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

Mystery Shopping Programme Findings

December 2014

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Executive Summary

1. The Securities and Futures Commission (SFC) introduced the mystery shopping programme in 2010. The exercise is an important tool for assessing compliance with selling practices requirements by licensed corporations for unlisted securities and futures investment products (Investment Products).

2. The SFC engaged the Hong Kong Productivity Council to carry out a second mystery shopping exercise between April and September 2014. About 150 samples were conducted by "shoppers" on 10 selected licensed corporations, which included two fund management firms, three investment advisory firms and five brokerage firms. The exercise covered three key areas, namely know your client (KYC), explanation of product features and disclosure of risks, and suitability assessment, including the enhanced requirements under the Code of Conduct[1] which became effective subsequent to the first mystery shopping exercise.

3. The exercise highlighted areas in the selling process that warrant further improvement by the industry, particularly concerning the sale of high-yield bonds and derivative products. Deficiencies in relation to the suitability assessment, such as lack of proper explanations of suitability when products are recommended, which were also identified in the last mystery shopping exercise, were also noted in this exercise.

4. The exercise also revealed deficiencies in the KYC process and information disclosure. These deficiencies included encouraging shoppers to change risk tolerance levels in risk assessment questionnaires and failing to disclose product features and major risk factors of recommended products. It was noted also that certain sales staff who are both SFC-licensed representatives and registered insurance agents tended to promote Investment-Linked Assurance Schemes (ILAS) to the shoppers ahead of other products.

Key Findings

Selling of high-yield bonds

5. In respect of the selling of high-yield bonds, the SFC has published circulars[2] in recent years reminding licensed corporations to properly explain key features and relevant risks, and provide relevant and material information to clients. Licensed corporations are also required to implement a proper suitability assessment process to ensure that high-yield bonds being solicited or recommended are reasonably suitable to the clients in all circumstances.

[1] Code of Conduct for Persons Licensed by or Registered with the SFC.

[2] Circular to Licensed Corporations and Registered Institutions - Selling of Fixed Income Products and Circular to Licensed Corporations - Selling of complex bonds and high-yield bonds issued on 19 November 2012 and 25 March 2014 respectively.

6. The findings of the exercise demonstrated that, particularly in the case of brokerage firms, it was not uncommon that high-yield corporate bonds, which are generally below investment grade or unrated, were recommended to the shoppers.

7. In particular, deficiencies were noted in the quality of explanation of product features and disclosure of risks. For example, some sales representatives did not explain that the recommended bonds are high-yield in nature and subject to higher risks, such as greater credit risk and higher vulnerability to economic cycles, than typical corporate bonds.

8. It was also noted in some instances that the sales representatives did not disclose relevant and material information, such as the credit rating and yield, to explain the nature of the investment and the risks involved.

9. In some instances, sales representatives even provided inaccurate information to the shoppers. For example, a sales representative advised that investing in bonds is a low risk investment, even though the recommended high-yield bond was exposed to higher credit risk. In another instance, the sales representative advised that default risk was the only risk associated with the recommended bonds.

Selling of derivative products

10. Licensed corporations are required to conduct proper KYC procedures on their clients. Enhanced measures under the Code of Conduct require that licensed corporations should, as part of the KYC procedures, assess clients' knowledge of derivatives and characterize them based on their knowledge of derivatives[3].

11. It was noted that the sales representatives of over half of the firms included in the exercise recommended SFC-authorized funds (Authorized Funds) that may use financial derivative instruments for investment purposes or leverage[4]. However, some of the sales representatives did not conduct an assessment of the shoppers' knowledge of derivatives.

12. In addition, sales representatives generally failed to explain to shoppers the use of derivative instruments in recommended products and the risks associated with investing in such products. And only a few of the sales representatives provided Product Key Facts Statements (Product KFS)[5] to the shoppers.

[3] Paragraph 5.1A of the Code of Conduct.

[4] The SFC issued a circular in April 2012 to provide intermediaries with guidance in determining whether an SFC-authorized fund is a derivative product for the purpose of the Code of Conduct.

[5] Product KFS are required under the SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products for SFC-authorized products.2

Suitability assessment

13. Sales representatives should provide reasonably suitable recommendations by, amongst other things, matching the risk return profile of each investment product with each client's circumstances. They are required to use their professional judgement to assess diligently whether the characteristics and risk exposures of each recommended investment product are suitable for and are in the best interests of a client, taking into account the personal circumstances of the client.[6]

14. In some instances, the sales representatives explained that the investment recommendation was suitable for the shopper merely on the basis that a product's risk rating matched with the shopper's risk tolerance level. However, consideration of all relevant circumstances of shoppers by the sales representatives in making the suitability assessment[7] was not demonstrated.

