Luncheon Speech delivered to the Institute of Financial Planners of Hong Kong

8 May 2007

Towards Best Practice

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I am delighted to be here today. The fact that I have been invited to speak to IFPHK members again (the last occasion being in 2005) shows that either (i) I am quite adept at talking about regulatory issues without putting all of you to sleep, especially after a good lunch or (ii) that financial planning and wealth management are hot topics and everyone is interested in hearing a regulator's take on it.

I hope the answer is a comfortable balance of both!

Today, I would like to broach the subject of "Towards Best Practice".

Wealth in Asia

We can all see great opportunity as Asia's growth spirals ever upwards, led by the economic powerhouse of Mainland China, closely followed by India and a re-energised Japan. This growth has led to burgeoning prosperity and almost unprecedented wealth creation with a rapidly expanding middle class and more entrepreneurs, professionals and investors joining the ranks of millionaires. In fact, the Merrill Lynch / Capgemini Asia Pacific Wealth Report announced that in 2006, Asia-Pacific High Net Worth Individuals wealth totaled US$7.6 trillion, with China and Japan accounting for more than 65% of this amount.

Hong Kong has ridden the wave of this growth and maintains its enviable position as a leading financial planning and asset management hub in Asia. However, we cannot rest on our laurels. As you all know, wealth management is highly demanding and knowledge-intensive. Investment advisers need to develop deep knowledge and keep abreast of the range of investment options as innovations in investment markets develop.

With an aging population, increasing cost of education and growing public awareness of the importance of financial and retirement planning, there is strong potential for the financial planning and investment advisory industry to grow and prosper.

I am now going to share with you some insights into the "health" of the industry from two SFC initiatives:

- The investor survey which was conducted between 2005 and 2006; and
- The ongoing inspection program on investment advisers.

Investor survey

The survey sampled 100 investors and these investors used the investment advisory services of banks (64%), SFC-licensed investment advisers (25%) and insurance companies (11%).

Overall, the respondents of the survey were generally satisfied with the services provided by the investment advisers concerned. But they provided feedback in a number of areas which include the following:

- Nearly 60% of the respondents hope to see more suitable product recommendations.

- About 65% of the respondents supported the idea of requiring investment advisers to provide written financial plans.

- About 45% the respondents found that the client agreements were not clear about the investment advisers' rights and obligations.

Investment advisers should reflect upon these findings and if necessary, take appropriate steps to meet investors' expectations.

Recent inspection findings

Secondly, the SFC has been conducting inspections on some investment advisers operating in Hong Kong. I would like to share with you some recent inspection findings which include:

- Insufficient knowledge of clients;
- No proper due diligence on the investment products sold;
- Lack of justification to illustrate suitability of advice;
- Ineffective management supervision; and
- Poor documentation.

The above findings indicate that the existing code of conduct requirements are not always being complied with. This is worrisome as it appears that some investment advisers do not appear to be paying proper regard to the code of conduct requirements that are imposed on them in connection with the provision of investment advice to their clients.

I have to believe that the objectives of the industry are in sync with those of the code of conduct, i.e. to instil investors' confidence by providing them with proper advice and services.

So, what are the SFC's responses to these observations? For a start, we will definitely take rigorous regulatory action against those who committed serious breaches of the law, code and rules. Alongside our ongoing supervision program, we have adopted a two-pronged approach:

- To enhance investor education; and
- To provide guidance to the industry on best practice.

Investor education

The SFC has been doing a lot of work to educate investors through different channels to raise their financial literacy and investment knowledge. During the past year, we held more than 80 seminars and reached a record 10,000 or more members of the public. In 2006, our key message to investors is "Before you invest, ask the right questions" and in 2007, we have been telling them - "Know your risk".

Moving towards best practice

As regards moving towards best practice, I have three specific areas which I want to talk about:

- Good corporate governance;
- High quality services; and
- Sound business practices.

I will deal with each of them in turn.

I. Good corporate governance

First and foremost, it is essential for investment advisers to have good corporate governance. The board of directors and senior management should set a strong governance culture within their firms and ensure that there is adequate management supervision, risk management and internal controls.

