loan itself was in Japanese Yen, a low-interest rate currency. An important aspect of the strategy was the expectation that the Sterling investments would produce a return higher than the rate of interest payable on the loan in Yen. It was envisaged that this, coupled with gearing at a ratio of 2.5 times, would significantly enhance the return of Ms Field's initial investment. Having heard the explanation, in the light of which Ms Field did not envisage that there were any significant risks involved in the scheme, she agreed to go ahead with it.

4. Unfortunately, as a result of the sharp appreciation of the Yen against Sterling in the following year, Ms Field was faced with demands to put up additional security on two occasions. On the second occasion in late 1999, she did not provide further collateral and therefore the lender switched the loan into Sterling, realising the exchange loss. Shortly afterwards, Ms Field closed out her entire position. All collateral investments were pre-encashed, attracting penalties, and the loan was repaid out of the proceeds. She ended up incurring a substantial loss in the whole investment arrangement, leaving behind only some £44,000.

5. In June 2003, the Court of First Instance ruled that Barber Asia owed Ms Field a duty of care in tort based on a voluntary assumption of responsibility by Barber Asia. Mr Barber had advised Ms Field to enter into an investment scheme which was unsuitable for her and inconsistent with her stated desire for a conservative investment strategy. The combination of gearing, currency mismatch, interest risk and the pre-encashment penalties of the collateral investments meant that the scheme was an investment with a high level of risk which should not have been recommended to Ms Field. Furthermore, Ms Field had not been provided with the scheme brochure which outlined the

features of the scheme and the concept of gearing which contained clear references to risks. Thus, despite that she acknowledged the existence of risks in signing the application form for the scheme, it was unlikely that a detailed explanation of the various risks involved was provided at the time of sale. The judge concluded that Barber Asia fell short of the standard of care to be expected of them in a number of significant respects, and awarded Ms Field damages of £219,890.25 together with interest. The Court of Appeal dismissed later in July 2004 an appeal by Barber Asia.

6. This case is significant in that it would set a precedent for investment advisers and remind them that they have a duty to properly assess the suitability of products for their clients and that they may not be able to avoid responsibilities even if their clients have acknowledged the existence of risks.

7. For investors, some lessons could also be learnt from this case:

   (a) Investors should not over rely on an investment adviser. They also have to take charge of their own interests and consider carefully whether an investment is suitable for them, taking into account their own circumstances.

   (b) It is important to ask questions about an investment proposal before accepting it (e.g. What are the downside risks? What is the potential maximum loss? How does the advice suit my circumstances? What are the fees and charges?). Investors should also read the offering documents of the recommended products.

   (c) Investors need to understand the recommended products, in particular the risks involved. If there is anything investors do not understand about a product, they should ask their investment adviser. It is dangerous to put money into something they do not understand.

   (d) Gearing up to invest in a product is particularly risky, even if the product itself is conservative in nature. Investors have to pay interest on the loan in any event and may even have to face margin calls in adverse situations. If the investments securing the loan and the loan itself are in different currencies, investors are also subject to the risk of currency mismatch.

   (e) Read any agreement, application form or disclaimer carefully before signing it. Investors should understand why they are required to sign any disclaimers, and what responsibilities their investment adviser or the product provider is disclaiming. If there is anything they do not understand, do not sign it.

   (f) Depending on the actual circumstances, an investor who has suffered financial losses due to mis-selling may still have the right to seek recourse through the civil courts, even if the investor has signed risk disclaimers. However, suing a person or company would be complex and costly. Thus, for their best interests, it is still better for investors to read carefully risk disclaimers before signing them.

**Appendix 3**

## Recommended Sales Practice Checklist for Licensed Investment Advisers ("IAs")

1. Before recommending an investment product to a client, an IA should develop a thorough understanding of the product, and in particular the nature and level of its risks. Where the IA plans to promote an investment product not authorized by the SFC, the IA should record in its files thorough due diligence work in connection with the product, and ensure that all material aspects of the product are understood.

2. A comprehensive written agreement should be entered into between an IA and its client before the IA provides services to the client.

3. An IA should at the outset collect a full client profile that should be kept on file and periodically updated if the client maintains a continuing relationship with the IA.

4. An IA should ensure that a financial plan or recommendation is provided to every client in writing and a copy is kept on file. The plan or recommendation should include the following:

   (a) a summary of the key features of the recommended product including a statement whether the recommended product is SFC authorized or not;

   (b) a clear explanation of the consequences of early encashment of the recommended product;

   (c) a clear explanation of the risks of the recommended product and how these are consistent with the client's risk profile and objectives;

   (d) why the product has been recommended and what the IA knows about it; and

   (e) alternative investments that the IA had considered and the reasons why alternative investments are not suitable.

5. An IA should monitor and supervise its sales staff to ensure that advice given to clients is suitable. Senior management or designated compliance staff should design appropriate systems and procedures to review and where possible, require a countersignature on all financial plans or recommendations given to clients.

6. Where there is an ongoing relationship between an IA and its client, the IA should ensure regular monitoring of that client's investments and updating of the client's profile and details. Where appropriate, any changes relating to that client's investments should be communicated immediately to the client and a copy should be kept on file.