15. Some sales representatives did not provide shoppers with a proper explanation or the underlying rationale as to why a recommended product was reasonably suitable for them. These deficiencies were also identified in the last mystery shopping exercise.

Other Findings

Know your client

16. Licensed corporations are required to take all reasonable steps to establish the true and full identity of each of their clients, and of each client's financial situation, investment experience and investment objectives[8]. In order to better understand their clients, licensed corporations are also required to collect from each client information about their investment knowledge, investment horizon, risk tolerance, etc[9].

17. Although the exercise found that some sales representatives used standardized questionnaires to collect relevant information about the shoppers, most sales representatives would generally ask about and collect shoppers' information by way of a conversation. Client information collected should be fully documented.

18. In some cases, sales representatives hinted or guided the shoppers to answer assessment questionnaires in such a way that a wider range of products could be recommended to them. This behaviour clearly undermines the protections afforded to clients under the suitability regime.

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[6] Question 4 of the Questions and Answers on Suitability Obligations (Suitability FAQ) issued by the SFC on 8 May 2007.
[7] Paragraph 5.2 of the Code of Conduct.
[8] Paragraph 5.1 of the Code of Conduct.
[9] Question 2 of the Suitability FAQ.

Information disclosure

19. In order to help clients make informed investment decisions, licensed corporations should properly disclose and explain to clients the key features and risks of the recommended products, as well as the relevant sales related information[10] as required under the Code of Conduct.

20. In addition to deficiencies in relation to selling of high-yield bonds and derivative products, risk disclosure for other recommended products also fell short. For instance, some sales representatives mainly emphasised advantages of the recommended products but failed to present a balanced view, including drawing the shopper's attention to disadvantages or downside risks. As for Authorized Funds and corporate bonds, some sales representatives tended to describe the product features in fund factsheets or marketing materials with little explanation about the relevant risk factors, and did not provide the shoppers with the Product KFS.

21. Licensed corporations are required to provide transaction related information under paragraph 8.3A of the Code of Conduct to clients prior to or at the point of entering into the transaction. In most cases, the relevant information was not complete. For example, some sales representatives did not disclose the capacity (principal or agent) in which they were acting.

22. Also, a few deficiencies were noted with respect to the provision of market information by sales representatives. For example, a sales representative stated that the performance fee of a recommended fund would guarantee an increase in the fund's return. A few sales representatives provided inaccurate representations about the SFC's requirements or practices. These issues were also identified in the previous mystery shopping exercise. For example, a sales representative wrongly represented that the SFC had published a benchmark of returns on investment products.

Selling of ILAS

23. While ILAS are not Investment Products[11] under the Securities and Futures Ordinance, it was noted that sales staff who are both SFC-licensed representatives and registered insurance agents were inclined to recommend such insurance contracts ahead of other products. In some instances, sales representatives did not properly disclose the capacity in which they were acting (i.e. whether as an insurance agent or a licenced representative), leading the shoppers to believe that ILAS and Investment Products are subject to the same regulatory regime.

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[10] Paragraph 8.3A of the Code of Conduct.

[11] Circular Clarifying the Licensing Requirements arising out of the Promotion, Offering or Sale of Investment-Linked Assurance Schemes to the Public was issued by the SFC on 13 August 2009.

24. In some instances, the sales representatives recommended shoppers to invest in ILAS and referred to ILAS as “fund platforms” during the selling process. It appeared that the sales representatives failed to explain the genuine nature of the recommended products, despite the fact that the shoppers were subsequently provided with marketing materials. One sales representative even explained to the shopper that ILAS were Investment Products or savings products which were sold in the form of insurance policies without any insurance element merely for taxation purposes.

Good Practices

25. During the exercise, some better selling practices by the sales representatives were noted. In some instances, sales representatives took extra care in advising elderly and unsophisticated shoppers. Other sales representatives reminded the shoppers that the historical performance of Investment Products may not be an accurate indicator of their future performance.

Way Forward

26. The SFC continues its effort to assist the industry to comply with the selling practices requirements set out in the Code of Conduct and Internal Control Guidelines[12] through circulars and frequently asked questions. The mystery shopping programme is an important tool to assess compliance. The exercise has demonstrated that certain deficiencies, particularly in relation to suitability assessments, KYC and disclosure of information a continuing concern. Accordingly, licensed corporations must improve to ensure full compliance. Our findings will be taken into account when formulating our supervisory plans and related measures, and areas where deficiencies have been identified will be subject to greater scrutiny during future inspections.

27. Licensed corporations should, in particular, enhance their systems and controls and management should exercise appropriate oversight over selling practices employed by sales representatives. Where there has been potential non-compliance, the SFC will follow up with individual firms.

28. The SFC will also meet with senior management of the licensed corporations concerned to discuss the findings, as well as any remedial measures necessary to ensure that deficiencies in selling practices are properly addressed.

[12] Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the SFC.