At a minimum, you should do the following:

(a) Employ competent and qualified staff

Investment advisers who employ competent and qualified staff exhibit a level of professionalism and commitment to deliver high standards of service. Competent investment advisers who understand their clients' specific needs and personal circumstances and who are able to provide suitable products and investment advice earn their clients' trust and confidence. In addition, investment advisory firms that have built up a good reputation will more easily attract talented staff.

(b) Strong compliance culture

Secondly, good investment advisers have a strong compliance culture. Some market practitioners may see compliance as a cost that reduces the firm's bottom line with no apparent benefits. But weak compliance increases the chance of violating the law, whether deliberately or not. The negative publicity arising from regulatory action, reprimands, fines and other public sanctions inevitably damages a firm's reputation, which leads to loss of investor confidence and clients.

II. High quality services

In a matured competitive market, those who provide high quality services and products win the race for investors and their mandates. Good service boils down to meeting the needs of the clients and their specific circumstances.

To meet your client's needs, you must first:

(a) Know your clients

Good investment advisers always take the time to understand their clients, each with their unique financial situation, needs and concerns. Logic dictates that the investment adviser must craft its investment advice and investment product recommendations that cater to the specific circumstances of the client.

In order to really understand the client, investment advisers should fully understand the client's investment objective, investment horizon, risk tolerance, especially the tolerance to withstand the loss of capital. In cases in which the client makes regular contributions to the investment or gears up the investment, the investment adviser should assess whether the client has the capacity to fund the regular contributions or meet margin calls by giving cash or additional collateral.

From our inspections and the cases we come across, some investment advisers do not appear to know their clients well enough to do this. For example, a number of investment advisers did not request from their clients essential information such as their personal net worth, occupation, monthly income and investment experience. Without this basic information, we wonder how the investment advisers could assess whether the recommended products were suitable for the clients' specific circumstances.

In one case, the investment adviser required its client to tick the investment objective option boxes in the client profiling form. This was to help the adviser understand the client's personal circumstances before giving investment advice. The client, unbelievably, ticked *all* the pre-printed options ranging from "capital preservation" to "aggressive growth". The client even ticked the "others (please describe)" option, but did not provide further details. And what did the investment adviser do? The investment adviser accepted all the conflicting answers as they were given and failed to take any follow-up action to establish the client's intended investment objectives.

I would say that these advisers are doing a disservice to their clients and are not acting in their clients' best interests.

The SFC's regulations and rules are very clear and firm on this point and my supervision colleagues will be coming down hard on those advisers that are found lacking in this area.

(b) Know the investment products

Following on from knowing their clients, good investment advisers must also know the kinds of investment products that they are recommending to their clients. Advisers should perform ongoing product due diligence to ensure that the investment products they select are best suited for their clients. Amongst other things, investment advisers would do well to analyze the risk/rewards trade-offs of the investment before recommending it and also check on the custody arrangements of the investments to ensure that their clients' interests are safeguarded.

Some investment advisers which we inspected had written policies on how product due diligence and internal approval processes had to be carried out before products could be recommended to clients. However, most of these investment advisers were unable to show us any evidence to indicate that the established policies were actually implemented in practice.

In one case, the investment adviser provided our staff with a product's offering memorandum and the presentation slides about the product's features obtained from the product issuer. The disturbing thing was that the investment adviser did not appear to be aware of the material inconsistency in the product's risk profile as set out in the two set of documents, until we pointed it out to them. The product was described in the offering memorandum as a speculative investment, which is designed only for sophisticated and experienced investors who can bear the risk of loss of their entire investment. But the product was described in the presentation slides as a product which is suitable for conservative investors with low risk tolerance!

Without truly exploring and understanding the risk/return profiles of the recommended product, the investment advisers would not be able to discharge their suitability obligations to the clients.

Investment advisers should not rely just on the disclosures in the offering memoranda or other marketing materials as necessarily sufficient for them to understand the features of the products. They should make their own enquiries and obtain full explanations from the product issuers or other parties concerned regarding the risks inherent in the investment products themselves.

In addition, investment advisers should clearly document the verification work done to understand the products and the senior management's subsequent approval for promoting the products to their clients.

(c) Provide suitable advice

As I mentioned earlier, good investment advisers must first assess the suitability of the proposed investments based on the client's specific needs, risk tolerance, financial situation and other circumstances. Only then can they provide suitable investment advice to their clients.

We noted a case during our inspections in which a client disclosed in writing that he earned around HK$10,000 per month and had personal net worth of less than HK$100,000. The client was advised to invest a sum in excess of his personal net worth in a collective investment scheme. The senior management was said to have reviewed and approved this advice given by the investment representative. But we were not provided with any documentation which recorded the rationale why this advice was given and approved.

In other cases, we found that investors with limited or no investment knowledge or experience invested in complex investment products whose product issuers were domiciled overseas. Some of investment advisers involved were unable to demonstrate why such investments were considered suitable to the clients concerned. Instead, the investment advisers relied on disclaimer statements signed by the investors confirming that they invested in these products without any advice from the investment advisers.

Now, whether or not an investment adviser gives investment advice is a question of fact and it also depends on all the surrounding circumstances of each particular case. Where we have evidence that an investment adviser gave investment advice, but failed to ensure that the advice is suitable for the client, we will take appropriate action against the investment adviser.

Suitability involves matching the risk return profile of each recommended investment product with each client's specific personal circumstances. There are no acid tests or fixed formulae as to how the matching exercise should be conducted. The facts and circumstances of each case differ and it is a matter for the investment adviser to use his professional judgment to diligently assess whether the characteristics and risk exposures of each recommended product are actually suitable for the client concerned.

(d) Put clients' interests first

Fourthly, good investment advisers always put their clients' interests first. Investment advisers who recommend investment products that solely deliver high commission to themselves are again doing a disservice to their clients and may well be in breach of their professional and, indeed, regulatory obligations.

III. Sound business practices

If you have good internal practices, then it is possible to avoid or at the very least, quickly resolve disputes with clients.

(a) Agreed nature and scope of services

Investment advisers should first define their relationships with the client and agree with them on the exact nature and scope of services to be provided and then sign off on written engagement letters. They should also ensure that their clients understand the duties, obligations and responsibilities of both parties. Investment advisers who provide continuous services to their clients should update their client agreements on a continuous basis.

(b) Document the rationale of investment advice

It is very important for investment advisers to maintain records that properly document the clients' specific personal circumstances, the investment advice provided and the rationale behind that advice. Keeping proper records greatly helps resolve any disputes or claims regarding the services provided.

(c) Balanced disclosure of investment product features

Investment advisers should also make full and fair disclosure of all material features of the investment products which they recommend so that clients understand the nature of the investments and the risks involved. Failure to explain risks can potentially lead to cases of negligence and liability. Studies have shown that customers prefer documents that are short, plainly and clearly worded and focused on the pertinent information (including risk disclosure and warnings) that the customers need.

(d) Other measures

If a claim from a customer does arise, then an investment adviser should act upon it immediately by following up on the complaint and promptly responding to the customer. If legitimate losses to the client are involved then the adviser should also have recourse to appropriate insurance arrangements to mitigate these losses.

Further guidance to industry

To help the industry become more aware of the practical considerations and importance of complying with the code of conduct requirements, I am pleased to announce that today we have issued further guidance in the form of questions and answers concerning the suitability obligations of investment advisers.

The good news is that the contents of the guidance notes have been, more or less, reflected in my speech today, although I am compelled to say that listening to me is not a substitute to actually reading the contents for yourselves.

This guidance note will be published on the SFC website and circulated to all licensed corporations at the close of business today. If you have any questions after you have had a chance to go through the guidance note, please contact my colleagues at the SFC.

In conclusion, may I say that the financial planning and investment advisory industry in Hong Kong is poised to grow from strength to strength but we must always uphold the highest standards and possess unimpeachable integrity in order to fully reap this golden harvest.

Thank you.